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To: Members of the Executive Board

From: The Secretary

Subject: Publication of "Foreign Direct and Portfolio Equity
Investment in Developing Countries"

There is attached a revision of the above mentioned paper that takes account of comments made in the Board discussion at Meeting 84/111 on July 18, 1984. As indicated in Supplement 2 of SM/84/145 (11/21/84), the revised text is being circulated in order to permit review prior to publication in the Occasional Papers series. Although further editorial changes can be expected to be made before publication, they would be minor and none would involve any changes of substance.

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INTERNATIONAL MONETARY FUND

Foreign Direct and Portfolio Equity Investment
in Developing Countries

by David Goldsbrough

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PREFATORY NOTE

Conceptual and Statistical Issues in Measuring Foreign Direct and Portfolio Equity 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/} Investments in enterprises that do not have these minimum proportions of foreign ownership are classified as portfolio investment.

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 external debt statistics.

Statistics on direct investment flows to developing countries can be derived on the basis of either the source or the recipient country and both types of data are used at various points in this report:

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 Organization for Economic Cooperation and Development (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.

^{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.

Recipient country basis: Direct investment flows received by each developing country are reported to the Fund as part of its balance of payments statistics and are published in the annual Balance of Payments Statistics Yearbook. However, many countries do not report information on reinvested earnings. More recent data on direct investment flows are also collected by the Fund staff in the course of its regular consultations with member countries and this data (which is sometimes based partially on Fund staff estimates) is used in preparing the World Economic Outlook (WEO). Data used in the WEO does not give a breakdown between reinvested earnings and other components of direct investment.

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.

Although the detailed presentation of the Fund's Balance of Payments Statistics makes provision for entries on portfolio investment in corporate equities, ^{1/} in practice recipient developing countries rarely collect separate data on such flows; if such flows are recorded at all, they are usually grouped with other categories of portfolio investment such as public sector bonds.

Classification of countries

The classification of countries in this report is the one adopted by the Fund in December 1979 and utilized in the Fund's International Financial Statistics for the March 1980 and subsequent issues. Industrial countries comprise:

^{1/} For instance, see Annex II to the Introduction, Balance of Payments Yearbook, Volume 34, Part 1, International Monetary Fund, 1983, p. xvii.

Australia	Germany, Federal	Netherlands
Austria	Republic of	New Zealand
Belgium	Iceland	Norway
Canada	Ireland	Spain
Denmark	Italy	Sweden
Finland	Japan	Switzerland
France	Luxembourg	United Kingdom
		United States

The developing countries are divided into two groups: --
"oil exporting countries" and "non-oil developing countries." The
countries covered under the heading of the oil exporting countries are:

Algeria	Libyan Arab	Saudi Arabia
Indonesia	Jamahiriya	United Arab Emirates
Iran, Islamic	Nigeria	Venezuela
Republic of	Oman	
Iraq	Qatar	
Kuwait		

The countries covered under the heading of non-oil developing countries include all Fund members (as of December 31, 1983) except those listed above as being "industrial countries" or "oil exporting countries," together with certain essentially autonomous dependent territories for which adequate statistics are available.

Among the "developing countries" a subgroup of major borrowers is distinguished. This group comprises those seven developing countries with total outstanding external indebtedness at end-1983 of at least \$30 billion or outstanding indebtedness to private creditors at end-1983 of at least \$20 billion. These countries are:

Argentina	Brazil	Indonesia	Korea
Mexico	Philippines	Venezuela	

It should be noted that the term "country" used in this document does not in all cases refer to a territorial entity that 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.

I Introduction

Since the early 1970s, foreign direct and portfolio equity investment flows into developing countries, although continuing to increase in absolute terms, have been relatively less important than in previous years, as foreign private capital flows have been dominated by debt-creating bank credit. This shift in the composition of private capital flows may arguably have increased the vulnerability of the developing countries to external payments difficulties, since debt requires regular repayments, while equity implies payments only when the investment earns a positive return. It has also been evident that, with a relatively slow growth of bank lending projected for these countries for the medium term, other sources of external financing, including private equity investment, will be needed if the development effort is to resume its former impetus. In this context, this paper examines the causes and consequences of the decline in the relative importance of direct and portfolio equity investment since the early 1970s and discusses the modifications in policies in both lending and borrowing countries that might encourage larger flows of such investment.

Direct investment can be new equity capital, reinvested earnings, or net borrowing from a parent company or its affiliates. A guiding criterion is that it is investment made to acquire a lasting interest and an effective voice in the management of an enterprise, while portfolio equity investment usually does not have such an aim. 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. Direct investment also generally involves the transfer of a package of resources, including technological, managerial, and marketing expertise in addition to capital; these may have an even greater impact than the capital flows on a recipient country's production capabilities. However, this paper is mainly concerned with the macroeconomic aspects of direct investment, in particular with its role in capital transfers and adjustment.

Two of the principal issues addressed are 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; and to what extent equity capital could have been substituted for some of the bank credits if different policies had been adopted by capital-exporting or importing countries. The increased role of banks in financial intermediation reflected changes in the structure of the international financial system that were accelerated by the increase in oil prices and the accumulation of substantial short-term deposits by the principal oil exporting countries. Much of the expansion in the borrowing from banks was undertaken either by governments of developing

countries, to finance balance of payments or fiscal deficits, or by state enterprises, to finance their investment programs often with a government guarantee. 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 in the short term. Most developing countries have limited and fragmented capital markets which makes substitution more difficult, and major differences in economic structure and resource endowment also cause wide variations in their ability to attract direct investment. Moreover, some observers have argued that there are limits on the global supply of funds available for overseas direct investment, because of capital market constraints on transnational corporations. Even so, the longer-term possibilities for substitution between direct investment and commercial bank debt can still be significant especially for those countries with substantial domestic markets or natural resource endowments, which were often among the largest borrowers from commercial banks. In this regard, the policies many developing countries adopted toward foreign equity investment also seem to have contributed to the greater reliance on bank credit.

Developing countries may find it advantageous to rely more on direct and portfolio investment than they have both because of the effects of the composition of capital inflows on adjustment and because of their impact on long-term development strategy. It has already been mentioned that the distribution of a country's external liabilities between debt and equity can significantly affect its vulnerability to unanticipated changes in economic conditions. This is because, unlike interest payments on external debt, no profit payments are required on equity unless the investment earns a positive return. 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. In addition, it can be argued that a larger share of direct investment in capital inflows makes these more sensitive to a country's adjustment policies, since direct investment can increase significantly as more appropriate exchange rates and interest rates are established that make investment more viable.

Foreign direct investment can have a longer-term beneficial impact on a country's development since it is generally directly linked to productive investment and also facilitates the transfer of technology and managerial and marketing skills, the diffusion of which can have substantial effects on productivity growth. In addition to the direct impact of such transfers, the introduction of efficient and internationally competitive enterprises into an economy can also help foster a more general, longer-term improvement in productivity by stimulating the adoption of improved

technology and management in other sectors of the economy, in particular among local competitors and suppliers. There are, however, a wide variety of institutional arrangements through which such transfers can be channelled, and alternatives to transfers through wholly- or majority-owned foreign affiliates may sometimes be better suited to host country sensibilities.

In addition, foreign direct and equity investment has become more important in the light of the sharp decline in new commercial bank lending since the onset of widespread debt-servicing difficulties among borrowers. New net bank lending is likely to continue to be constrained, particularly for those countries with especially large amortization payments of rescheduled debt falling due over the next several years. A greater emphasis on policies designed to attract direct and portfolio equity investment could offset part of the overall decline in bank lending.

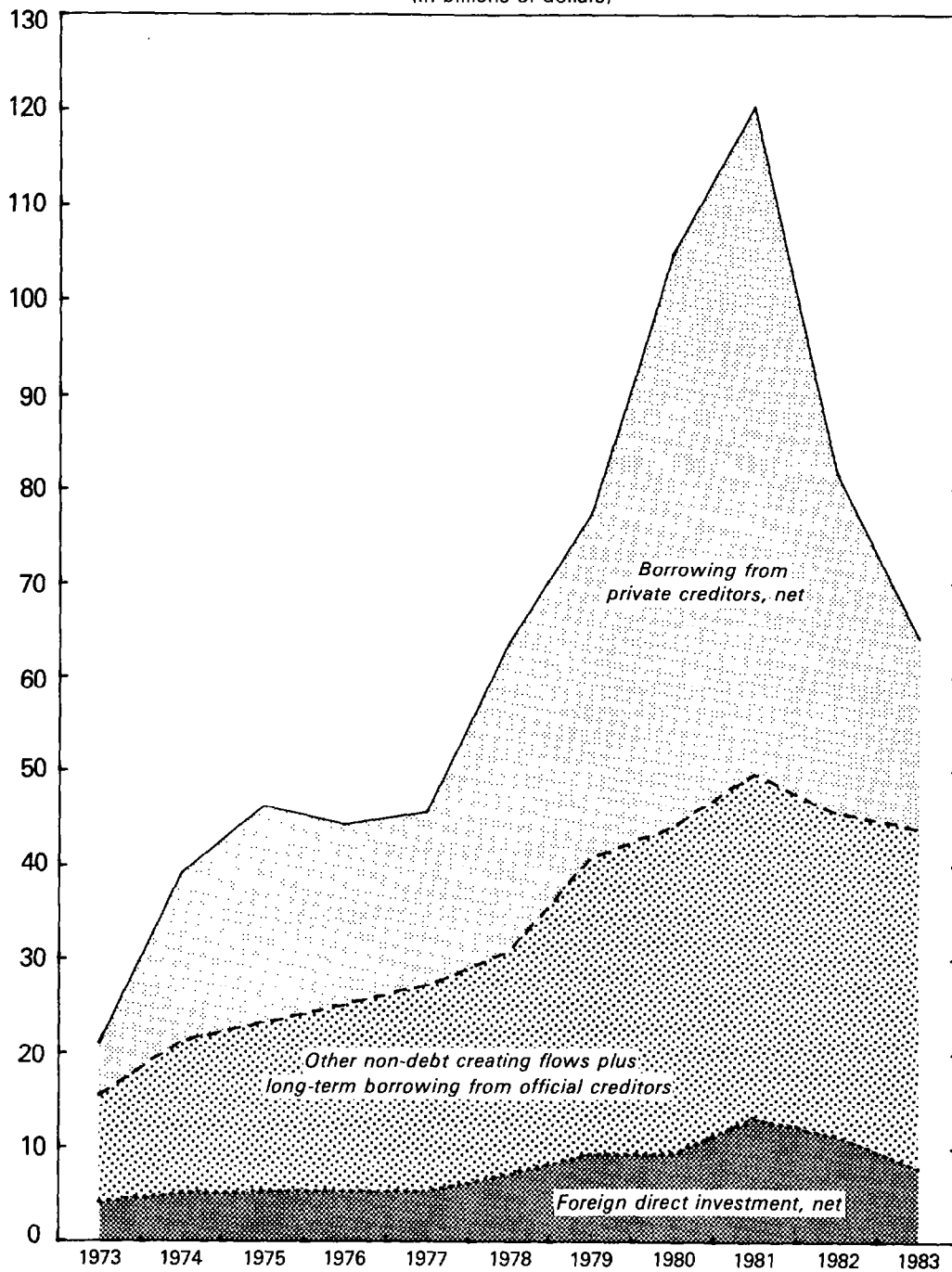
Section II of this paper discusses trends in the size and composition of foreign private investment and in income payments on such investment. Section III examines the role of direct investment in the transfer of resources, discusses the scope for substitution between direct investment and other forms of resource transfer, and considers some of the possible advantages and disadvantages of allowing foreign private investment a greater role in the development process, with emphasis on the policies of host countries and attitudes of transnational corporations that are likely to increase 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. Appendix I lists some of the restrictions and regulations concerning foreign direct and portfolio investment in 25 of the largest borrowing countries. Appendix II contains an empirical examination of the relationships between payments on direct investment and external debt, and host countries' ability to make such payments.

