MASTER FILES

ROOM C-120 04

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/111

3:00 p.m., July 18, 1984

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	T. Ramtoolah, Temporary
	S. Kolb, Temporary
	X. Blandin
	M. Teijeiro
	J. Delgadillo, Temporary
	M. K. Bush
M. Finaish	
T. Hirao	T. Yamashita
J. E. Ismael	
	L. Leonard
A. Kafka	C. Robalino
G. Laske	
G. Lovato	N. Coumbis
R. N. Malhotra	
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	
	R. L. Bernardo, Temporary
	O. Kabbaj
	E. I. M. Mtei
	E. Portas, Temporary
	I. Fridriksson, Temporary
	T. A. Clark
	Wang E.

J. W. Lang, Jr., Acting Secretary
K. S. Friedman, Assistant

Also Present

Asian Department: S. Shah. Exchange and Trade Relations Department: M. Guitián, Deputy Director; S. Mookerjee, Deputy Director. External Relations Department: P. J. Bradley, R. M. Stough. Fiscal Affairs Department: E. S. Kreis. Legal Department: G. P. Nicoletopoulos, Director; A. O. Liuksila, J. K. Oh. Research Department: A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; D. J. Goldsbrough, A. Lanyi. Western Hemisphere Department: H. M. Flickenschild, P. Kohnert, C.-J. Lindgren. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, S. El-Khouri, W. Moerke, M. Z. M. Qureshi, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, I. Angeloni, J. Bulloch, M. Camara, Chen J., C. Flamant, V. Govindarajan, D. Hammann, L. Ionescu, J. M. Jones, M. Lundsager, G. W. K. Pickering, J. Reddy, D. J. Robinson, Shao Z., M. A. Weitz, A. Yasseri.

1. BOLIVIA - 1984 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/84/110, 7/18/84) their consideration of the staff report for the 1984 Article IV consultation with Bolivia (SM/84/141, 6/20/84; and Cor. 1, 7/12/84). They also had before them a report on recent economic developments in Bolivia (SM/84/100, 5/10/84; and Cor. 1, 6/21/84).

Mr. Clark commented that Bolivia's severe difficulties--a high rate of inflation, declining activity in the formal economy, and a heavy debt burden--reflected structural weaknesses, particularly inappropriate relative prices and an ineffective tax system, which had led to a decline in the proportion of tax revenues to GDP. The economy had also suffered from an inadequate administrative infrastructure and from what the staff had called a highly volatile political situation.

If fully implemented, the April 1984 package of measures would have a significant impact on the overall deficit of the nonfinancial public sector, Mr. Clark remarked. The new measures clearly demonstrated the authorities' recognition of the need to make substantial policy changes and to restore stable economic conditions if economic growth were to resume. However, considerable political difficulty in implementing the new measures seemed likely. Mr. Delgadillo's statement on the revised budget for the remainder of the present year and on the budget for 1985, which included a number of proposals to increase revenues and to restrain the overall growth of public expenditure, was welcome.

Commenting on the role of the Fund in Bolivia, Mr. Clark said that he supported the continued provision of technical assistance to strengthen administrative capacity and welcomed the authorities' request for additional assistance in the fiscal, monetary, and external debt areas. He hoped that, in due course, Bolivia would implement a Fund-supported program as a first step toward achieving a sustainable economic situation. Any stand-by arrangement for Bolivia would have to be supported by the political commitment needed to restore confidence in the economy. In that connection, the authorities would have to be willing to adopt and follow through on difficult decisions. They should act in ways that would help to maintain an adequate inflow of credit.

The staff representative from the Fiscal Affairs Department (head of mission) noted that Bolivia's relations with the World Bank in recent years had been strained. The most recent World Bank loan to Bolivia had been made in June 1980, and since then Bolivia had made net repayments to the institution. However, during the previous several months, a number of major projects had been discussed by the authorities and the World Bank. One of them, a restructuring of the state mining company, would involve participation by other countries. Another, a gas pipeline from Bolivia to Brazil, would require ten years to complete, and the amount of gas in Bolivia would have to be verified before it could be undertaken. A third project, to recover oil from secondary sources, could not be started until the very low price of gasoline in Bolivia--about $0.40 per gallon--was raised to approximately $1.00. A World Bank mission to Bolivia in June 1984 had informed the authorities that some $45 million in loans would be disbursed to the Government soon.

Mr. Delgadillo stated that his authorities were committed to correcting the present economic and financial imbalances in Bolivia. They were aware that further adjustment was needed and that they would have to adopt simultaneously a number of politically difficult and controversial measures.

Executive Directors' strong support for an increase in the Fund's technical assistance to Bolivia was encouraging, Mr. Delgadillo remarked. His authorities had always attached great importance to the Fund's advice, were keenly interested in negotiating an arrangement with the Fund, and understood that additional steps in the adjustment process would have to be taken. Additional technical assistance by the Fund and the World Bank would help them to formulate a program that could qualify for the financial support of both institutions.

The Chairman made the following summing up:

> There was broad agreement among Executive Directors with the views on economic policies expressed in the appraisal of the staff report for the 1984 Article IV consultation with Bolivia. Directors expressed great concern about Bolivia's severe economic situation, which included large internal and external imbalances. They noted that the Bolivian authorities have made a number of courageous attempts in the recent past, and in particular with the April 1984 package of measures, to stabilize the economy, but that those attempts have not met with success. Directors observed that the poor performance of the economy and the rapid deterioration of the financial situation were attributable in part to the volatile political situation and to frequent changes in the economic team.
>
> Directors stressed that, in order to achieve the stabilization objectives, any package of policy measures had to be comprehensive, applied consistently, and maintained for a sufficiently long period.
>
> Directors viewed with great concern the progressive worsening of the fiscal situation. The loss of control over expenditure of the Central Government and of the operations of public entities was noted as a very serious problem, as was the erosion of the machinery for tax collections. Directors remarked that the large public sector deficit had resulted in a major credit and monetary expansion and a sharp acceleration of inflation. Given the high rate of inflation, exchange rate management had not been sufficiently flexible and there had been recurring episodes of currency overvaluation.

Directors emphasized that strong fiscal action, covering both revenue and expenditure, was necessary to reduce the fiscal imbalance to a manageable level and to ensure that credit expansion by the Central Bank was brought under control to permit private investments to be financed. An appropriate fiscal plan would need to include a broadening of the tax base, the indexation of tax liabilities to inflation, and improvements in tax administration. More effective control over public spending was required, including a wage policy consistent with the slowing of inflation. The reorganization of the administrative and financial structure of the state enterprises also was considered necessary.

Directors noted the need to strengthen monetary and credit control, including action to raise interest rates to positive levels in real terms.

Directors stressed the need to adjust the exchange rate as necessary, to ensure the competitive position of the Bolivian economy, and to protect the balance of payments. They emphasized that maintaining a fixed exchange rate for long periods at a time of high inflation had adverse effects on production and distorted resource allocation. In this respect, Directors noted that, as the peso had appreciated by over 100 percent since the last devaluation in April 1984, there was an urgent need for exchange rate adjustment. In view of the high inflation rates being experienced by Bolivia, a policy of frequent adjustments of the exchange rate was greatly needed.

Directors noted the severity of the country's external debt servicing problem in a situation in which foreign exchange reserves were depleted. It was also noted that many of Bolivia's creditors have expressed willingness to help the country with additional economic assistance and debt relief, provided that the authorities are willing to implement a comprehensive economic program which eventually would qualify Bolivia to use Fund resources.

In sum, Bolivia needed to undertake major, far-reaching adjustment measures and implement them in a steadfast fashion for an extended period. In addition to better policies, economic control and management needed to be strengthened. Also, a substantial improvement in the availability and quality of economic data was necessary for effective implementation of such measures. Directors said that the Fund should provide technical assistance in the relevant areas.

Further cooperation in the framework of a valid program could only be developed on the basis that financial assistance would be used effectively by the authorities.

It is recommended that the next Article IV consultation with Bolivia be held on the standard 12-month cycle.

2. FOREIGN DIRECT AND PORTFOLIO EQUITY INVESTMENT IN DEVELOPING COUNTRIES

The Executive Directors considered a staff paper on foreign direct and portfolio equity investment in developing countries (SM/84/145, 6/26/84).

Mr. Polak remarked that the staff had made the important assumption that foreign investment and commercial bank financing were close substitutes. In fact, they were not: in recent years, bank credit, obtained mainly by governments to finance balance of payments deficits, had been essentially supply-determined, while direct investment had resulted from foreign corporations' decisions to support profit-oriented enterprises in host countries. A recent report by the Group of 30 showed that the trend in direct investment had been away from equity capital and borrowing by enterprises from parent companies or affiliates, and toward greater reliance on reinvestment of earnings. The trend was understandable, as investors normally tried to match the currency in which earnings were made--usually the currency of the host country--with the currency in which investments were denominated; and the trend would be accentuated if the present widespread restrictions by host countries on access to local credit were reduced.