II Trends in Foreign Direct Investment

Net flows of direct investment from industrial to developing countries as a group generally increased after the 1960s; from an average of under \$2 billion a year during the early 1960s they rose to an average of around \$10 billion a year during 1974-82 (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 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 were accounted for by medium-term bank lending or export credits. Official development assistance also grew more rapidly than direct investment throughout most of the 1970s and early 1980s.

CHART 1
NON-OIL DEVELOPING COUNTRIES;
DISTRIBUTION OF FINANCING FLOWS¹

(In billions of dollars)



Source: Table 1.

¹Excluding reserve-related liabilities and errors and omissions.

Although the rapid expansion of commercial bank lending to developing countries was already under way before the first large increase in oil prices in 1973-74 that event accelerated the decline in the relative importance of direct investment flows. Non-oil developing countries financed most of their larger current account deficits through external borrowing, while a number of oil exporting developing countries used part of their increased revenues to reduce the foreign share of their oil industry. In 1973, direct investment 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, the growth of net direct investment flows to non-oil developing countries after the first oil price increase was still, on average, around 3 percent per annum in real terms through the 1970s, compared with an average annual real growth rate of around 5 percent for the combined GDP of these countries. ^{1/} This 3 percent of growth was about 1/2 percent a year less than the growth in real gross direct investment inflows into industrial countries, although the average growth in industrial countries' combined GDP, at around 3 percent, was lower than that of developing countries.

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, direct investment was less severely affected by the recession than was borrowing from private creditors (including bank lending, bond issues, and suppliers' credits). Direct investment fell by 29 per cent between 1981 and 1983, while net borrowing from private creditors fell by 72 per cent over the same period. Almost all the decline in direct investment appears to have been concentrated in the main borrowers in Latin America; other regions were only moderately affected.

The shift in the composition of financing of current account deficits was reflected in the changing structure of the external liabilities of non-oil developing countries. The stock of foreign direct investment (at its book value) is estimated to have grown at an average annual rate of 11.6 percent between 1973 and 1983 while total external debt grew at a rate of 18 percent (Table 2). However these figures understate the relative importance of the stock of foreign direct investment; the current market value of most would be higher than its book value, which is based on historic cost. Public and publicly guaranteed debt to financial institutions grew even more rapidly. Consequently, the share of direct investment in the total gross external liabilities of non-oil developing countries declined from an estimated 26.5 percent in 1973 to

^{1/} Real growth of direct investment flows is measured by nominal growth deflated by the index of wholesale prices in the United States.

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

(In billions of U.S. dollars)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
<u>Non-Oil Developing Countries</u>											
(1) Current account deficit	10.9	37.1	46.3	31.7	30.4	42.9	63.3	88.7	108.5	85.9	52.6
(2) Reserve accumulation	9.7	1.7	-1.7	14.4	11.6	16.3	11.7	4.4	3.7	-4.7	10.0
Financing:											
Sum of (1) and (2)	20.6	38.8	44.6	46.1	42.0	59.2	75.0	93.1	112.2	81.2	62.6
(3) Net direct investment	4.2	5.1	5.3	5.3	5.3	7.2	9.4	8.9	13.1	12.6	9.3
(4) Official transfers	5.5	8.8	7.1	7.4	8.2	8.2	11.5	12.5	13.1	12.5	12.0
(5) Net long-term borrowing from official creditors	5.7	7.8	11.8	12.8	12.7	13.7	16.9	19.4	24.3	23.5	24.5
(6) Net external borrowing from private creditors	5.7	16.5	22.2	18.6	18.6	32.4	36.9	58.1	66.4	37.1	18.4
(7) Other sources <u>2/</u>	-0.5	0.6	-1.8	2.0	-2.8	-2.3	0.3	-5.8	-4.7	-4.5	-1.6
<u>Seven major borrowers <u>3/</u></u>											
(1) Current account deficit	2.6	6.4	14.3	11.3	9.5	18.4	22.3	26.6	35.7	39.8	11.0
(2) Reserve accumulation	4.9	4.5	0.7	5.8	5.0	7.3	9.5	2.2	-1.2	-16.7	3.3
Financing:											
Sum of (1) and (2)	7.5	10.9	15.0	17.1	14.5	25.7	31.8	28.8	34.5	23.1	14.3
(3) Net direct investment	1.9	1.7	2.8	1.6	2.5	3.7	4.3	4.2	6.3	4.6	2.6
(4) Official transfers	0.3	0.2	0.2	0.2	0.1	0.3	0.4	0.4	0.7	0.5	0.6
(5) Net long-term borrowing from official creditors	1.7	2.2	2.5	2.5	2.2	2.3	3.2	2.6	5.0	5.0	7.1
(6) Net external borrowing private creditors	4.4	8.7	11.1	14.6	13.4	23.1	26.0	36.7	40.8	22.7	9.4
(7) Other sources <u>2/</u>	-0.8	-1.9	-1.6	-1.8	-3.7	-3.7	-2.1	-15.1	-18.3	-9.7	-5.4

Source: International Monetary Fund, World Economic Outlook, Occasional Paper No. 32 (Washington, D.C., September 1984).

1/ This table updates Table 19 of Occasional Paper No. 31.

2/ Includes errors and omissions.

3/ Argentina, Brazil, Indonesia, Korea, Mexico, the Philippines, and Venezuela.

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

	<u>Stock of Liabilities 1/</u>		<u>Average Annual Growth Rate, 1973-83 (In percent)</u>
	<u>1973</u>	<u>1983</u>	
	<u>(In billions of U.S. dollars)</u>		
Foreign direct investment 2/	47.0	140.9	11.6
Total external debt 3/	130.1	685.5	18.1
Short-term debt	18.4	110.6	19.6
Long-term debt	111.8	574.9	17.8
Official creditors	51.0	219.9	15.7
Private creditors 4/	60.8	355.0	19.3
of which:			
Financial institutions 5/	(17.3)	(204.1)	(28.0)

(As percent of exports of goods and services)

Foreign direct investment	41.5	31.7
Total external debt	115.4	154.4

Sources: OECD: Development Cooperation, various issues, and Geographical Distribution of Financial Flows to Less Developed Countries, various issues; World Economic Outlook, September 1984; Occasional Paper No. 32, Table A.2, 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.

17 percent in 1983, while the share of public and publicly guaranteed debt to financial institutions rose from 10 percent to 26 percent. ^{1/} As a percentage of exports of goods and services, the stock of direct investment in non-oil developing countries declined between 1973 and 1983, whereas the stock of external debt grew considerably (Table 2).

Within these global trends, of course, direct investment patterns in individual countries have varied greatly according to differences both in economic environment and policies. 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 almost half of the stock of direct investment in non-oil developing countries at the end of 1983 (Table A.2). In contrast, external debt was less concentrated; the five countries with the largest external debt among non-oil developing countries (Mexico, Brazil, Argentina, Korea, and the Philippines) accounted for around two-fifths of total outstanding debt of all non-oil developing countries at the end of 1983. However, some other countries that have 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. Countries that had small domestic markets and that lacked substantial natural resources or an export-oriented manufacturing base (including many in Africa) were often relatively unsuccessful in attracting direct investment, even if they offered substantial incentives and imposed few restrictions. 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 were reflected in its share in gross external liabilities. At the end of 1983, direct investment was estimated to account for 5 percent or less of the stock of total external liabilities of Algeria, Korea, and Yugoslavia, but for over 28 percent of liabilities for Malaysia and Hong Kong, 44 percent for South Africa, and over 90 percent for Singapore (Table A.2).

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 1983 was valued only at an estimated \$1.4 billion, and a substantial proportion of this consisted

^{1/} Gross external liabilities are defined as total external debt plus the stock of foreign direct investment.

of stock in companies based in Australia or in tax havens. ^{1/} Among the many causes for the slow development of portfolio equity investment in developing countries have been the restrictions imposed by some of these countries (discussed in Section IV), which are sometimes even more stringent than those applied to direct investment, and regulatory restrictions imposed on the portfolios of institutional investors in many capital exporting countries. 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 (such as the Mexico Fund and the Korea Fund) sometimes with the assistance of the International Finance Corporation, with the aim of investing in corporate equity of selected developing countries.

The United States has been the principal source of private direct investment in developing countries, although it, together with the two other traditional sources--the United Kingdom and France--has become less important recently, while investment from the Federal Republic of Germany and Japan has grown 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 almost 21 percent for Germany and Japan, respectively. However, the United States still accounted for almost half of the total stock of such investment in 1982 (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.

There has also been a small but growing level of direct investment flows from a number of developing countries, much of it directed to neighboring developing countries. If South Africa is excluded, the total recorded direct investment outflow from non-oil developing countries 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 (Table A.4). ^{2/} The outward flow of direct investment from South Africa also increased rapidly, to an average of around \$700 million a year during 1980 and 1981, but dropped sharply in 1982, when

^{1/} Survey of Current Business, June 1984, p. 75, Table 1.

^{2/} These figures do not include direct investment outflows from Hong Kong and Singapore, which do not collect regular statistics on direct investment outflows. The stock of Hong Kong- and Singapore-based direct investment in East Asian countries is estimated to have been 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.

there was actually a small net repatriation of capital. After the first large oil price increase, a number of major oil exporting countries also increased their overseas direct investments, mainly in the industrial countries.

Sectoral composition

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 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 generally rose (Table A.5). Direct investment from the United States demonstrated the largest sectoral shift, as the share of the extractive industries in total investment fell from almost half in 1967 to just over a quarter 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 the efforts of some governments to increase domestic control of natural resources, either through the nationalization of existing foreign-owned assets or through regulations restricting the 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 in developing countries was undertaken primarily to serve growing local markets and was often made in response to trade restrictions imposed as part of a strategy of import-substituting industrialization. This was especially true of investment 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 manufacturing for export. Majority-owned manufacturing affiliates of U.S. companies in Latin America exported only 6 percent of their total sales between 1966 and 1976, whereas manufacturing affiliates in Asia had exports amounting to 24 percent of total sales. These figures refer to gross exports; the relatively low value-added in some export-oriented industries may exaggerate the difference between the regions. 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-owned enterprises.

The services sector has attracted a growing proportion of direct investment, much of it concentrated in finance, insurance, trade, and tourism. Direct investment in various public utilities, which was once considerable, particularly in Latin America, is now of minor importance. Since utilities are generally natural monopolies, they were early candidates for nationalization, while their regulated prices depressed profitability and discouraged new investment.

Financing and ownership

Direct investment flows include all funds provided by the direct investor, either directly or through an affiliate. Reinvested earnings generally constitute a large proportion of these flows. During 1975-82 they accounted for some 60 percent of all direct investment from the United States to developing countries, for over half of all the direct investment flows from the United Kingdom, 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 for which data covering a sufficiently long time period are available reinvested earnings represented an average of some 39 per cent of recorded direct investment during 1973-82. (These countries are: Bolivia, Brazil, Cameroon, Colombia, Costa Rica, El Salvador, Honduras, Israel, Jamaica, Mexico, Morocco, and Sierra Leone.)

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, compared with over 40 percent for Germany, but there were substantial year-to-year fluctuations in its importance. ^{1/} 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 rates 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 such external borrowing is classified as foreign debt, it would often not be possible without the direct investment relationship between the affiliate and the parent

^{1/} Data for the United States excludes the overseas borrowing of U.S. parent companies channeled through their finance affiliates in the Netherlands Antilles.

company. There is little information on the overall magnitude of such borrowing, but it appears to have been substantial. For example, by 1979 at least 17 percent of all external borrowing by Brazil was undertaken by the local subsidiaries of foreign companies; such borrowing was equivalent to around one-half of total direct investment in Brazil. ^{1/} 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.

This financing pattern is influenced by the host country's interest rate, 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 both of 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. ^{2/} 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.

Income

The recent recession and decline in oil prices had sharply contrasting effects on developing countries' income payments on direct investment and on their external debt. In discussing these, 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, while the latter, narrower, definition influences 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.) In practice, total income payments on direct investment are underestimated since a number of developing countries do not collect information on reinvested earnings.

Total net recorded income payments by all developing countries on direct investment rose from \$10.4 billion in 1973 to a peak of \$26.7 billion in 1981, but then declined sharply to an estimated \$17.7 billion in 1983,

^{1/} C. Oman, *New Forms of International Investment in Developing Countries*, Organization for Economic Cooperation and Development, 1984, p. 32.

^{2/} C. Oman, *op. cit.*

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 investment in non-oil developing countries rose from \$3.6 billion in 1973 to \$9.4 billion in 1981, before declining sharply to an estimated \$6.3 billion in 1983. Most of the decline after 1981 was due to sharply reduced income on direct investment 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 over \$5 billion in 1982. 1/

Expressed as a percentage of exports of goods and services, total income payments by non-oil developing countries on direct investment declined gradually over the decade, to less than 1.5 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 seven major borrowers among developing countries (i.e., Argentina, Brazil, Indonesia, Korea, Mexico, the Philippines, and Venezuela).

However, a large proportion of earnings on direct investment are reinvested in the host country. For the 12 non-oil developing countries noted above 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 \$2.6 billion in 1980 to under \$1 billion in 1982, but reinvested earnings fell even more sharply, particularly in Latin America. Consequently, gross dividend remittances from these affiliates to the United States actually increased from under \$0.7 billion to \$1 billion over the period. 2/ The implication for developing countries' adjustment to economic disturbances of such divergent movements in remitted and reinvested earnings are discussed in Section VI.

Royalties and licensing fees are payments for the transfer of technology and are not exclusively related to direct investment flows.

1/ Complete information for 1983 is not yet available.

2/ Gross remittances are calculated before deduction of the host countries' withholding taxes on dividends.

In practice, however, a substantial proportion of such payments were made 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 9.5 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.

III The Role of Foreign Direct Investment in Development

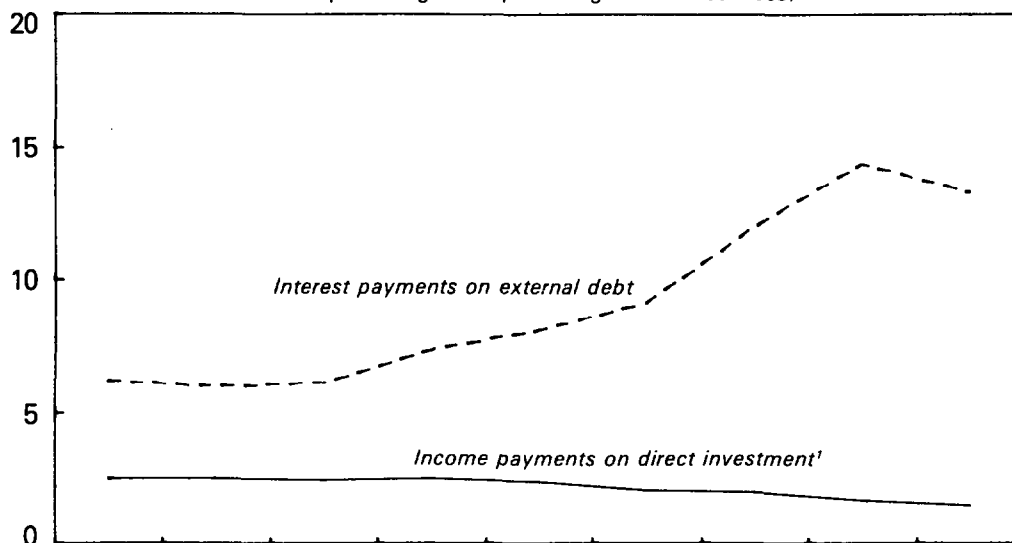
There is considerable controversy about the relative costs and benefits of foreign direct investment to developing countries. The principal argument in its favor is that the package of capital, technological, and managerial resources generally increases the real domestic income of the host country by more than the profits returned to the investor. This increase is manifested 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. Nevertheless, the association of direct investment with some degree of overseas managerial control, and generally with large transnational companies, can have wide-ranging effects on the economy of the host developing country. Concern that some of the activities of the enterprise might have adverse consequences for a country's development prospects may lead to the adoption of restrictive policies toward foreign direct investment. This concern has been reinforced by dissatisfaction with some of the results of earlier investments.

In assessing the overall effects of direct investment, however, it is relevant that many of the principal benefits and costs can be 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; if these are inappropriate, the investment will also be inappropriate and of less benefit to the economy. The foreign investors themselves can also help to ensure that the direct investment process is mutually beneficial by cooperating with a host country's chosen development strategy and showing willingness, where necessary, to consider alternative arrangements, such as joint ventures and minority equity participation.

The Transfer of Resources

There are wide variations in the extent to which different developing countries have relied on direct investment. Direct investment inflows have made an important contribution to total capital formation in only a few

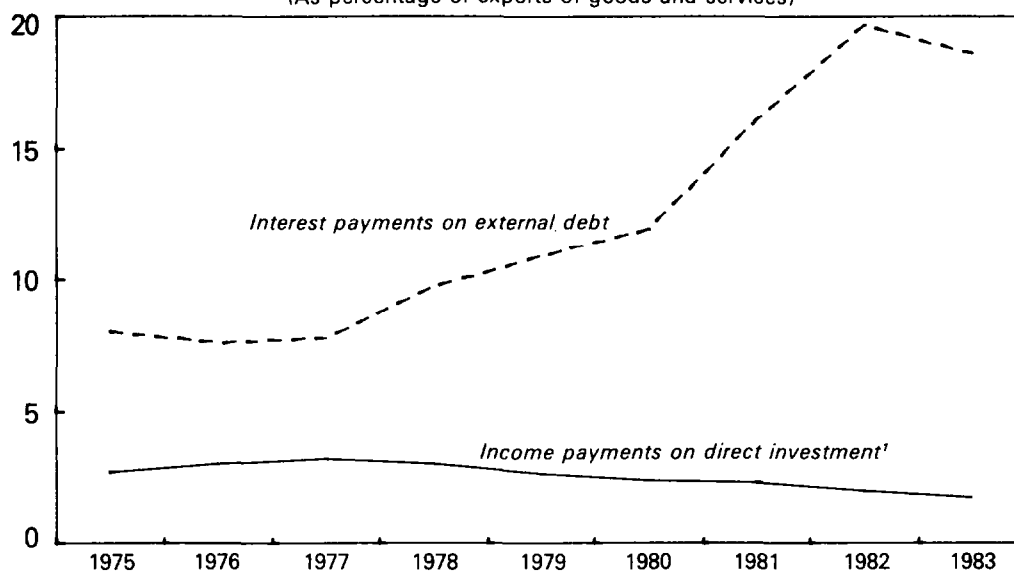
CHART 2
NON-OIL DEVELOPING COUNTRIES;
INCOME PAYMENTS ON DIRECT INVESTMENT
AND INTEREST PAYMENTS ON EXTERNAL DEBT
(As percentage of exports of goods and services)



Source: World Economic Outlook.

¹Dividends 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.

¹Dividends and net interest payments plus recorded reinvested earnings.

developing countries since 1973, as many countries turned to overseas borrowing as a source of foreign savings. Between 1979 and 1981, direct investment inflows represented about 25 percent and 11 percent of total fixed capital formation in Singapore and Malaysia, respectively; around 5 percent in Chile and the Philippines; only about 1.5 percent in Brazil, Indonesia, and Mexico; while they were negligible in India, Korea, and Nigeria. 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.

There are major differences among countries in the degree to which direct investment can be substituted for other forms of foreign capital inflow. (The issue of whether, on the supply side, international capital markets could have coped with a large-scale substitution of direct investment for overseas commercial borrowing on the part of developing countries as a group is discussed in Section V.) The differences in substitutability are the result both of variations in economic structure that affect countries' attractiveness to investors, and differences in the underlying macroeconomic causes of the need for capital inflows. Countries with small internal markets, few natural resources, a relatively underdeveloped infrastructure, and limited possibilities for manufactured exports may not be able to attract substantial direct investment, even with liberal regulations and generous incentives. Such countries are also generally not able to borrow significantly on commercial terms, and must rely primarily on borrowing at concessionary terms. Consequently, the possibilities for substitution between overseas commercial borrowing and direct investment mainly concern countries that are larger, better-endowed with natural resources, or that have a more developed industrial sector. Countries that already have a substantial amount of foreign-affiliated investment will also generally find it easier to influence the future composition of capital inflows, since they can also influence direct investment through the financial structure of existing subsidiaries of foreign companies, and in particular the amount of borrowing from domestic sources and from third parties abroad. But, as indicated in Section III, direct investment has tended to be even more concentrated in a few countries than has external borrowing.