It was important to distinguish between two forms of direct investment, namely, the take-over of an established enterprise, and the start of a new enterprise, which typically involved purchases outside the host country of technology and machinery, Mr. Polak said. The staff had not mentioned the connection between the positive effect on the balance of payments of foreign direct investment flows and the negative effect of purchases of technology and equipment outside the host country. Still, direct investment in developing countries was certainly desirable, and one of the main questions was how much room developing countries had to encourage and accept it. At first glance, the fact--mentioned on page 7 of SM/84/145--that just five countries accounted for half the estimated end-1983 stock of direct investment in non-oil developing countries suggested that there was ample room for increasing direct investment in other non-oil developing countries. Actually, however, the opportunities for such investment in many developing countries were limited for a number of reasons.

He did not agree with the staff that protection had tended to discourage foreign direct investment, Mr. Polak went on. After all, such investment was designed to enable an investor to gain access to the domestic market of a host country; accordingly, an increase in protection in the world might well encourage direct investment, a conclusion that the Group of 30 had recently reached. It was probably for that reason that direct investment had held up relatively well during the recent world recession.

The staff had not addressed the question of the competition for direct investment between developing and industrial countries, Mr. Polak noted. The report by the Group of 30 stressed that some two thirds of total direct investment took place in industrial countries, and only about one third in developing countries. And a significant increase in indirect investment in the form of capital flows to developing countries in the short or medium term seemed unlikely. Even one of the developing countries in his constituency--namely, Israel--that had no restrictions on direct investment and had good access to the EC market, had not received as much direct investment as some small industrial countries in Europe.

He agreed that an increase in direct investment could play a far greater role than hitherto in the transfer of resources to developing countries, Mr. Polak went on. The most important effect of increased direct investment was on a country's development process--through associated transfers of technical and managerial resources--rather than on its balance of payments through transfers of capital.

Because of its multifaceted nature and the long time member countries typically took to make needed regulatory changes affecting it, foreign direct investment should be the primary responsibility of the World Bank, not the Fund, Mr. Polak considered. A systematic account of the World Bank's experience and plans relating to direct investment would be helpful. The World Bank obviously attached great importance to direct investment, which was to be examined in detail in the 1985 World Development Report.

The most important contribution the Fund could make was to encourage member countries to maintain appropriate macroeconomic and financial policies, Mr. Polak said. The Fund should not make direct investment policy the subject of performance criteria; a member country's decision to cut itself off from such investment would probably hurt its development effort, not its balance of payments position. It was important to stress that foreign direct investment could stimulate both growth and development and should certainly be encouraged. However, in its consultations with member countries the Fund need not pay greater attention than hitherto to developments and policies regarding direct investment. Not all aspects of a member country's policy stance had to be systematically included in the Fund's consultation discussions, and it was important to avoid overloading the consultation process with subjects not of essential importance to the Fund's work. Reports on recent economic developments could usefully indicate important new developments with respect to foreign direct investment, but the Fund normally should not take a view on a member country's policies on such investment.

Mr. Ramtoolah remarked that foreign investment could play a positive role in the development process, and that all the member countries in his constituency welcomed any foreign financing that suited their needs. However, no country could hope to attract foreign investment unless it was sufficiently endowed with natural resources and had either a large domestic market, preferential access to other markets, or both. Member countries not possessing those characteristics had to resort to other sources of finance for their investment programs, even if they maintained attractive policies on foreign investment. Moreover, some projects, particularly those with long gestation periods and those in the areas of health and education, were unlikely to attract foreign direct investment. Consequently, the substitutability between foreign borrowing and investment should not be overstated; borrowing was essentially demand-determined, while foreign investment was mainly supply-determined.

In some circumstances, Mr. Ramtoolah continued, foreign borrowing could also be supply-determined--for instance, when holders of substantial short-term deposits sought attractive investments, as had happened after the 1974 and 1979 oil price increases. Hence, he did not agree with the staff conclusion on page 2 that "nevertheless, policies adopted by many developing countries seem to have contributed to a greater reliance on bank credit rather than foreign equity investment." In fact, non-oil developing countries had had no choice but to finance the sudden increase in their current account deficits resulting mainly from oil price increases, and bank credit had been readily available as a result of both competition among banks and substantial increases in their short-term deposits. At the same time, from the developing countries' point of view, their inflows of foreign investment had continued to depend on factors essentially beyond their control. Given all those factors, commercial bank borrowing's crucial importance in the 1970s was hardly surprising.

Protection was a serious impediment to the normal flow of foreign direct investment and to the ability of developing countries to reap the benefits of such investment, Mr. Ramtoolah remarked. For instance, Mauritius had successfully implemented an investment program concentrated mainly in textiles, in which it enjoyed a comparative advantage, but three industrial countries had imposed quotas on its exports, thereby making it difficult for Mauritius--which had relatively small domestic markets--to reap the economies of scale necessary to make the textile enterprises profitable. Investing countries could encourage direct investment by eliminating barriers to developing countries' exports.

As for host countries, Mr. Ramtoolah went on, the staff had concluded on page 37 that "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." It remained to be seen whether the unprecedented effort by non-oil developing countries to implement adjustment programs, their recent successful demand management policies, and their efforts to increase efficiency, reflected in the dramatic decline in their current account deficits, would result in a major increase in foreign direct investment. In a recent paper, the Group of 30 had stressed that "the factors which do not influence foreign direct investment, or hardly so, are as interesting as those that do. Political stability and labor cost advantage in most countries were ranked very low among the influences on foreign direct investment decisions. Even inducements offered by most countries are rated as marginal." At best, developing countries had limited room for maneuver to increase inflows of foreign direct investment which, after all, were essentially supply-determined.

The Fund was already paying considerable attention to member countries' policies with regard to direct investment, Mr. Ramtoolah commented. In so doing, it relied to a considerable extent on analysis by the World Bank. He doubted whether there was anything more that the Fund could and should do in the specialized area of assessing foreign direct investment in a particular country.

Mr. Finaish noted that the case for a more rapid growth of foreign direct and equity investment could be approached from two angles: first, its role in maintaining an adequate volume of capital flows to developing countries and, second, its role in raising the quality of those flows. With respect to the former, in view of the recent sharp reduction in the flow of private bank finance to developing countries, and the likelihood that the availability of such finance would remain constrained in the future, a greater part of the financing needs of those countries in the coming years to maintain adequate growth rates and provide for orderly adjustment would probably need to be met from other sources, including official development assistance, other official bilateral and multilateral lending for development, as well as general balance of payments financing, and foreign direct and equity investment. Reflecting the much more rapid growth of bank lending over the past decade or so, the shares of all those other sources in total financial flows to developing countries, and not only that of foreign direct and equity investment, had fallen appreciably. Indeed, for most of that period, the rates of growth of the various components of official flows to developing countries, in particular official development assistance, had not appeared to be much higher than that of foreign direct and equity investment, and had been outstripped by growth in private bank lending by broadly the same margin. While trends in official sources of external finance had not been discussed in the paper, it was useful to take them into account to put the matter of the changed composition of financial flows to developing countries in full perspective. To the extent that the contraction of bank credit was going to cause the availability of external finance to developing countries to fall short of their future requirements, the gap would have to be filled through increased flows from a combination of other sources. Part of that increase in the share of nonbank financing could well come from foreign direct and equity investment, if suitable conditions for an increase in such investment existed. However, it was useful to note that, given the much larger weight of official flows of various kinds in total flows to developing countries, future trends in those flows would remain more important.

It had been argued, Mr. Finaish continued, that increasing the share of foreign direct investment in total capital flows to developing countries would improve the quality of the flows because of its greater stability relative to bank lending, and because of the relatively favorable match between the investment's maturity structure and the financing of the investments. However, official development assistance had the same advantages, and a relative increase in either foreign direct investment or official development assistance could help to stabilize financial flows to developing countries, while reducing their need to resort to short-term bank lending to finance long-term investment, a pattern that had contributed to the intensification of debt servicing problems in recent years. Achieving a better maturity structure for financing of development projects could also be accomplished by increasing the share of long-term bond issues in total financing. The access of developing countries to bond markets remained limited, but it could be enhanced through appropriate international action.

Foreign direct investment, however, had some additional distinct advantages over other sources of external finance, Mr. Finaish continued. One was that risks associated with such capital inflows were shared by foreign investors; since the magnitude of income payments on foreign investment depended on the profitability of projects it financed, the servicing of such capital inflows could create less difficulties than servicing payments on debt finance in periods of economic disturbances and adjustment to them. The other possible advantage of foreign direct investment was the combination of a capital inflow with an inflow of technological and managerial resources. The first of those two characteristics of foreign direct investment had received particular attention recently, and was the main factor augmenting interest in the promotion of such capital flows, in view of the severe intensification of difficulties faced by many developing countries in servicing the rapid accumulation of their external liabilities in the form of debt finance, especially from private sources. It was true that, because of that characteristic, a larger share of foreign direct and equity investment in total capital flows to developing countries could serve to raise the overall quality of those flows by reducing the risk assumed by those countries on their external liabilities and their vulnerability to economic disturbances on that score, a consideration that was particularly relevant for countries with an already high level of indebtedness.

The host countries needed to balance the advantages of foreign direct investment against some of its possible adverse effects, such as foreign domination of domestic industry, loss of local autonomy, a weakening of indigenous enterprise, unfair or excessive exploitation of natural and human resources, extraction of excessive profits, and inappropriate transfer pricing policies, Mr. Finaish noted. The history of the foreign direct investments of big industrial-country based oil companies provided an illustration of some of those costs. A policy to promote the role of foreign direct investment must, therefore, seek to realize the advantages associated with that type of resource inflow while minimizing the possible costs to host countries that it might entail. It was also worth pointing out that the potential advantage to the host country in servicing foreign direct investment relative to servicing debt finance--arising from the dependence of service payments on the former on its profitability--could be offset to the extent that the average rate of return on equity investment exceeded the average rate of interest on debt finance and to the extent that the impact of a decline in profits resulting from economic disturbance led to a fall in reinvested earnings rather than to lower dividend remittances.

He agreed with Mr. Polak that sources of external finance might not be easily substitutable, Mr. Finaish said. While foreign direct investment might play a greater role in financing longer-term development projects, by its very nature it was not a vehicle for short-term, general balance of payments financing. Moreover, foreign direct investment could not be counted on to increase rapidly in response to sharp increases in financing needs, as it depended on identification of individual opportunities for profitable investment. A large part of the rapid increase in recent years in the indebtedness of developing countries to private creditors was motivated by financing needs of the latter kind, as official financing of such needs lagged behind. In such circumstances, a significant decline in the share of foreign direct investment in total capital flows to developing countries was only to be expected, regardless of the policies of host countries toward those investments. In passing, he noted that the same considerations could not be invoked to explain that part of the decline occurring in the share of official flows.

For various reasons, the choice between alternative sources of external finance might not be available to all countries, Mr. Finaish continued. Many smaller low-income countries had been unable to attract significant inflows of foreign investment, despite offering substantial incentives, because of such factors as the smallness of the domestic market and the limited natural resource base. Certain noneconomic factors could also influence the direction of the flow of direct investment.

The inflow of technological resources that often accompanied foreign direct investment sometimes was not a genuine transfer of technology to the host country, as those resources often flowed from a parent company to an affiliate in the host country that retained close control of the resources, Mr. Finaish remarked. That situation was particularly likely when new and more advanced technology was involved.

The staff had correctly stressed that investing countries could make a fundamental contribution to encouraging foreign direct and portfolio equity investment by reducing barriers to the exports of host countries, thereby enhancing the prospects of export-oriented investment, Mr. Finaish commented. It would also be helpful to make foreign investment available in flexible ways, rather than in rigidly established packages. Host countries should have more flexibility to choose among the various components of foreign investment, namely, capital and technological and managerial resources. Investors should consider optional arrangements for increasing local participation in equity and management, including various forms of joint ventures that could be encouraged by such agencies as the International Finance Corporation (IFC). More effective codes of conduct for transnational corporations and for the transfer of technology to developing countries would also be helpful. Investing countries could also expand their insurance schemes for investment abroad. At present, such schemes covered only a small fraction of industrial countries' investment in developing countries. In that connection, creation of the multilateral insurance scheme that had been under consideration by the World Bank could help both to increase the total flow of direct foreign investment in developing countries and to widen its dispersion among those countries; direct foreign investment had been highly concentrated in a small number of high-income developing countries.

The staff had correctly noted that the host countries' policies that could have the greatest impact on investment inflows were overall macroeconomic policies, affecting domestic financial stability, external balance, and the efficiency of resource use, Mr. Finaish remarked. Appropriate financial policies and relative prices could not only encourage larger investment inflows but also contribute to increasing net benefits to host countries from such investment. Some liberalization of policies directed specifically at foreign investment could also encourage larger inflows where such policies had been an important inhibiting factor. However, it was important to appreciate that host countries' specific policies on foreign direct and equity investment reflected a number of considerations, including the country's economic philosophy, its development strategy, past experience with foreign investments, and a desire to regulate the inflow of new investments to minimize associated costs, real or perceived. Apprehensions about foreign direct and equity investment were not confined to developing countries. Groups in some industrial countries had been apprehensive about the increase in such investment in their countries by oil exporting countries. To the extent that restrictions on foreign direct investment reflected developing countries' concern about possible adverse effects, measures that could serve to establish greater confidence in the host countries in its potential benefits and allay their apprehensions could be instrumental in the adoption of more liberal and flexible policies. Some developing countries had recently tended to liberalize their policies on foreign investment because of the increased willingness of investors to use arrangements such as joint ventures and minority equity participation that were well suited to the sensibilities of the host country.

A stable economic environment, appropriate financial and exchange rate policies, and a more open trade and payments system were probably at least as important for encouraging foreign direct investment as host countries' policies relating specifically to such investment, Mr. Finaish considered. The Fund, in exercising its surveillance function and its jurisdiction under Articles VIII and XIV, already indirectly promoted foreign direct and equity investment by encouraging member countries to maintain appropriate domestic policies and an open trade and payments system, and that seemed to be the best way in which the Fund could encourage such investment in developing countries in the future. The Fund should not take a view with regard to a member's specific policies toward direct investment, such as those regulating its form, field of activity, and other terms; such matters were within the province of the IFC and World Bank, and not of the Fund. As Mr. Polak had stressed, consultations between member countries and the Fund should not be overloaded with matters that were not of direct relevance to the institution.

Ms. Bush considered that foreign direct investment could provide substantial and diverse benefits to developing countries and investors alike. The staff had correctly emphasized the usefulness of foreign equity capital as a substitute for debt-creating flows and had noted that foreign direct investment would have to increase 5 percent a year in 1986-90 merely to regain the level prevailing before the 1982/83 recession. Other benefits of foreign direct investment for host countries included a rise in domestic output, a broadening of the resource base from which public sector revenues were generated, an increase in employment opportunities and a consequent decline in the need for public social spending, the development of sectors requiring technical expertise not available domestically, and increased opportunities for profitable ventures by host country private sector companies operated jointly with foreign investors.

The staff had noted the general impact of investing countries' restrictions on investment, but it could have usefully investigated the effect of measures introduced by debtor countries to alleviate trade deficits and foreign exchange shortages, Ms. Bush continued. Many of those measures--such as import restrictions, local content requirements, and restrictions on transfers--reduced the ability of foreign-owned firms, as well as locally owned ones, to operate efficiently. The staff could also comment further on the significant adverse effects on foreign investment of performance and other requirements imposed by host countries on foreign investors; the effects were usually inconsistent with the developing country's economic development objectives.

The staff should study in detail the factors behind an investor's choice of possible investment forms, including participation in an existing enterprise, establishment of a new enterprise, and participation in a joint venture, Ms. Bush considered. Clarifying the relationship between such decisions and the transfer of real resources to host countries would be helpful in assessing the economic impact of foreign direct investment on developing countries.

Eliminating barriers to the flow of capital and improving the climate for investment in host countries would encourage foreign direct investment to expand to its natural limits, Ms. Bush remarked. Investing countries could sponsor missions to developing countries to investigate investment opportunities, and they could maintain export credit programs. Host countries should remove restrictions on foreign investment, including administrative barriers; give foreign direct investors the same treatment as domestic investors; ensure that contract terms were enforced; and provide adequate and effective compensation for any expropriated or nationalized enterprise.

In its consultations with members, the Fund should pay greater attention to developments and policies regarding foreign direct investment, which could make a substantial contribution to developing countries' economies in general, and could have a significant effect on their external accounts in particular, Ms. Bush stated. The Fund should take a view with regard to a member's policies toward direct investment if those policies were inconsistent with the country's adjustment effort. In sum, a good economic performance, and economic and political stability were needed to attract and keep foreign direct investment.

Mr. Kafka agreed with Mr. Polak that the elasticity of substitution between commercial bank loans and portfolio equity investment was not high.

The staff paper contained some imprecise statements, Mr. Kafka continued. For instance, on page 19 it was said that some countries reserved important sectors exclusively for state-owned enterprises; the staff should have specified which sectors were so reserved. In fact, in most countries other than the United States, those sectors were usually limited to public utilities; they did not comprise a wider range of activities, as might be supposed from the staff's general statement. Moreover, the statement on page 24 that "virtually all industrial countries pursue relatively open policies with respect to equity capital outflows" also lacked precision. In that connection, the text on the top of page 25 failed to emphasize the importance of restrictions in industrial countries on holdings of foreign securities--particularly those of developing countries--by insurance companies, pension funds, and other investors.