The macroeconomic causes of capital inflows can also have a large influence on the degree of substitutability between direct investment and commercial borrowing as sources of foreign capital. In countries with well-integrated capital markets, the particular sources of macroeconomic imbalance would have only a limited impact on the composition of capital inflows. However, most developing countries have fragmented domestic capital markets, and for them the causes of capital inflows are of greater significance. Three types of factors lead to a need for increased capital inflows, presenting varying possibilities for substitution between direct investment and external borrowing.

First, aggregate demand may increase relative to aggregate supply because of increased expenditure on investment projects that are regarded as financially viable. If such investment takes place in the private sector, then the potential for substitution is high, provided the tax and regulatory frameworks are suitable for direct investment. If the investment is undertaken mainly by state enterprises, then in many countries the potential for substitution is lower because of institutional barriers to the participation of foreign direct investment. Nevertheless, there could still be substantial possibilities for the participation of foreign equity through various forms of joint venture arrangements with state enterprises, provided these were consistent with the host country's overall development orientation. Such arrangements are common in mineral exploration and development, where much of the risk is borne by foreign equity capital operating in partnership with public corporations, but are also evident in many other sectors. Brazil has encouraged joint ventures involving a combination of state and both local and foreign private equity capital, particularly in the petrochemical industry. The experience of China, which at present uses foreign direct investment more than overseas commercial borrowing, demonstrates that a system of state enterprises need not be a barrier to substitution between different forms of foreign capital. One policy measure that has frequently reduced such substitutability has been the provision of government guarantees on overseas commercial bank borrowing by state enterprises. These lower the cost of commercial borrowing to the enterprise, since the government assumes part of the lender's risk, so it becomes relatively more attractive to the state enterprise than foreign equity participation.

Second, aggregate demand may rise relative to aggregate supply because of increased expenditure on consumption or on investment projects that are not regarded as financially viable, including infrastructure projects that might have high overall economic returns but that do not generate any revenue directly. Such excess demand frequently takes the form of larger fiscal deficits as government expenditure on subsidies, higher wage bills, or social infrastructure rises. In this situation, the possibilities for substituting foreign direct investment for overseas borrowing, which is usually undertaken directly by a government or central bank, are lower. There are no additional investment projects that would be attractive to direct investors. In principle, higher domestic borrowing by the government could drive up domestic interest rates, and lead to greater inflows of direct investment, in part by reducing domestic borrowing by transnational companies. In practice, however, such indirect effects on foreign capital flows are limited because capital markets are fragmented and flexible interest rate policies do not exist in many developing countries.

Finally, part of the external borrowing of some developing countries has been used not to finance an increase in aggregate domestic expenditures, but to offset an outflow of private residents' capital. The possibilities

for substituting direct investment for such borrowing are generally low, especially since the inappropriate exchange and interest rate policies that are often the cause of such capital flight are also likely to discourage direct investment.

Therefore, the extent to which different developing countries could have substituted foreign direct investment for part of their external borrowing over the last decade would have depended on the uses to which such borrowing was put. A significant proportion of the borrowing that took place immediately after the two large increases in oil prices was for short-term balance of payments support, for which the possibilities for substitution were probably quite low. However, the scope for switching between types of capital inflow probably increase with the length of the period after the initial external imbalance. In this regard, evidence presented in the Fund's 1983 World Economic Outlook suggested that, for most of the largest borrowers among non-oil developing countries, the increase in external debt during the last decade was associated with a higher rate of investment and was not used primarily to finance consumption. ^{1/} However, part of the higher investment must have been in infrastructural projects of a sort that would not have attracted foreign direct investment.

Technology transfers (including managerial and marketing expertise) are more difficult to measure than capital flows 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 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. ^{2/} 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 direct investment.

^{1/} World Economic Outlook (May 1983), Appendix A, Supplementary Note 7, pp. 140-44.

^{2/} 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.

Impact on Host Developing Countries

The overall economic impact of enterprises established through direct investment goes well beyond the direct transfer of capital and technology. Since these enterprises also borrow in the host country and from third parties abroad, the share of total resources they affect 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 their host's balance of payments. Consequently, the achievement of development objectives can be significantly affected by the actions of foreign-controlled affiliates and their parent companies. Many developing countries have been concerned by the loss of local autonomy that this might imply. Moreover, substantial foreign ownership of major sectors of the economy has frequently been regarded as involving a weakening of indigenous industry and the growth of oligopolistic market structures which impose welfare costs on the population. In addition, it has been argued that foreign-controlled firms may adopt overly capital-intensive production techniques (which are available, but inappropriate), make insufficient transfers of technology at too high a cost (to retain technological advantage), set artificially high transfer prices (to extract excessive profits), and exert strain on the balance of payments (because, as part of an enterprise with multinational production facilities, they may be less able than firms under domestic control to expand exports and may be overly dependent on imports).

Judgments on the permissible degree of foreign ownership and control involve wide-ranging political as well as economic considerations. Nor are such issues confined to developing countries, since groups in some industrial countries have also been apprehensive about the growth of foreign direct investment. Each host country, therefore, must determine the appropriate level of foreign participation in particular sectors in the light of its needs and objectives. It should be borne in mind, however, that many of the costs and benefits associated with direct investment can be strongly influenced by the host country's economic policies. The attitudes and policies of transnational companies can also play an important role in ensuring that the direct investment process is one of mutual benefit.

Foreign direct capital can have complex and wide-ranging effects on indigenous enterprises and the level of competition in a developing country. It can stimulate local entrepreneurship by providing increased competition and opportunities for subcontracting by local suppliers; it can also, however, reduce the number of locally owned firms, either by takeover or because such firms are not able to compete with the greater resources of foreign-controlled subsidiaries. It is estimated, for instance, that around one third of foreign subsidiaries in developing countries were

established through the acquisition of existing enterprises. ^{1/} Whether such takeovers reduce overall competition would depend partly on the competitiveness of other firms in the industry. The policies of the host country also play an important role, since the welfare costs of excessive market concentration are greater when the domestic market is also insulated against competition from imports.

Because of the nature of technological information, its transfer takes place in a highly imperfect market in which it is often difficult to fix an exact price. Developing countries are frequently in a weak bargaining position in these markets, especially if they lack specialized manpower that can help determine the likely contribution of proposed technology transfers. This can be particularly so when the technology is transferred as one element of a package of resources provided by direct investment, since the exact cost of such technology is frequently unclear. Some developing countries have attempted to strengthen their bargaining position by imposing limits on royalty payments (as a fixed percentage of total sales receipts, for instance) or by establishing vetting procedures for all technology contracts. The increased willingness of some transnational corporations to consider alternative forms of technology transfer—including licensing, franchising and subcontracting—may help lower the costs of these transfers, especially for host countries that may not need other elements of a direct investment package, such as managerial or marketing skills.

It is frequently argued that since the technology transferred to developing countries through direct investment is generally developed for industrial countries, it involves overly capital-intensive techniques, especially since multinational enterprises conduct little research and development in most developing countries. There is some evidence that, in many developing countries, average capital-labor ratios of foreign subsidiaries in manufacturing are higher than those of local firms. However, this appears to be largely due to their greater concentration in industries with high capital requirements; differences in capital intensity between foreign and locally owned firms within the same industry are less clear-cut. In any event, host country governments can significantly influence the choice of production techniques. A number of frequently adopted policies encourage the substitution of capital for labor, including overvalued exchange rates that reduce the cost of imported capital equipment, administered interest rates below current rates of inflation, and various fiscal incentives for investment that reduce the cost of capital.

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

The external trade of foreign-controlled companies may be less responsive to shifts in relative competitiveness between the host country and its trading partners 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. ^{1/} Although 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 (parties of which one owns 5 percent or more of the voting stock of the other) accounted for only around one quarter of manufactured imports into the United States 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. ^{2/}

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, to evade foreign trade taxes, 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.

As has already been mentioned, an inappropriate set of policies can significantly increase the costs and reduce the benefits of foreign direct investment in the host country. 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, and was encouraged by high tariff barriers and quantitative restrictions on imports. The results of such investment were frequently disappointing; costs of production were high, value added at international prices and exports were low, and dependence on imported intermediate inputs was significant. At the same time, import restrictions contributed to an overvalued exchange rate that, together with fiscal incentives granted to

^{1/} D. Goldsborough, "International Trade of Multinational Corporations and its Responsiveness to Changes in Aggregate Demand and Relative Prices," International Monetary Fund, Staff Papers, September 1981.

^{2/} G.K. Helleiner, Intra-Firm Trade and the Developing Countries, 1981.

attract direct investment, increased the real resource costs of profits earned on the investment. Disappointed with these results, host developing countries frequently attempted to increase their net benefits by imposing more detailed regulations on direct investment, including requirements for a minimum level of exports or local value added. Nevertheless, such regulations were generally less effective than more open exchange and trade policies would have been. 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/

Transnational corporations can help reduce developing countries' concerns about foreign economic influence by respecting the economic and social objectives and priorities of host governments and by signalling their willingness to abide by generally acceptable standards of behavior in such areas as transfer pricing, restrictive business practices for both domestic and international trade, and the transfer of technology. International codes of conduct, such as that established under the auspices of the OECD or the more comprehensive code still under discussion under the auspices of the United Nations, may help to reduce potential areas of conflict in this area by setting guidelines for the responsibilities of both investing companies and host governments. 2/ The growing diversity of sources of foreign direct investment, and an increased willingness by many investors to consider alternative organizational arrangements other than wholly or majority owned affiliates, may also help reduce host country concerns about loss of local autonomy.

Thus, although the overall costs and benefits derived from specific direct investments depend on the particular circumstances of each country and each project, it is evident that the direct investment process can be of mutual advantage to the host country and the foreign investor. Moreover, the net benefits of such investment can be 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.

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

2/ Guidelines for Multinational Enterprises, International Investment and Multinational Enterprises, OECD, 1976; and The 1984 Review of the 1976 Declaration and Decisions, International Investment and Multinational Enterprises, OECD, 1984.

IV Policies of Host Developing Countries Toward Foreign Direct and Portfolio Investment

Most developing countries combine some degree of regulation and control of direct investment, aimed at improving their net benefits, with various incentives designed to attract such investment. During the 1960s and much of the 1970s there was a general trend toward greater restrictions: alternative forms of external financing were more readily available, there was disappointment with some of the results of previous direct investment, and nationalist sentiment in many countries was growing. A number of developing countries also restricted foreign portfolio investment in securities of domestic enterprises. In recent years, however, some countries have adopted more flexible policies, partly because of the need to bolster weakening external economic and financial positions. This section will discuss these policies, as well as the effects of some of the principal restrictions and incentives 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 net benefits to the host country as are policies related specifically to such investment.

Although the combination of policies chosen depends 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-à-vis potential direct investors. Factors such as the size of the domestic market, the potential for export-oriented production, and natural resource endowments all influence the combination of regulatory and incentive policies that is adopted. 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 during the 1970s, 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 on it a number of restrictions or specific performance requirements 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.

In many instances, the screening or regulation of direct investment may have improved a host country's bargaining position and contributed to a greater political acceptability of such investment. However, the complicated mixture of incentives and disincentives sometimes made it difficult to evaluate the overall net contribution of direct foreign capital. Nevertheless, although various restrictions and regulations often acted as a barrier to new investment, they were not always insuperable for countries that offered an attractive location. In some instances, complexity and frequent changes in regulations may have been a greater disincentive than the existence of rigorous, but stable and clear-cut, controls.

Restrictions 1/

Many developing countries restrict foreign investment in certain sectors, either on the grounds of political sensitivity of certain industries (especially public utilities, broadcasting, publishing, banking, and the petroleum industry) or to reserve for local enterprises those industries with relatively simple technical and financial requirements (such as the retail and wholesale trade). Some countries (such as Nigeria) have established comprehensive lists of industries and their permitted degree of foreign participation, which varies 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.

The permitted degree of foreign ownership of all enterprises is also limited in many countries and the takeover of existing local firms is prohibited 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 economic 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

1/ A brief description of various restrictions and regulations concerning foreign direct and portfolio investment in effect at the end of 1983 in 25 of the largest borrowers among developing countries is given in Appendix I.

compete on equal terms with foreign enterprises, but with initial costs-- in terms of higher prices or lower quality and reduced foreign capital. But 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) which have fairly strict rules on foreign ownership are still relatively successful in attracting direct investment. Limitations on the proportion of foreign participation in particular industries are likely to reduce foreign investment less 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. It 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; some (including the Andean Pact countries and Greece) limit remittances to a certain percentage of invested capital; while others make overseas dividend transfers subject to additional taxation or limit them to a proportion of the firm's foreign exchange earnings. Yet 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 reduce the host country's share of profit tax receipts. Moreover, dividend remittances are sometimes subject to greater restrictions than interest payments on loans; 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 regulations are applied, for instance, to 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). Such a restriction is often part of wider controls on capital movements, as the authorities attempt to insulate the domestic financial system to maintain noncompetitive interest rates. Without a restriction on local borrowing, interest rates below those consistent with equilibrium in the local financial market could lead to a crowding-out of domestic enterprises and a net capital outflow, because of the generally greater creditworthiness of foreign firms. 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. These include 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 that are often well above international averages. Until recently, only a few countries (but 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 over 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 liberalizing policies to attract more 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) have shifted from detailed control of direct investment to much more flexible arrangements, while more gradual policy changes have taken place in other countries (including Korea, Mexico, Morocco, and Pakistan). A few countries have also introduced some relatively

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

modest provisions to encourage the conversion of outstanding external debt into equity investments. Turkey allowed claims arising from nonguaranteed 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; a similar arrangement was available in Indonesia, while Brazil granted a tax credit for nonresidents converting their loans into investment during 1983. ^{1/} 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.

The policies of some centrally planned economies toward foreign direct investment have also been modified in recent years. A number of countries (including Hungary and Romania) have permitted the entry of foreign capital through joint equity ventures, generally with minority foreign equity participation. The greatest change in policies has been in China, which now encourages investment either through joint ventures or through wholly owned foreign enterprises, and has also concluded a number of important agreements for foreign participation in offshore petroleum exploration. In 1984, China also announced new, more favorable treatment for foreign direct investment in 14 coastal cities, including a liberalization of regulations governing the purchase of inputs and the sale of a proportion of output on the domestic market.

Incentives

Many developing countries use a complex set of direct and indirect incentives to attract foreign investment. Most can be classified as offering either commodity protection, which alters 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 alters the prices of the inputs of production employed by a firm (factor protection might consist of tax holidays, investment allowances, and subsidies for the training of local labor). ^{2/} 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

^{1/} The information on Turkey comes from Foreign Investment in Turkey; Changing Conditions under the New Economic Program, OECD, 1983, pp. 8 and 15.

^{2/} Much of the discussion in this section is based on S. Guisinger, "Investment Incentives and Performance Requirements: A Comparative Analysis of Country Foreign Investment Strategies" (mimeo), World Bank, July 1983, Table 2, page 9. This study also contains a more detailed analysis of some of the effects of various incentive policies.

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 incentives provided.

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 abolish unilaterally all its incentives. For example, a detailed investigation of the location of new investment in a cross section of developed and developing countries concluded that in two thirds of the cases analyzed the choice of country for the investment was influenced by incentives provided, in the sense that the investment would have been located elsewhere in the absence of all incentives. 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. ^{1/} Moreover, there are strong indications that incentives become less effective the more complex they are 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 these may do more to facilitate such investment than

^{1/} 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.

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 Developments and Policies in Industrial
Countries on Foreign Direct and Portfolio Equity Investment

At present, most industrial countries maintain relatively few restrictions on capital outflows and provide some encouragement for direct investment in developing countries, through guarantee and insurance schemes and various forms of official financial support. The decline in the relative importance of direct investment in total capital flows to developing countries since the early 1970s was not due to any major change in such policies. Rather, it reflected 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.

Developments in Financial Markets

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 principal 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. As a result, the share of claims on developing countries in banks' total net international claims increased from under 23 percent in 1970 to around 30 percent by the early 1980s. ^{1/}

^{1/} International Monetary Fund, International Capital Markets: Recent Developments and Short-Term Projects, Occasional Paper No. 1 (September 1980), Table 35 and International Capital Markets: Developments and Prospects, 1984, Occasional Paper No. 31 (August 1984), Table 43.

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 between 1974 and 1978, together with expectations that such rates would continue, probably encouraged developing countries to rely on external borrowing for their financing requirements.

This increased role of commercial bank lending was probably unavoidable, especially in the years just after the large increases in oil prices, and it certainly helped cushion non-oil developing countries from the immediate effects of adverse external influences. The question as to whether, over the longer term, direct investment could have substituted for at least a part of the increased bank lending has already been discussed in Section III. In addition, some observers have argued that the international capital markets may not have been able to cope with a substantial increase in the share of direct investment in total capital flows to developing countries. The oil exporting countries preference for relatively liquid assets meant that banks were inevitably heavily involved in international financial intermediation, and transnational corporations faced limits on debt/equity ratios and foreign exchange exposures. It has been argued that this could have affected their willingness to raise the necessary finance for a large-scale increase in direct investment, even if suitable projects and regulatory environments had been present in host developing countries.

The degree to which bank lending to non-oil developing countries reflected a recycling of the deposits of oil exporting countries fluctuated substantially. The latter were major contributors of funds to the international banking system in the periods shortly after the two oil price increases, but were much less important in the mid-1970s, and their deposits declined after 1982 (Table 3). Consequently, the influence of their asset preferences on the composition of capital flows declined as the world economy adjusted to the new oil prices, while portfolio preferences in the capital markets of the industrial countries became predominant once again. As a result, the possibilities for substitution between bank lending and direct investment in capital flows to non-oil developing countries may have been greater once the initial impact of the higher oil prices had been absorbed.

Moreover, the increase in direct investment that might have resulted from any substitution are not likely to have been large enough to have encountered significant capital market constraints, at least on a global basis. The net cumulative flow of direct investment and bank lending into non-oil developing countries during 1974-83 are estimated at \$82 billion and \$216 billion, respectively (Table 3). By contrast, the total assets of the

Table 3. Non-Oil Developing Countries: Selected Financial Flows
through International Capital Markets, 1974-83

(In billions of U.S. dollars)

	Average Annual Flow				Cumulative 1974-83
	1974	1975-78	1979-81	1982-83	
Net borrowing from banks	15	19	33	21	216
Net long-term borrowing from official creditors	7	12	20	24	165
Net inflow of direct investment	5	6	10	11	82
<u>Memorandum items:</u>					
Current account deficit of non-oil developing countries	-37	-38	-87	-69	-588
Net increase of oil exporting countries' bank deposits in industrial countries	30	11	28	-15	127

Source: World Economic Outlook 1984, (Occasional Paper No. 32) and
International Capital Markets (Occasional Papers No. 1 and 31).

parent companies of U.S. transnationals alone (excluding the assets of overseas affiliates) amounted to over \$1,500 billion at the end of 1977. ^{1/} Even a major increase in direct investment financed solely by increased borrowing would have had only a modest effect on the debt/equity ratios of transnational companies. Moreover, if additional investment opportunities had been available, these companies could also have raised additional equity financing.

One other set of influences on the composition of capital flows to developing countries has been the financing decisions of the foreign-owned affiliates. Although little concrete information on these is available, there are some indications that the share of affiliates' capital expenditures financed by overseas borrowing from third parties (in particular, bank lending and suppliers' credits), rather than by transfers from the parent company, may have increased during the last decade. This appears to have been especially true immediately after the first large oil price increase. ^{2/} In addition to reflecting a number of general influences (such as low real interest rates) in world financial markets that tended to encourage a substitution of debt for equity, this trend may also have been influenced by a desire by some parent companies to reduce their risk exposure in some developing countries and by host country tax and foreign exchange regulations that often favored overseas payments in the form of interest rather than dividends.

Policies of Industrial Countries

Virtually all industrial countries have relatively open policies regarding equity capital outflows. ^{3/} A few impose exchange controls, generally as part of broader restrictions on capital flows designed to

^{1/} N.G. Howerstine, "Growth of U.S. Multinational Companies, 1966-77", Survey of Current Business, April 1983.

^{2/} See I.M. Mantel, "Sources and Uses of Funds of Majority-Owned Foreign Affiliates of U.S. Companies, 1973-76", Bureau of Economic Analysis Staff Paper, U.S. Department of Commerce, May 1979.

^{3/} However, this was not always the case. The U.S. Foreign Direct Investment Program was in effect, with varying degrees of stringency, from the beginning of 1965 to mid-1973 (on a voluntary basis until 1968, and mandatory thereafter). Its aim was to limit the strain on the U.S. balance of payments resulting from direct investment outflows, and it imposed quantitative controls on U.S.-parent financing of foreign affiliates. The quotas took the form of a proportion of the firm's direct investment in a geographic area during a specified benchmark period, but more liberal quotas were allowed for investments in developing countries. The program caused a large increase in affiliates' foreign borrowing from sources outside the multinational company, particularly during 1968 to 1970.

support the balance of payments. For instance, some countries (including France) 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 discriminate in favor of investment flows to developing countries.