There were a number of gaps in the staff's presentation, Mr. Kafka considered. For instance, there was no analysis of the relationship between foreign direct and portfolio investment--not merely remittances or remuneration--in a developing country, or of such economic factors as the growth rate and degree of openness of the host country's economy. By failing to provide that analysis, the staff had given the impression that the main determinants of investment flows were restrictions and incentives in investing and host countries. In fact, other factors affecting equity capital flows mentioned by the staff on page 37 should be examined more closely. The economic effects of foreign portfolio investment should be carefully studied, despite the previous work on the subject by the IFC and other institutions. The relationship between the flow of foreign equity capital and the overall structure of investment particularly warranted further analysis. In general, infrastructure investment and residential construction had not been as attractive to foreign equity investors as directly productive investment.

The staff had asked whether more rapid growth of direct and portfolio equity investment in developing countries was a desirable goal of international economic policy for both investing and host countries, Mr. Kafka noted. Although many of the countries in his constituency favored an increase in such investment, the staff's question was so general that it was difficult to answer. The staff itself had not drawn any general conclusions, even on purely economic grounds, about the desirability of more rapid growth of direct and portfolio equity investment. It was useful to bear in mind that there was also an important political dimension to the question.

The staff had also asked what measures on the part of investing and host countries might be most useful in encouraging direct and portfolio equity investment, Mr. Kafka noted. In seeking an answer to that question the Fund would profit from the assistance of the World Bank and the IFC, which had primary responsibility for investment policy.

Another question posed by the staff was whether or not the Fund should pay greater attention to developments and policies with regard to direct investment, Mr. Kafka noted. The meaning of "greater attention" was not clear to him. In any event, members' policies concerning direct investment were not in the Fund's purview. The Fiscal Affairs Department might have useful advice to give on the tax treatment of foreign investment, but that should be the full extent of the attention paid by the Fund to foreign direct investment.

Similarly, Mr. Kafka went on, it was not clear to him what the staff had meant in asking whether or not the Fund should "take a view with regard to a member's policies toward direct investment." Did the staff believe that a number of countries should issue a declaration of policy intent, or that foreign direct investment should be the subject of performance clauses? Both actions would be entirely inappropriate; the Fund lacked the necessary expertise, and investment policy raised a number of delicate political issues that were not the Fund's concern. More important, even for countries with a stand-by or extended arrangement, the Fund should not attempt to deal with every policy or development that had a potential effect on the balance of payments. The Fund should not give member countries the impression that it wished to prescribe all their policies.

Mr. Nimatallah, responding to the first question raised by the staff on page 39, said that experience and the staff findings clearly showed that investment flows into developing countries were desirable. Developing countries obviously needed both loans and investment flows, but, while loans required continuous interest payments, investment income transfers from developing countries depended on the profitability of the investment.

It was important to have a clear understanding of the benefits of foreign private investment for both investing and host countries, Mr. Nimatallah continued. Potential investors normally looked for a favorable return on their investment and sufficient assurance of the safety of their investment. The host country normally expected benefits in the form of local purchases, training of domestic labor, transfers of technology, and financial gains. It could encourage investment inflows over the medium and long run by maintaining political stability and steady economic policies; fluctuations in policies could create uncertainty regarding, for instance, the likely course of interest and exchange rates, which could discourage direct investment. The host country could also provide both fiscal incentives to encourage an attractive return on investments, and a suitable legal and administrative framework to facilitate the movement of foreign investment and personnel.

Governments in investing countries should maintain economic policies that encouraged foreign investment and supported the comparative advantage of the host country, even if the investing country was losing its comparative advantage in the same industries, Mr. Nimatallah considered. Saudi Arabia had all the attributes required to attract investment: political stability, steady economic policy, simple administrative procedures, and fiscal incentives that provided a good return on investment. As a result, it had attracted huge investments from the United States and Japan in petrochemical industries, in which Saudi Arabia enjoyed a comparative advantage.

Investing countries must also reduce protection and avoid giving even the impression of interfering in the domestic affairs of host countries, Mr. Nimatallah continued. The apprehension of risk in those respects went far to explain the reluctance of potential host countries to open their economies to foreign direct investment.

Much of the financial support by industrial countries in the form of direct investment in developing countries was provided through public investment corporations, such as the IFC, Mr. Nimatallah noted. His authorities believed that that was a good channel for investment flows. In recent years, the IFC had played an increasingly important role in encouraging portfolio investment in developing countries, supported by the Saudi Arabian Government, which had provided the IFC with a large amount of capital to be invested in equity form in member countries.

Commenting on the third main policy question raised on page 39, Mr. Nimatallah said that, if the Fund were to pay greater attention to member countries' policies regarding direct investment, it should do so only with a view to helping to improve the climate for such flows. Only in that context should policies concerning direct investment be discussed during consultations with member countries; they should not be the subject of performance criteria. The Fund had helped to improve the climate for foreign direct investment by using a cautious, yet positive approach to member countries, but the main responsibility for enhancing such flows--which had a greater effect on development and growth than on the balance of payments--belonged to the Development Committee and the World Bank.

Mr. Malhotra considered that a major weakness of the staff paper was its implication that foreign direct investment was a close substitute for commercial bank lending. Most of the sharp increase in lending in the 1970s had been to governments requiring short-term balance of payments support and budgetary financing. Foreign direct investment flows had gone largely into industrial projects. It was untenable to suggest that, from the standpoint of balance of payments financing, foreign direct investment was more advantageous than commercial bank financing. Commercial bank financing had declined sharply in recent years, but direct investment flows had also fallen, from $13.1 billion in 1981 to $7.9 billion in 1983. Moreover, in the long run, as the staff had shown, dividend payments on foreign direct investments had understandably proved more expensive than commercial bank debt, as the outflow of dividends had not declined during periods of recession. What had declined was reinvestment, a trend analogous to the reduction in new commercial bank credit during such periods. It was therefore erroneous to suggest that developing countries could complacently count on such investment as a major financing source. As Mr. Finaish had stressed, developing countries had to rely on a variety of capital inflows, such as official development assistance, external bank credit, and foreign investment.

In assessing the usefulness of foreign direct investment, it was also important to note that equity investment was often accompanied by commercial bank loans, Mr. Malhotra remarked. In many instances, reliance on such loans was heavy, and, therefore, foreign direct investment flows did not obviate the need to service foreign debt. In any event, in most developing countries, the inflow of equity capital had not been very large.

He agreed with the staff that foreign direct investment had been concentrated in a small number of countries, and that the potential for increasing such investment in other countries was significant, Mr. Malhotra commented. Generally, developing countries had attracted foreign direct investment in limited areas of their economies, particularly the oil and mining sectors. Many of those countries lacked sufficient infrastructure, entrepreneurial talent, and trained manpower and were generally not attractive to foreign investors on the basis of comparative advantage. Such countries, therefore, had a clear need for long-term development finance. Moreover, studies had suggested that, in many instances, export-oriented industries had made only a small contribution by way of domestic value added and had depended heavily on imported inputs; they had thus not contributed much to strengthening the balance of payments.

He did not wish to give the impression that developing countries had a negative attitude toward foreign direct investment, Mr. Malhotra continued. In fact, many countries, including India, had a well-developed and positive policy of welcoming such investment where the need for cooperation with foreign investors, particularly for the infusion of new technology, was clearly established. His Indian authorities followed a policy whereby firms supported by foreign investment were treated the same as firms relying on domestic investment. There was no bar to remitting dividends or to other flows abroad by external investors in India. However, he emphasized that while foreign direct investment was desirable, its importance for a large number of developing countries, especially in the short run, should not be exaggerated.

The implication of the staff paper that developing countries' policies regulating foreign direct investment were necessarily inappropriate was worrisome, Mr. Malhotra commented. Foreign direct investment was a complex matter and, in his view, in the long run its regulation by host countries probably helped to promote such investment rather than to hinder it. In that context, he noted that the staff paper had not fully explained why many developing countries were apprehensive about the practices of multinational corporations. He also drew attention to the failure so far to finalize a code of conduct for multinational corporations despite a prolonged effort in the United Nations.

Foreign direct investment could play an important role in helping to transfer technology to developing countries only if it was suitably regulated by host countries, Mr. Malhotra remarked. There had been a growing reluctance by investors to transfer technology to developing countries, and such transfer was unlikely to occur if the host countries lacked sufficient bargaining power. In that connection, he thought that joint ventures could help to reduce the apprehensions of host countries. Given the complexity of issues regarding foreign direct investment, each country's policy would necessarily be based on its own particular experience, circumstances, and objectives; general policy prescriptions by the Fund or the World Bank might not be helpful.

There was no indication in the Articles that developments and policies with regard to foreign direct investment were central to the Fund's activities, Mr. Malhotra stated. Indeed, SM/84/145 was the first paper in the history of the Fund by which the staff had sought the Executive Board's guidance on the issue. If such investment was central to the Fund's concerns, it would certainly have been discussed by the Executive Board previously. In any event, the staff should not be overloaded with tasks that were not of crucial importance to the Fund; extensive staff work on foreign direct investment might well be counterproductive. Moreover, the involvement of international institutions in the area of foreign direct investment could undermine the positive trends already evident in several developing countries, whose governments would wish to maintain regulations on such investment while gaining a better understanding of potential investors. The process of encouraging foreign direct investment in India had picked up; there were already some 600 instances a year of such collaboration. He cautioned that if the general public and political groups felt that the Fund and the World Bank were pushing such investment, progress in that area could be slowed.