Capital market regulations in developed countries may also hamper portfolio equity investment in developing countries. The costs of meeting registration requirements, and the comprehensive disclosure of information required, mean that direct equity issues in industrial countries are not a viable alternative for most companies from developing countries. Moreover, 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.

There has been concern in many industrial countries about the effects of outward direct investment on domestic employment opportunities and real wage levels. Most studies have concluded that foreign investment does not lead to a net loss of employment in the capital-exporting country, once such indirect effects on employment as the increased exports generated by direct investment packages 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. Even more important is the spread of protectionist trade measures during the recent period of high unemployment. Although these new 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 in developed countries can have various and significant effects on 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 and a number of treaties have been concluded along these lines. 1/

In this context, two key aspects of industrial countries' tax policies are whether they are neutral between domestic and foreign investment and whether any tax incentives granted by a host developing country will be offset by increased taxes in the capital-exporting country. Most industrial countries avoid double taxation of income generated abroad either by exempting it from taxation or by granting a credit for foreign taxes paid. 2/ 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 cannot 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

1/ 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.

2/ 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 of the Fund 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, unpublished, IMF May 1983.

overseas; it also creates a strong incentive to finance additional direct investment out of reinvested earnings. 1/

Most industrial countries make available insurance for new direct investment in developing countries, generally with coverage of noncommercial risks such as expropriation, losses due to war, and inconvertibility of dividend and capital transfers. 2/ Such insurance can help promote investment by reducing risks, particularly for small and medium-size firms. However, with the exception of Japanese and Austrian 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. 3/

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 IFC and similar national organizations, that usually invest directly in projects in partnership 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 establishment of a number of private investment funds for the purchase of equity in particular developing countries. Some 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.

1/ 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.

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

3/ See Ibrahim Shihata, "Increasing Private Capital Flows to LDCs," Finance & Development, December 1984.

VI Foreign Investment and External Adjustment

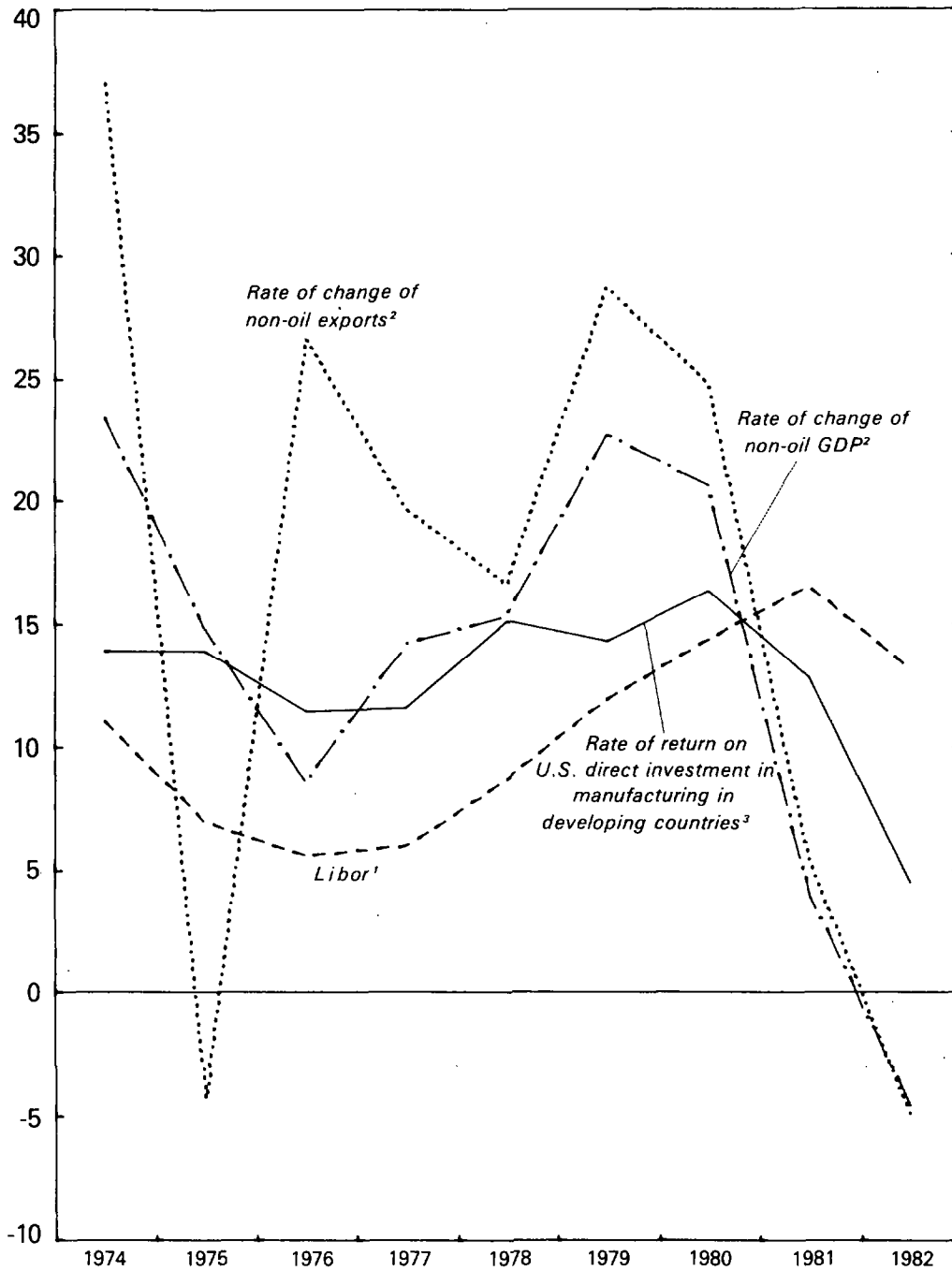
The shift in the composition of capital inflows into developing countries toward a relatively greater reliance on bank credit and lesser reliance on foreign equity investment is likely to have increased their vulnerability to various economic disturbances. Total income payments on direct investment tend to move more closely with a country's ability to service such payments than do interest payments on external 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 may be higher, the greater the share of equity instruments in the portfolio. (Although this does not imply that a host country would necessarily need to raise the expected rate of return to foreign investors in order to attract a greater volume of foreign equity investment, since a removal of restrictions on such inflows would probably be enough to generate increased investment at existing returns.) The desired composition of the portfolio will 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 goods sectors. The relatively low levels of per capita consumption and limited supply responses in many developing countries mean that the costs of making large adjustments over a short time 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 impact of the composition of a country's external liabilities on the costs of adjustment can be illustrated by considering the different 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 affects foreign exchange earnings (such as a decline in the terms of trade or a fall in volume of exports) would not alter interest payments due on external debt. Future expenditures would have to be reduced and resources switched from the nontraded 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. It is, of course, possible that in some circumstances 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. These effects are discussed in greater detail later in this section. But generally the required reduction in future expenditures to generate resources for repayment would be less when investment is financed by equity than by debt. However, whether the immediate foreign exchange outflow was also lower than for debt-financed investment--which would reduce 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 also be discussed later in this section.

Comprehensive empirical comparisons between the service payments on direct investment and those on external debt, and a country's ability to make those payments are hampered by the lack of reliable key information in many developing countries, in particular of time series on reinvested earnings. 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 non-oil developing countries with sufficiently long time series on reinvested earnings, the estimated annual rate of return on direct investment was positively associated with the annual rate of 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 between 1974 and 1982. There was a similar, but much weaker, positive association between rates of return on direct investment and rates of growth of exports. The results are discussed in more detail in Appendix II. By contrast, there was little association between these countries' rate of growth of GDP and exports and the average interest rate paid on their outstanding external debt. The difference in movements in rates of return and interest rates was particularly marked during the recent recession. Similar results were obtained for rates of return on direct investment from the United States in the manufacturing sectors of developing countries; these returns tended to move more closely with growth rates in non-oil exports and non-oil GDP in the host countries than did interest rates on world financial markets (Chart 4; these results are also discussed in more detail in Appendix II).

CHART 4
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)



¹London Interbank Offered Rate on three-month deposits.

²In U.S. dollars.

³From Department of Commerce: Survey of Current Business, various issues.

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 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. ^{1/}

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 the earnings from direct investment is generally reinvested and constitutes a substantial proportion of total direct investment in developing countries. For 12 non-oil developing countries with relatively long time series on reinvested earnings (Bolivia, Brazil, Cameroon, Colombia, Costa Rica, El Salvador, Honduras, Israel, Jamaica, Mexico, Morocco, and Sierra Leone), 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 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 4). 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 true in 1982 when earnings of manufacturing affiliates fell by 60 percent while dividend payments remained unchanged. (However the decline in the share of reinvested earnings was much less marked for affiliates outside the manufacturing sector and during earlier recessions.) Other elements of the affiliates' sources and uses of funds must have 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.

^{1/} The difference between the two means is statistically significant at the 1 percent level, on the basis of the Mann-Whitney test. The 28 countries that rescheduled their debt were: 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.

Table 4. U.S. Incorporated Affiliates in Developing Countries:
Trends in and Distribution of Earnings, 1973-82

(In billions of U.S. dollars)

	All Industries				Manufacturing			
	Earnings	Gross Dividends <u>1/</u>	Reinvested Earnings	Reinvestment Ratio <u>2/</u>	Earnings	Gross Dividends <u>1/</u>	Reinvested Earnings	Reinvestment Ratio <u>2/</u>
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: U.S. Department of Commerce Survey of Current Business, various issues.

1/ Before host country withholding taxes on dividends.

2/ Reinvested earnings as a proportion of total earnings.

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 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 that the maturity structure is more in line with the underlying investments than is that of commercial loans. This helps a country 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 the loans over.

A larger share of direct investment in capital inflows is likely to make the latter 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 will therefore be encouraged by an exchange rate policy that maintains international competitiveness. A real exchange rate depreciation may decrease the profitability of direct investments in enterprises

^{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.

whose output is less traded than inputs. Investment in public utilities or in the 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. 1/

Moreover, direct investment flows are only one component of the overall financing of the total capital expenditures of a foreign-controlled firm, and 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 reduce domestic financing of a firm's expenditures and encourage foreign direct investment, particularly during the initial period as the firm's stock of liabilities adjusts to the new interest rate differentials. Conversely, where direct investment in a country is substantial, it can significantly increase the costs of inappropriate policies. Affiliates of foreign-controlled companies have substantial opportunities to engage in short-term intracompany 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 Prospects and Policies for Future 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 foreign¹⁴ direct and portfolio 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 to maintain sufficient resource inflows to support an adequate growth rate, as well as to reduce vulnerability to any future deterioration in economic conditions.