Mr. Clark said that, as his chair had often stressed the role that foreign direct investment could play in developing countries, the staff's review of the relevant issues was welcome. Direct investment certainly had a part to play, although perhaps not a dramatic one, in addressing the present debt problem. As the staff had shown, flows of direct investment had been, and were likely to remain, a relatively small part of total financing flows to developing countries, and the net balance of payments benefit of such flows was usually much smaller than the gross benefit. However, he agreed with the staff that there was scope for a substantial increase in direct investment, which was not true of other types of capital flows.

He would comment for the most part on direct, rather than portfolio, investment, mainly because the information on portfolio flows was sketchy, Mr. Clark continued. However, the potential importance of expanding capital markets in developing countries, enabling them, inter alia, to attract a wider range of investors, should not be overlooked. The recent activities in the field of national development trusts--the establishment of the Korea Fund in particular--were welcome.

Foreign direct investment had a number of attractive features, Mr. Clark noted: some of the risk was borne by the investor as well as the host country; the repatriation of dividends was more likely to be closely related to economic performance than was the payment of interest on commercial debt; a significant proportion of total earnings were likely to be reinvested in the host countries; and the maturity structure of direct investment was often more appropriate than that of commercial debt. But the most important advantages of foreign direct investment were probably structural rather than purely financial; for instance, the promotion of the transfer of technology and managerial expertise could benefit not only a particular project and sector, but also other sectors of an economy. In addition, because foreign direct investment was typically concentrated in the export or import-competing sectors, it made a relatively large contribution to the balance of payments of the host country.

At the same time, direct investment had certain actual or perceived disadvantages and did not always live up to expectations, Mr. Clark continued. Occasionally investments were made in inappropriate projects or in projects for which the supporting infrastructure was inadequate. As the staff had noted, the host country's policies--especially if they resulted in overvalued exchange rates, import restrictions, and artificially low domestic interest rates--were another important reason for disappointment with foreign direct investment. The more fundamental concern that direct investment could result in the loss of local autonomy was understandable and, in certain sectors, could be overriding, but it need not be a crucial factor in all cases and was often offset by the benefits of direct investment.

The modest short-term and substantial long-term benefits to be gained from encouraging direct investment flows should not lead to the conclusion that investment should never be financed in other ways, Mr. Clark considered. Direct investment was a useful supplement to other capital inflows, had many economic benefits, and had recently been underutilized as a channel for finance.

Basically, he agreed with the staff analysis of the measures needed to encourage direct investment, Mr. Clark remarked. The framework for such investment should be as simple, consistent, and stable as possible; for instance, "red tape" should be kept to a minimum. In addition, the understandable wish of host countries to impose conditions on direct investment in order to maximize its contribution to value added could cause difficulties. At best, the conditions could act as a disincentive to foreign investors and constitute a form of protection of local factors of production, resulting in a loss of efficiency; at worst, they could result in ineffective and unsuccessful investment that would benefit no one. Perhaps the most important step that host countries could take to encourage direct investment was to maintain a stable and consistent macroeconomic policy framework.

The policies of investing countries also played an important role in encouraging investment in developing countries, Mr. Clark continued. In the United Kingdom, for instance, the removal of capital controls in 1979 had allowed a substantial increase in portfolio investment overseas. However, as the staff had concluded, increased protection discouraged investment in the most productive locations and was a cause for concern. The presence of foreign firms in the host country might in some cases help to reduce the protection against that country.

Through its continuing dialogue with borrowing countries, the World Bank could help them to formulate appropriate policies on long-term investment, Mr. Clark remarked. The recently agreed doubling of the capital of the IFC should enable it to step up significantly its activities, particularly as a catalyst for private investment in areas where investors might otherwise feel reluctant to risk their funds. Bilateral institutions, such as the Commonwealth Development Corporation, also had an important role to play, and investment insurance schemes might be helpful, although it was too soon to say whether they should be national or multinational in nature.

In considering the role of the Fund in direct investment, it was useful to distinguish two aspects of such investment, namely, its impact on a host country's supply capacity, and its contribution to the country's capital account, Mr. Clark commented. The main responsibility for the effect of direct investment on supply capacity rested with the World Bank, but the Fund had an interest in the role of such investment in the capital account. It would therefore be helpful if Article IV consultation reports routinely included, at a minimum, a brief description of each country's policies on direct investment. Each report on recent economic developments in a member country could usefully include a list of the incentives and restrictions concerning investment, along with the detailed survey of tax regulations and protective measures that was already routinely included.

He wondered whether the staff, in computing rates of return on direct investment, had revalued capital to take account of inflation, and whether stock appreciation was excluded from the measurement of earnings, Mr. Clark remarked. If those adjustments had not been made, he seriously doubted the usefulness of the comparison of the rates of return in Charts 4 and 5.

Mr. Ismael observed, first, that in most developing countries the level of economic activity and of incomes was still low, national savings were not sufficient to finance the enormous development needs, and current account deficits had therefore been inevitable. Second, as the economies of most developing countries were vulnerable to changes in the pattern and overall volume of demand for their major export commodities, their economic growth and balance of payments position fluctuated with the business and economic cycles in the world economy. Third, most developing countries had to thread their way between a vulnerable balance of payments position and a pressing need for growth to provide meaningful employment opportunities for their growing labor force. The burden of adjusting to balance of payments fluctuations should not be placed entirely on external borrowing in order to keep countries' external debt within prudent limits, defined by the extent of their debt servicing capacity. Part of the necessary adjustment should be achieved by internal policy changes, which might impose hardships on the population. Fourth, the importance of foreign investment as a source of nondebt-creating flows should be recognized. It could help to lessen a country's need for external borrowing, thereby limiting its debt service burden. However, an increase in foreign direct investment should not be accompanied by a decline in official development assistance, another major source of nondebt-creating flows.

The desirability of increased direct and portfolio equity investment in developing countries depended on the particular conditions in the countries concerned, Mr. Ismael noted. In the area of general debt management, a correct mix of foreign borrowing and investment could play an important role in limiting the debt burden. At the same time, foreign investment could be used to maintain a country's development momentum without necessarily requiring the public sector to act as the prime mover of development.

The promotion of foreign investment was a complex matter, but it was difficult to spell out measures needed to establish a favorable investment climate, Mr. Ismael remarked. However, investment regulations should be kept as simple as possible, investment policy should be consistent with stable and coordinated overall policies, and economic and political stability should be maintained. Finally, he agreed with the comments of Mr. Polak and Mr. Kafka on the limited nature of the Fund's interest in its members' policies on direct investment.

Mr. Hirao accepted the thrust of the analysis in the staff paper, which provided a valuable overview of recent trends in foreign direct and portfolio investment. He agreed with the staff that there was some evidence that returns on direct investment were generally more positively correlated with changes in a country's ability to service those payments than were interest payments on external debt. During periods of economic adjustment, countries might have less difficulty in remitting payments abroad on foreign direct investment than in making interest payments on foreign borrowing. He tended to agree with the staff that, since the future external financing needs of many developing countries could considerably exceed their access to international bank credit, it was desirable and important for such countries to make a sustained effort to promote the growth of direct and portfolio equity investment.

Encouraging direct investment through the establishment of a national investment trust--by the IFC--and a multilateral investment insurance scheme should be further studied, Mr. Hirao considered, although technical innovations alone would not cause direct investment flows to increase substantially in the coming period. Host countries would have to maintain sound macroeconomic policies designed to sustain appropriate prices and exchange rates and a favorable overall economic environment. He agreed with the staff's conclusion on page 18 that "a few countries with relatively small domestic markets...that pursued open economic policies and maintained few restrictions on foreign investment were able to attract substantial export-oriented direct investment...." Stable economic prospects, the availability of trained workers, and the existence of supporting communications and transportation networks probably had also been an important factor in the degree of direct investment in those countries.

The reduction of protection in investing countries would significantly contribute to increasing investment flows to developing countries, Mr. Hirao continued.

The Fund should analyze a member country's policies regarding direct investment if it was thought to be a factor in the country's future flows of foreign exchange, Mr. Hirao concluded.

Mr. Lovato remarked that foreign direct investment had three essential aspects: financial, in the form of investment flows and income on investment; structural, as it was often associated with inflows of managerial and technological resources; and political, owing to the influence of the investor on the host country's economic affairs. The first and third aspects were more directly relevant to the Fund than the second one.

In the years ahead, the role of direct investment could be substantial in heavily indebted developing countries requiring large financing despite successful adjustment programs and because of the gradual decline in commercial bank lending, Mr. Lovato went on. The staff could have usefully provided a more detailed analysis of the determinants of such investment, particularly the restrictions in world financial markets. The restrictive policies of host countries, too, had apparently limited the opportunities for direct investment flows.