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

The scope and need for a larger role for direct investment can be illustrated in the context of the medium-term scenario for developing countries prepared for the World Economic Outlook. ^{1/} 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, ^{2/} 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 policies toward direct investment, provided that the generally more encouraging policies of recent years toward direct investment are maintained and that the improvements in the world economic environment assumed in the medium-term projections in the World Economic Outlook of 1984 are 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 the total financing of the combined current account deficits 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 that had debt-servicing difficulties in recent years also generally attracted much less direct investment. 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. ^{3/} Consequently, many of the more heavily-indebted countries will need to make more substantial

^{1/} International Monetary Fund, World Economic Outlook, Occasional Paper No. 27 (April 1984) and Occasional Paper No. 32 (September 1984).

^{2/} 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.

^{3/} Group of Thirty (1984), op. cit.

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 seems likely, new bank lending to countries with large rescheduled debt expands less rapidly than lending to countries with less debt.

The initial direct impact on growth rates of more or less direct investment would probably be relatively small, since they finance only a small proportion of imports (around 2.3 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 (which means no growth in 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, through the loss of its contribution to efficient resource use and the technological and managerial expertise it transfers, 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 for 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, could in some countries 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 controls will pose less of a barrier to new investment, and the fiscal incentives 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. 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, recent experience 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 IFC involves the establishment of "national investment trusts." The basic concept is to establish a country-specific closed-end investment trust, which would issue shares denominated in foreign currency to participating commercial banks in exchange for a small proportion 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 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.

Although at present policies of industrial countries do not appear to present substantial barriers to outflows of direct investment and portfolio capital, some countries could further encourage such outflows to developing countries. This could be achieved by relaxing remaining restrictions (such as limits on the 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 to encourage investment into developing countries and to allow them 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, to increase the opportunities for profitable investment in those sectors where developing countries have demonstrated a comparative advantage.

Restrictions and Regulations Concerning Foreign Direct and Portfolio Investment in 25 of the largest 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 of the International Monetary Fund 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 channelled 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 Nacional 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	<p>All foreign investment subject to prior approval.</p> <p>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 reciprocal 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.</p>		<p>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.</p>	<p>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.</p>	
Egypt	<p>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.</p>		<p>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).</p>	<p>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).</p> <p>Repatriation of capital normally requires prior approval but this is generally granted provided the capital has been in Egypt for at least five years.</p>	
Hungary	<p>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.</p>		<p>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.</p>	<p>A guarantee is given for the transfer of the foreign investors' share of profits.</p>	<p>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.</p>

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 non-residents, 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 non-residents.	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 Board. 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 percent, 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 minimum 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 diversify 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 non-resident-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	<p>All foreign capital imported for investment purposes must be registered.</p> <p>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.</p>		<p>Certain activities (including most financial services, public services, broadcasting and communications) are reserved for "national" companies (i.e., with under 20 percent foreign ownership).</p> <p>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.</p>	<p>In accordance with Andean Pact rules, profit remittances are limited, in principle, to 20 percent a year of registered foreign capital.</p>	<p>The Central Bank regulates domestic bank credit to companies more than 50 percent owned by nonresidents.</p> <p>Royalty payments are prohibited between parent companies and their majority-owned subsidiaries</p>
Yugoslavia	<p>Foreign investment is permitted through joint ventures only.</p>		<p>Apart from exceptional cases, foreign investment is limited to 49 percent of a joint venture's capital.</p>	<p>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.</p>	<p>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.</p>

Some Comparisons of Movements in Income Payments on Direct Investment and External Debt and Host Countries' Ability to Pay

Any attempt to compare movements in rates of return on foreign direct investment and interest rates on external debt with measures of host countries' ability to support such payments is made difficult by the poor quality of much of the data on direct investment, and returns thereon, in many developing countries. There are two key problems. First, adequate time series on reinvested earnings are only available for a few developing countries. Second, 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. It is not clear whether this leads to an under or overestimation of the rate of return on direct investment. The rate of return is overestimated to the extent that the book value of the stock of investment is less than its true value at current market prices, but is underestimated to the extent that no account can be taken of the fact that, unlike debt instruments, the value of direct investment assets are likely to rise with inflation. Consequently, all comparisons between estimated rates of return on direct investment and market interest rates can only be approximate.

The two simplest measures of movements in a host country's ability to service its external liabilities are the rates of growth of its GDP and its exports. The greater the association between movements in income payments on external liabilities and in output, then the less reduction in expenditures is required to generate resources to meet the income payments. Similarly, the greater the association between movements in income payments on external liabilities and in export earnings, then the less is the need to transfer resources between traded and non-traded sectors of the economy to generate the necessary foreign exchange for income payments. This latter connection is less strong, however, because the need for expenditure switching policies is also affected by the scope for import substitution. Indeed, for many developing countries, particularly in Latin America, much of the external debt and foreign direct investment was accumulated in connection with import substitution rather than promotion of exports.

For a group of 12 non-oil developing countries (Brazil, Bolivia, Cameroon, Colombia, Costa Rica, El Salvador, Honduras, Israel, Jamaica, Mexico, Morocco, and Sierra Leone) with sufficiently long time series on reinvested earnings, rates of return on direct investment and average interest rates on external debt were compared with rates of growth of GDP and exports (both in dollar terms). Average rates of return and rates of growth were calculated for the group as a whole, on a GDP-weighted basis. The annual rate of return on direct investment was calculated as total income payments on direct investment (i.e., dividend and net interest payments plus reinvested earnings) as a percentage of the mean of the

of the estimated stock of direct investment outstanding at the beginning and end of each year. The average interest rate on external debt was calculated as scheduled interest payments as a percentage of the mean of the stock of external debt outstanding at the beginning and end of each year.

The average rate of return on direct investment was positively associated with the rate of 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 between 1974 and 1982 (Chart 5). By contrast, there was little association between the rate of growth of GDP and the average interest rate paid on external debt. Over the entire period, however, the estimated average return on direct investment, which--for the reason mentioned above--can only be used as a rough guide, was higher than the average interest rate on external debt (at around 11 percent and 8 1/2 percent, respectively), so that there may have been some positive trade-off between the risks and returns associated with equity and debt instruments.

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 GDP, in dollar terms, (g) in the host countries (all time series are GDP-weighted averages for the group of 12 countries). The regressions are not intended to be full models of the determinants of returns on direct investment or on external debt, but simply to illustrate the differences in their association with rates of economic growth.

$$\begin{array}{llll} \text{R.FDI} & = & 9.8 & + & 0.069^*g & R^2 & = & .51 & \text{D.W.} & = & 1.71 \\ & & (21.4) & & (2.72) & & & & & & \end{array}$$

$$\begin{array}{llll} \text{R.DEBT} & = & 9.7 & - & 0.088 g & R^2 & = & .16 & \text{D.W.} & = & 0.43 \\ & & (7.1) & & (1.15) & & & & & & \end{array}$$

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 (g.exp).

$$\begin{array}{l} \text{R.FDI} = 10.5 + 0.019 \text{ g.exp} \quad R^2 = .17 \quad \text{D.W.} = 1.72 \\ (17.7) \quad (1.21) \end{array}$$

$$\begin{array}{l} \text{R.DEBT} = 9.1 - 0.037 \text{ g.exp} \quad R^2 = .05 \quad \text{D.W.} = 0.28 \\ (6.60) \quad (0.60) \end{array}$$

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.

More comprehensive information is available for rates of return of direct investment from the United States in the manufacturing sectors of developing countries. ^{1/} For this investment, there appears to be a positive association between rates of return on direct investment in manufacturing (US.ROR) and 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:

$$\begin{array}{l} \text{US.ROR} = 8.57 + 0.309^{**}g \quad R^2 = 0.69 \quad \text{D.W.} = 2.46 \\ (6.97) \quad (3.98) \end{array}$$

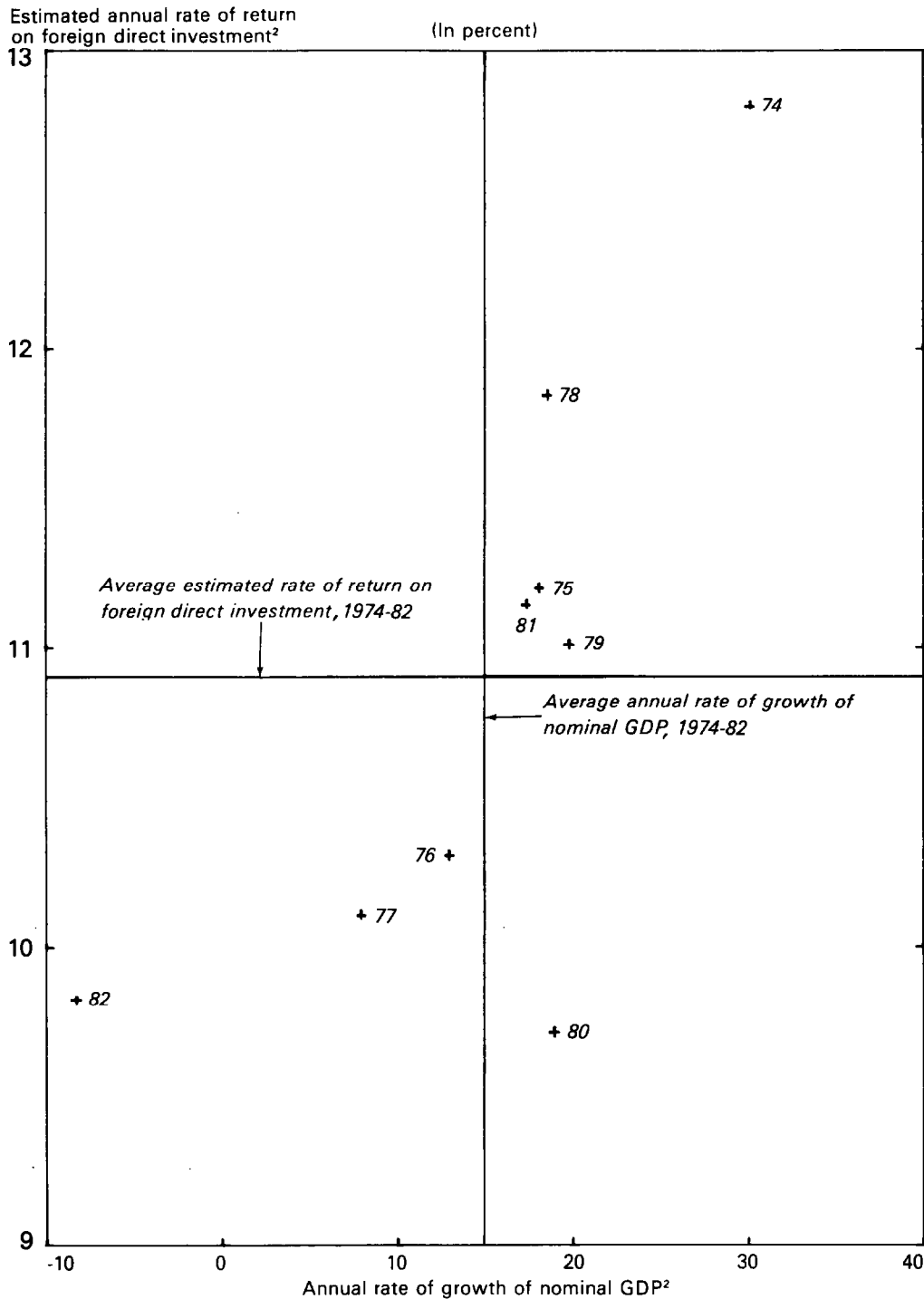
$$\begin{array}{l} \text{US.ROR} = 10.70 + 0.118 \text{ g.exp} \quad R^2 = 0.26 \quad \text{D.W.} = 2.00 \\ (6.58) \quad (1.58) \end{array}$$

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 London interbank offer rate (LIBOR) on growth rates of non-oil GDP and exports yielded negative, and insignificant, coefficients.