The sound financial and external policies promoted by the Fund helped to increase international confidence, thus encouraging foreign investment, Mr. Lovato remarked. The Fund could help host countries not only to maintain high-quality policies, but also to reduce administrative obstacles to foreign investment.

Mr. Mtei commented that much had already been written about the costs and benefits of direct investment and the factors that made a host country attractive to foreign investors. As foreign direct investment was a complex issue, he would have preferred to examine it in a seminar, giving Executive Directors an opportunity to hold a more wide-open discussion. In any event, he doubted whether the Fund had either the jurisdiction or the expertise to consider fully the subject of direct investment in developing countries. And he was worried that, even if a formal decision was not adopted, a summing up of the present discussion might lead the staff to take positions on member countries' policies regarding foreign investment, with far-reaching consequences for the Fund's surveillance effort. The Executive Board should resist the temptation to involve the Fund in every aspect of the economic life of member countries; the Fund was clearly not suited to play the role of an international policeman in the direct investment field. For the sake of efficiency, the Fund should concentrate its efforts on areas where it was most proficient, leaving the main responsibility for direct investment to the World Bank and the IFC.

Some developing countries could benefit from a large inflow of direct investment, not only financially, but also because of the transfer of managerial and technological know-how, Mr. Mtei remarked. However, it was presumptuous to assume that direct investment should be an objective of all developing countries, some of which had good reasons for limiting such investment in their economies in general, and in certain sectors in particular. Some of the reasons were political in nature and were therefore beyond the Fund's jurisdiction. The institution should avoid linking its assistance to a member country with the authorities' policies regarding direct investment. In any event, it could not be presumed that direct investment resulted in a net capital inflow and in accelerated economic growth in the host country. As direct investment flows typically financed only a small portion of non-oil developing countries' imports, they did not make a large contribution to relieving the import compression that had been a major constraint on economic growth in those countries. In addition, since investment decisions were made on the basis of profitability, attempts to repatriate capital were likely during economic downturns, thereby worsening the host country's balance of payments position during difficult periods. Policies aimed at attracting foreign investment should be based on the specific circumstances of individual countries; broad generalizations resulted in proposals for simplistic solutions to what was in fact a complex problem.

Industrial countries must keep their markets open to finished and semifinished products of developing countries, Mr. Mtei said. It was inconsistent for them to encourage developing countries to maintain outward-looking policies while they themselves implemented inward-looking policies that protected inefficient domestic industries.

The analysis in, and scope of, the staff paper could usefully be expanded, Mr. Mtei remarked. For instance, little effort had been made to explain why similar policies had had broadly varying results in different member countries. In particular, some countries with fairly strict rules on foreign ownership had been relatively successful in attracting direct investment, while others with the same rules had not. In addition, the staff had underemphasized the factors that determined the attractiveness of the host country, such as the size of the domestic market, the country's suitability for export-oriented production, its natural resource endowment, and its concern about the potential loss of domestic control over local enterprises. Instead, the staff had emphasized host countries' macroeconomic policies. Those policies were of course important but, under the staff's unbalanced approach, they were wrongly blamed for low rates of foreign investment in some host countries.

There was no clear-cut evidence supporting the staff conclusion that the most important step host countries could take to increase the inflow of direct investment was to maintain appropriate macroeconomic policies, Mr. Mtei continued. In that connection, it was difficult to distinguish the staff conclusions based on empirical evidence from those based purely on judgment. For instance, he wondered whether there was evidence supporting the conclusion on page 20 that a host country's restrictions of foreign-owned firms' access to its capital markets were a part of a wider design to insulate the domestic financial system so that the authorities could maintain noncompetitive interest rates. It could be argued that, even if interest rates in those countries were the same as rates abroad, the capital restrictions were meant to encourage capital inflows and to protect local firms from being crowded out of the domestic capital market by large multinational corporations, which were obviously more creditworthy than many local enterprises. In addition, he doubted whether there was any evidence that a policy of increasing interest rates toward market-clearing levels was likely to result in an increase in foreign direct investment.

The staff paper had not adequately discussed developing countries' concerns about possible adverse consequences of foreign direct investment, Mr. Mtei remarked. The acknowledgement of those concerns on page 14 was diluted by the implication that developing countries should pay more attention to implementing correct domestic policies in order to gain the maximum benefits from direct investment. In fact, some developing countries had learned from experience that investors were not always concerned about their development goals and did not act in good faith. He wondered why the staff had chosen not to examine the important role of multinational corporations in total investment flows. The staff would have given a fuller picture of the overall situation by examining the structure and global strategy of those corporations. It should have also included data on investment by regions, which presumably would underscore the uneven distribution of direct investment among member countries. Further comments on the investment outlook for Africa, and on the experience of countries that had not restricted foreign investment, would have been helpful. A number of developing countries had been unable to attract direct investment, even though they had no restrictions on such inflows.

The examination of issues concerning direct investment should not shift attention away from the need for commercial banks, multilateral agencies, and bilateral donors to increase the flow of their resources to developing countries, Mr. Mtei considered. Direct investment could complement, but could not substitute for, such flows, which developing countries needed to bolster their adjustment efforts. In many small countries and some African countries, even the most liberal economic policies were unlikely to attract foreign direct investment on a scale that would make a significant contribution to growth and the balance of payments.

Mr. Laske generally agreed with the staff's analysis and endorsed its conclusions. Direct investment flows could be more stable than, but could not substitute for, the flow of credit from commercial banks and suppliers. Perceptions of the creditworthiness of developing countries tended to fluctuate, and direct investment could play a useful role in supporting and strengthening the development process and the internal position of those countries; such investment made them less vulnerable to volatile credit markets, and transfers of investment income were made only if an investment was profitable. In addition, investors often reinvested profits, especially when the host country did not impose restrictions on transfers of profits. Moreover, with an appropriate legal framework, direct investment need not conflict with a host country's national interests.

The staff had concluded that developing countries facing debt servicing problems had generally attracted relatively little foreign investment, and that countries maintaining liberal policies had attracted relatively more investment and had a better record with respect to economic growth, price stability, and the balance of payments, Mr. Laske commented. The increase in the number of developing countries adopting liberal policies on direct investment was encouraging. Many of them could hope to increase the inflows of such investment only if their complex incentive schemes were simplified. They should carefully re-examine their rationale for restrictions on foreign investment and make every effort to provide an encouraging economic environment; in that context an appropriate exchange rate was crucial. Developing countries would then be in the best position to benefit from direct investment through increases in their capital stock, technological know-how, and debt servicing capacity.

Industrial countries must maintain appropriate and coordinated policies if developing countries were to reap all the benefits of foreign direct investment, Mr. Laske went on. Accordingly, investing countries should refrain from restricting developing countries' imports that had been supported by direct investment. Of course, as a general rule, reducing protection in industrial countries was in the best interests of all countries.

It would be appropriate for the staff to discuss issues regarding foreign direct investment with member countries, Mr. Laske concluded. Examination of macroeconomic policies of developing and industrial countries would be particularly helpful. The Fund need not make specific recommendations, provide detailed policy prescriptions, or make foreign direct investment the subject of performance criteria. After all, such investment was not fully within the Fund's range of expertise.

Mr. Wang considered that the staff analysis of the relative stagnation in foreign direct investment in recent years placed undue emphasis on the effects of policies of developing countries. The situation with respect to such investment varied from one developing country to another. In a number of those countries, foreign equity capital had played a significant role in the overall economy, and in the export sector in particular. Some countries understandably were attempting to improve their regulation of foreign capital in order to maximize the gains from, and to minimize the adverse effects of, such inflows. The adjustment problems in developing countries were perceived by foreign investors as a source of additional risk, and some countries were making a considerable effort to find the appropriate mix of regulations on, and incentives to, foreign capital. Foreign investors remained reluctant to provide equity capital to a large number of developing countries that lacked essential infrastructure; in fact, for those countries an increase in official capital flows would be more appropriate than a rise in investment flows. Hence, while the role of foreign direct investment should not be underestimated, its limits should be recognized.

Investment in developing countries was in the best interests of investing countries, but the latter's policies were often not conducive to such flows, Mr. Wang remarked. Investing countries should reform their tax systems to reflect the interests of both investors and host countries; and the rise in protection in investing countries had had an even more restrictive effect on foreign direct investment. Investing and developing countries should cooperate more actively to permit the latter to gain the greatest possible advantage from foreign direct investment while avoiding its potential negative effects.

No study of foreign direct investment was complete without an examination of the role of multinational corporations, Mr. Wang considered. Since the 1970s, the trends in such investment had been significantly affected by those corporations. Developing countries' concern about the adverse effect of foreign investment on their economies was warranted by experience, and the lack of an international code of conduct for multinational corporations had undermined the growth of foreign direct investment.

In the circumstances, it was difficult to give general answers to the first two main policy questions posed by the staff on page 39 of SM/84/145, Mr. Wang said. On the third question, the main responsibility for foreign direct investment rested with investment organizations such as the World Bank. Fund consultations with member countries should not be overloaded by the inclusion of the topic of direct investment.