^{1/} U.S. Department of Commerce, Survey of Current Business, various issues.

CHART 5

SELECTED NON-OIL DEVELOPING COUNTRIES¹
ANNUAL RATES OF GROWTH OF
NOMINAL GDP AND ANNUAL RATES OF
RETURN ON FOREIGN DIRECT INVESTMENT, 1974-82



¹This 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.

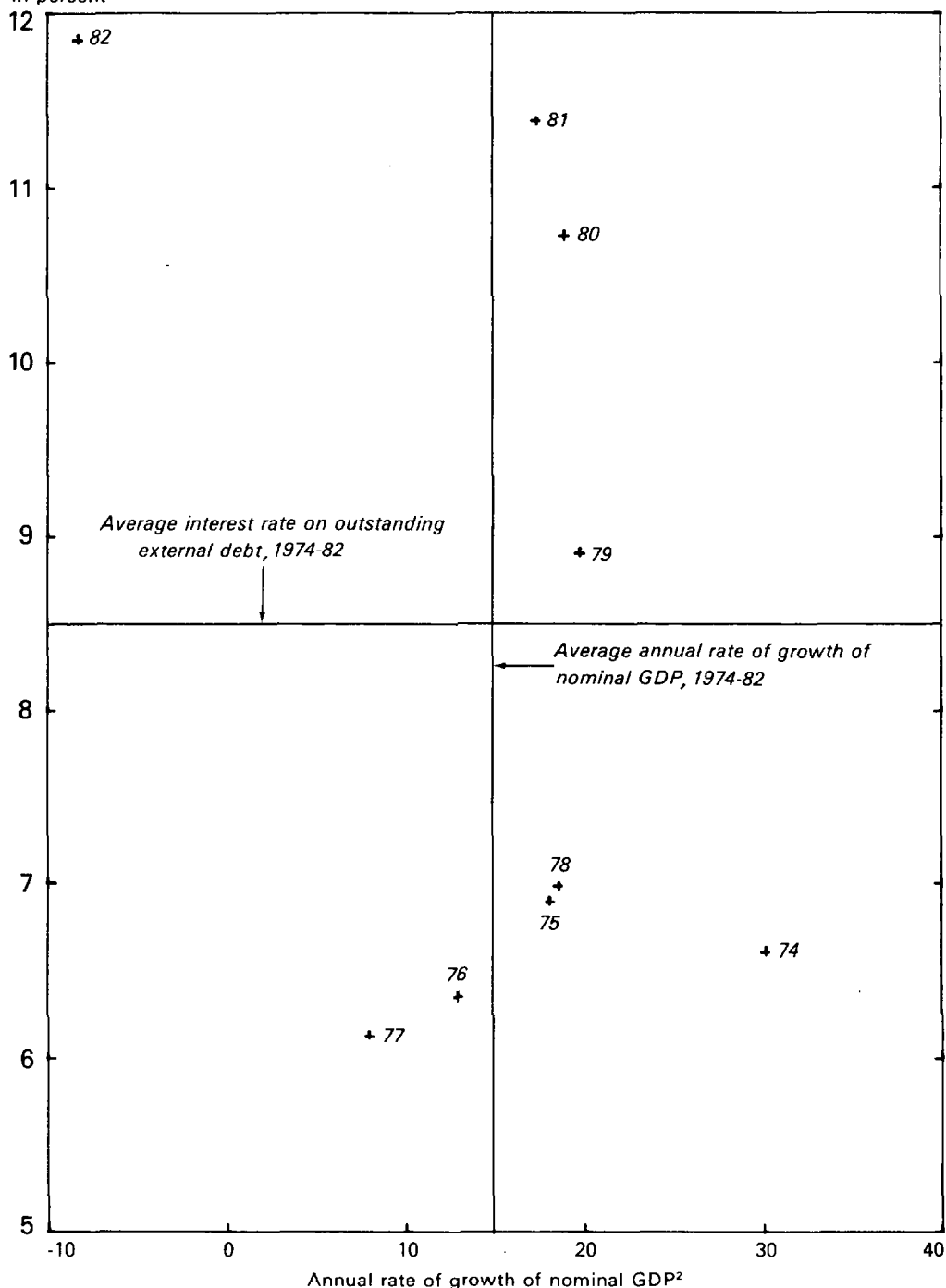
²Calculated as direct investment-related payments (i.e., dividend and interest plus reinvested earnings) as a percentage of the mean of the estimated stock of direct investment outstanding at the beginning and end of each period. The time series for stock of direct investment was derived by adding annual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



CHART 6

SELECTED NON-OIL DEVELOPING COUNTRIES¹
ANNUAL RATES OF GROWTH OF
NOMINAL GDP AND ANNUAL INTEREST
RATES ON OUTSTANDING EXTERNAL DEBT, 1974-82

Average annual interest rate on outstanding debt²
in percent



¹This 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.

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

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

(In billions of U.S. dollars)

	Average 1960-66 ^{2/}	Average 1967-73 ^{2/}	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
Export Credits	0.7	2.1	2.5	4.1	6.8	8.5	9.9	9.4	11.5	10.5	7.3
Other non-concessional (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)
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	<u>9.2</u>	<u>17.9</u>	<u>22.0</u>	<u>40.1</u>	<u>46.6</u>	<u>52.0</u>	<u>71.2</u>	<u>75.8</u>	<u>75.6</u>	<u>89.7</u>	<u>83.7</u>

Source: Organization for Economic Cooperation and Development, 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. See Prefatory Note.

^{2/} Figures prior to 1972 exclude flows from New Zealand and Finland.

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

	Stock of Foreign Direct Investment ^{1/}			Total Outstanding External Debt 1983 ^{2/} (In billions of U.S. dollars)	Share of Foreign Direct Investment in Total Gross External Liabilities 1983 ^{3/} (In percent)
	1973 (In billions of U.S. dollars)	1983 Estimate (In billions of U.S. dollars)	Average Annual Growth, 1973-83 (In percent)		
Seven major borrowers ^{5/}	<u>20.0</u>	<u>59.6</u>	<u>11.5</u>	<u>350.1</u>	<u>14.5</u>
Argentina	2.5	5.8	8.8	44.4	11.6
Brazil	7.5	24.6	12.6	88.0	21.8
Indonesia	1.7	6.8	14.9	30.4	18.3
Korea	0.7	1.8	9.9	38.9	4.4
Mexico	3.1	13.6	15.9	89.4	13.2
Philippines	0.9	2.7	11.6	23.9	10.9
Venezuela	3.6	4.3	1.8	35.1	10.9
Non-oil developing countries	<u>47.0</u>	<u>140.9</u>	<u>11.6</u>	<u>685.5</u>	<u>17.0</u>
of which:					
Algeria	0.3	0.7	8.1	13.3	5.0
Chile	0.5	3.0	19.6	14.1	17.5
Colombia	1.0	2.6	10.0	10.7	19.5
Egypt	0.1	2.1	35.6	24.0	8.0
Hong Kong	0.9	4.2	16.7	5.5 ^{4/}	43.2
Israel	0.2	1.2	19.6	22.6	5.0
Malaysia	1.2	6.2	17.8	15.9	28.1
Morocco	0.3	0.7	8.8	12.1	5.5
Nigeria	2.3	2.0	-1.4	17.7	10.2
Pakistan	0.5	1.2	9.1	9.7	11.0
Peru	1.0	2.5	9.6	12.4	16.8
Portugal	0.2	1.1	18.6	14.4	7.1
Singapore	0.6	7.9	29.4	0.7 ^{4/}	91.9
South Africa	8.4	17.1	7.4	17.4	43.8
Thailand	0.5	1.4	10.8	14.2	9.0
Turkey	0.4	1.2	11.6	17.5	6.4
Yugoslavia	0.1	0.2	7.2	16.9	1.2

Source: Fund staff estimates.

^{1/} The 1983 end-of-year stock figures equal the estimated book value of the stock of direct investment from industrial countries at the end of 1978 plus total direct investment flows during 1979-83.^{2/} End-of-year; includes short-term debt, but not reserve-related liabilities.^{3/} Total Gross External Liabilities are defined as Stock of Foreign Direct Investment plus Total Outstanding External Debt.^{4/} Excludes short-term debt.^{5/} See note 2, Chart 2.

Table A.3. Industrial Countries: Stock of Foreign Direct Investment in Developing Countries, 1970-82 ^{1/}

	1970 (In billions of U.S. dollars)	1982 (In billions of U.S. dollars)	Average annual growth rate, 1970-82 (In 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	<u>42.7</u>	<u>141.1</u>	<u>10.5</u>

Source: Organization for Economic Cooperation and Development, Investing in Developing Countries, 1983; Development Cooperation, 1983.

^{1/} End-of-year figures. Uses OECD definition of developing countries, which differs from Fund classification. See Prefatory Note.

^{2/} Excludes official support for private investment (estimated at over \$6 billion).

^{3/} Austria, Denmark, Finland, New Zealand, and Norway.

STATISTICAL ANNEX

Table A.4. Non-Oil Developing Countries: Net Recorded Outflows of Foreign Direct Investment, 1973-82
(In millions of U.S. dollars)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Non-oil developing countries <u>1/</u>	146	228	270	335	333	520	338	1,425	1,039	856
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	-5 <u>2/</u>

Source: International Monetary Fund Balance of Payments Yearbook, various issues.

1/ Many non-oil developing countries (including Hong Kong and Singapore) do not report data on direct investment outflows.

2/ - implies net repatriation.

Table A.5. Four Industrial Countries: Sectoral Composition of Foreign Direct Investment Stock 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: Organization for Economic Cooperation and Development (OECD): Stock of Private Direct Investments by DAC Countries in Developing Countries, End-1967; United States: U.S. Department of Commerce, 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.