As the staff had noted on page 22 of its paper, China had been encouraging foreign investment, Mr. Wang remarked. The Government intended to create a favorable environment for investment by further improving regulations while protecting the legitimate interests of investors. As the staff had shown, the Chinese Government's policies had become increasingly flexible; it was formulating a law permitting wholly owned foreign enterprises, even outside the established special economic zones. The authorities hoped that the various measures being introduced would be to the mutual benefit of investors and China.

Mr. Leonard remarked that, given the likely reduction in the flow of commercial bank loans, developing countries would clearly benefit from an increase in foreign direct investment. However, it was important to see investment flows in perspective: they could merely help to solve the present debt problems and were clearly not a substitute for commercial bank lending. During the previous decade, the stocks and flows of foreign direct investment had grown at only moderate rates, and even a fairly substantial increase for some time to come would be unlikely to have a beneficial effect on the financial position of developing countries. Moreover, investment flows varied significantly from one country to another; they were particularly prominent in countries with large domestic markets and substantial natural resources. Of course, the overall impact of a sustained increase in direct investment could be considerably greater than the initial financial effect, but would be difficult to measure.

The staff's description of the benefits to host countries of foreign direct investment was correct, and he agreed that experience suggested that the benefits increased when host countries maintained appropriate general economic policies and were minimal in the absence of such policies, Mr. Leonard said. Compared with commercial bank borrowing, well-managed direct investment reduced the host country's financial vulnerability to economic shocks and was a useful means of importing managerial marketing and technological skills. Moreover, while dividend outflows from host countries tended to be maintained in periods of economic difficulty, they were unlikely to increase, in contrast to interest payments. In any event, the disadvantage of an outflow of dividends was somewhat offset by the risk borne by foreign investors. Moreover, the outflows were often payments for inputs for research and development, market organization, and other factors, rather than profits. In addition, the adjustments in their operations that foreign businesses usually made in response to changed economic conditions facilitated the overall adjustment process in host countries.

He strongly agreed with the staff that host countries should avoid price distortions in order to attract appropriate investments, Mr. Leonard remarked. The tendency of direct investment funds to flow toward capital-intensive projects could be reduced through appropriate domestic interest rate, wage, and foreign exchange policies. Antitrust legislation and appropriate tariff measures could minimize the creation of oligopolies and of low-export and import-intensive investment. Countries could encourage foreign investment by maintaining stable policies minimizing administrative regulations, and reducing public sector domination of the economy of the host country. Direct specific incentives to foreign investment were somewhat out of favor, but they should not be ruled out altogether. Cash grants could reinforce undesirable tendencies in a particular project, such as a bias toward capital intensity; alternatively, they could briefly support the competitiveness of an essentially unviable enterprise. Incentives designed to offset economic weaknesses of a host country--for instance, a lack of marketing expertise, a scarcity of entrepreneurial talent, and a lack of technology--could also strengthen the economy's productive capacity and help to alter its structure.

Industrial countries maintained relatively few restrictions on the outflow of investment capital, Mr. Leonard observed. Reducing protection was the most important step that they could take to encourage investment in developing countries.

It would be appropriate to address certain broad foreign direct investment issues during consultation discussions, Mr. Leonard considered. For instance, the policies regarding foreign direct investment of a country that had stated its intention of attracting such investment could be usefully discussed. The Fund could encourage member countries not to compete harmfully with each other in offering investment incentives, but it should not act on its own initiative to advocate or discourage foreign direct investment in a particular country.

Mr. Teijeiro agreed with the staff's main conclusions. The decline in the relative importance of foreign direct investment in recent years, due to an important extent to the growth of international bank lending, had increased the vulnerability of host economies. He agreed with the staff that the likely slowing of the growth of bank lending to developing countries over the medium term called for increases in other sources of external financing, including private equity investment, if development efforts were to resume their former momentum.

The first important question to address was whether developing countries benefited from foreign investment, Mr. Teijeiro continued. Such investment clearly increased real incomes and tax revenues in a host country, but it was difficult to know how the total gains from the investment were distributed between profits and increased real income in the country. Government intervention, through protective measures or artificial incentives, could increase profits, thereby permitting foreign capital to reap most of the benefits of investment. If host countries were to benefit significantly from foreign investment, they must create a stable and predictable environment for private decision making and avoid artificial incentives that might unduly benefit foreign investors. Large-scale foreign investment, the final step in establishing a clear role for a host country's private sector, was possible only if there was a stable political and macroeconomic framework that made reliance on artificial incentives unnecessary. A host country should maintain a simple and nondiscriminatory set of regulations on foreign investment. The Fund's general policy recommendations were conducive to the creation of macroeconomic conditions that encouraged foreign direct investment, but any further steps to encourage such investment were the responsibility of the World Bank, not the Fund. In its consultations with member countries, the Fund should pay attention to developments and policies regarding foreign direct investment, just as it had recently paid greater attention to trade policies; however, the Fund should not take any additional steps in that direction.

Foreign direct investment could be expected to help to improve the prospects of highly indebted countries only in the medium term, after the debt crisis had been handled and debtor countries could offer investors a more predictable economic and political environment, Mr. Teijeiro continued. Even then, however, the magnitude of outstanding debt would preclude more than a limited role for foreign direct investment in improving the prospects of such countries.

It was important to pay as much attention to capital outflows from developing countries to industrial countries, as to inflows of foreign direct investment, Mr. Teijeiro considered. There were significant incentives for capital outflows from developing countries, including such transitory factors as high interest rates abroad and uncertain economic conditions in developing countries, and such permanent incentives as tax-free, government-insured financial assets in industrial countries that served as a means of circumventing domestic taxation in developing countries. In that connection, attention should perhaps be given to weaknesses and distortions in domestic tax systems in developing countries.

Mr. Portas agreed that, as new net international bank lending to developing countries was likely to be more constrained in the future than in the recent past, foreign direct investment must be encouraged, so that its role in promoting growth and development in host countries could be increased. Similarly, since the prospective growth of international credit through capital markets would not provide the resources needed by developing countries to finance positive rates of growth of per capita income, optional channels of financing, particularly nondebt-creating flows, should be explored and promoted. More rapid growth of direct investment in developing countries was therefore not only a desirable goal of international economic policy for both investing and host countries, but also was necessary for the attainment of a stable world economic environment.

The effectiveness of new measures by investing and host countries to encourage investment in developing countries was constrained by the uneven distribution of the stock of capital among industrial and developing countries, Mr. Portas commented. The problem was that flows of foreign investment were available to the countries that least needed them, while countries with heavy debts had experienced a contraction of all forms of capital inflows and often had no access to international credit markets. In the present unstable world economic environment, incentives to foreign private investment would be necessary if its share of total inflows in developing countries was to be maintained through the rest of the 1980s. To that end, sound economic policies in host countries would make an important contribution.

It was too soon to recommend that the Fund take a more systematic view with regard to a member country's policies on direct investment, Mr. Portas considered. Even if Executive Directors agreed in principle at the present meeting that the Fund should do so, the matter required further discussion. As previous speakers had stressed, the World Bank and the IFC were more suited than the Fund to deal with foreign direct investment issues.

Mr. Kabbaj remarked that, although the ratio of direct investment to the combined current account deficit of developing countries had recently increased, the absolute amount of such investment had actually fallen since 1981. At the same time, the combined current account deficit of the developing countries had substantially declined, owing to contraction of capital imports that had serious implications for their future growth and employment. Table A.1. showed that private flows of financial resources from industrial countries to developing countries had fallen from $48.1 billion in 1979 to $46.1 billion in 1984, and the decline in real terms had been even more pronounced. Portfolio investment in particular had declined in 1982, and grants by private voluntary agencies had been smaller in 1981 and 1982 than in 1980. The staff had concluded on page 2 that restrictive policies toward foreign private investment in many developing countries had prevented an increase in flows of such investment. It was not clear to him whether that decline had occurred because the restrictions had increased in intensity during the previous several years; the mere continuation of existing restrictions should not by itself have caused the decline. The staff had not provided evidence that the restrictions had increased in intensity, or that exogenous factors had played a role in the decline in investment. Indeed, on pages 17 and 21, the staff had mentioned that in recent years a number of countries had adopted more flexible policies in order to attract foreign investment.

Foreign direct investment had been concentrated in a small number of member countries with large markets, rich resource bases, and export-oriented production, Mr. Kabbaj noted. However, as the staff had indicated on page 7, those features were not a necessary and sufficient reason for an increase in direct foreign investment, and he wondered to what extent other factors, including, perhaps, the relative attractiveness of a host country's investment code, explained the heavy concentration of foreign direct investment.

The sectoral composition of foreign direct investment in developing countries had been marked by a shift away from investment in sectors involving natural resources, and toward investment in the manufacturing and service sectors, Mr. Kabbaj observed. The shift away from agriculture in particular was discouraging, given the importance of that sector in many developing countries. The main reasons for the relative decline in the attractiveness of agriculture to foreign investors were not obvious, but World Bank studies suggested a possible connection with the declining profitability of agricultural projects in recent years. There had perhaps also been some intensification of host country restrictions on agricultural investment.

In assessing the role of foreign direct investment in development, the staff correctly noted the relationship between the host country's economic policies and the net benefit of such investments, Mr. Kabbaj said. In considering the kinds of macroeconomic policies that benefited direct investment projects, a critically important issue was the extent to which the design of adjustment programs benefited, or conflicted with, direct foreign investment. In principle, of course, such programs were supposed to pave the way for attracting foreign investment. The free trade and exchange systems and, by implication, the less restrictive and more open economies, advocated under programs, should help to create a favorable climate for foreign investment. In fact, however, the outcome generally had been different. Furthermore, as the staff had explained, an income-generating and growth-oriented approach to the design of adjustment programs should enhance host countries' ability to service investment.

Total returns paid on foreign direct and equity investment were more positively correlated with changes in a country's ability to service those payments than were interest payments on its external debt, Mr. Kabbaj noted. That feature not only helped host countries to adjust to economic disturbances, but also underscored the benefits for investors of growth-oriented and income-generating policies in developing countries.

The Fund should be somewhat involved in monitoring direct and portfolio investments because of the implications for member countries' balance of payments, Mr. Kabbaj considered. However, members' policies regarding such investments should not be incorporated into the design of adjustment programs. The World Bank and the IFC had more expertise in investment than the Fund. Any conclusion meant to expand the role of the Fund with respect to member countries' investment policies should be the subject of a separate discussion and a more detailed staff paper prepared with the benefit of the present discussion.

Mr. Fridriksson commented that more rapid growth of direct and portfolio investment in developing countries was clearly desirable, not least because of the likely constraints on the availability of foreign capital from various other sources in coming years. A host country could provide the greatest encouragement to prospective investors by maintaining a relatively stable economy, by implementing careful economic policies, and by having simple, incentive-oriented rules and regulations on foreign participation. For their part, investing countries must acknowledge the importance of foreign direct and equity investment and reduce or eliminate rules governing it; at the same time, they must give developing countries' exports access to their markets.

Staff missions to member countries could perhaps informally give their views on the authorities' foreign investment policies, Mr. Fridriksson said, but he hesitated to support any deep involvement of the staff in advising member countries on investment. That role would be more appropriately played by other international institutions.

A Deputy Director of the Research Department remarked that, as some speakers had noted, the subject of foreign direct and equity investment in developing countries had not been extensively discussed in the Executive Board on previous occasions; indeed, it was a relatively new subject for the staff itself. In responding to the request for the present paper, the staff had not attempted to be complete in all respects; in addition to describing conditions in the host countries and restrictions in investing countries, more could perhaps have been said about the general factors determining foreign direct investment, although the information available was not extensive.

In describing the advantages and disadvantages of foreign direct investment compared with other sources of foreign financing, the staff had attempted to be evenhanded, the Deputy Director explained. It had seemed natural to concentrate the discussion on the conditions in host countries that encouraged foreign direct investment. There was already considerable foreign direct investment among industrial countries, and the possibility of increasing the flow of such investment to developing countries depended considerably on the conditions in the host countries.

Before writing the present paper, the staff's interest in foreign direct investment had arisen mainly in connection with estimates and projections made for the world economic outlook reports, the Deputy Director explained. In that context, the staff provided figures on various sources of external current account financing for developing countries. Out of that practice the staff might have inadvertently given the impression that foreign direct investment was considered a substitute for other financing flows, particularly commercial bank lending. The staff had not meant to argue that foreign direct investment was fully substitutable for other financing flows in the sense that, if one kind of flow lagged, the other could take up the slack. Nor had the staff meant to say that, for the purposes of countries receiving financing, one kind of flow was as good as another. The various flows were obviously different, and foreign direct investment had advantages and disadvantages that differed from those of commercial bank financing. Moreover, the extent to which a host country benefited from, or was disadvantaged by, foreign direct investment depended to an important extent on the conditions in the country and on the policies it maintained. He fully agreed with Executive Directors who had stressed that no general answers could be given to the first two main policy questions the staff had posed on page 39 of its paper.

As speakers had also stressed, the World Bank and the IFC had considerable expertise in the area of foreign direct investment, the Deputy Director of the Research Department commented. The IFC staff had offered comments on the draft text of the staff paper, but there had not been the kind of full cooperation that had sometimes characterized work on staff papers on subjects that were within the competence of the Fund and a cooperating institution.

The staff representative from the Research Department commented that, while the staff had not meant to suggest that there was automatic substitutability between commercial bank financing and foreign direct investment, policies of host countries and multinational corporations had in many instances combined to determine whether a private sector firm in a developing country received needed external financing in the form of a bank loan, on the one hand, or through participation with a foreign firm or the sale of its stock in capital markets, on the other hand. Choices also existed for public sector enterprises. For instance, in some countries, such enterprises entered into joint ventures with foreign firms, while in other countries many public enterprises over the previous decades had raised large amounts of money from international banks. Hence, in the sense of the choices available to some enterprises, there was scope for substitutability between the two forms of financing. The staff had meant to say that there was scope for additional foreign investment when bank credit was unavailable. Table 1 showed that direct investment flows were not a small portion of external financing of developing countries compared with net external borrowing. The extent to which direct investment or any other flows were used to finance imports of capital equipment could not be measured, and it was therefore impossible to assess the net contribution of various kinds of flows to host countries' balance of payments.

The staff had argued that protection in industrial countries might well hamper foreign direct investment in developing countries, the staff representative commented, and that the benefits developing countries would gain from following a policy of protection against direct foreign investment were ambiguous. Foreign direct investment in import-substituting sectors might conceivably be stimulated, but only if the domestic markets were sizable; at the same time, the long-term costs and benefits of protective measures were clearly limited because of the resulting distortions in the price and production structures.

The interaction between interest rate and credit policies, and foreign direct investment was difficult to define, the staff representative said. In that connection, Mr. Hirao had usefully noted that countries that did not have effective exchange controls on outflows of capital had to maintain interest rate policies designed to prevent outflows. The staff had meant to say that credit controls could include limitations on credit to foreign enterprises located in a host country in order to induce those enterprises to obtain their funds from abroad rather than from domestic savings; at the same time, interest rate policies might be geared to preventing capital outflows.

The concentration of foreign direct investment in certain developing countries and in specific sectors was a large topic to explore, the staff representative remarked. The main determinants of such investment--in the absence of restrictions or controls--were the host country's natural resource endowment and the size of its domestic market. In the past, there had been much more foreign direct investment--mostly export-oriented--in agriculture than at present. Apparently there had been a relative decline in the importance of export-oriented agriculture and an increase in the importance of mineral and manufacturing exports. In addition, the ownership of many large agricultural entities in developing countries had been transferred from foreign ownership to domestic ownership.

The staff had not had the data necessary to take into account the impact of inflation on the book value of direct investment and profits, the staff representative explained. The comparison between shifts in the rate of return and interest rates on external debts was approximate but suggested actual developments in the economies of host countries. The subject was briefly discussed in footnote 3 on page 29.

The staff had not concluded that the decline in foreign direct investment flows in 1982 and 1983 had been related to either the intensification or liberalization of restrictions on such investments, the staff representative from the Research Department said. The main factor was the decline in economic activity which, in turn, had contributed directly to the sharp reduction in the reinvestment of profits. Nor had the staff meant to say that foreign direct investment could make a large contribution in the short term to solving the balance of payments problems of developing countries.

The Chairman made the following summing up:

I would like to summarize the discussion by noting the Executive Directors' responses to the three policy questions posed by the staff.

First, is more rapid growth of direct and portfolio equity investment in developing countries a desirable goal of international economic policy for both investing and host countries? On the whole, Directors said that equity financing should be encouraged for the reasons given in the staff paper. These nondebt-creating flows have a desirable financial impact, which is especially important for heavily indebted countries, and the technological and managerial resources associated with direct investment make an important contribution to the structural adjustment efforts of host countries. However, a number of Directors stressed that, for various reasons, some countries are better placed than others to attract foreign investment, and that such investment was not a substitute for other forms of financial flows, especially bank lending and official development assistance. Those Directors also noted the relatively limited role of private direct investment in total balance of payments flows.

The second question was what measures on the part of investing and host countries might be most useful in encouraging direct and portfolio equity investment in developing countries? Executive Directors agreed that, for host countries, an appropriate macroeconomic setting and, in particular, adequate exchange rate and interest rate policies, were important for attracting foreign direct investment. A number of Directors stressed that it is important for host countries to reduce restrictions, and streamline and simplify rules and regulations pertaining to foreign direct investment, so that investors could be assured of receiving nondiscriminatory and predictable treatment.

Directors also stressed that it was essential for investing industrial countries to maintain both appropriate macroeconomic policies, which would lead to higher savings and to lower inflation, and liberal trade policies, which would permit developing countries to take advantage of direct investment to increase their exports.

Several Directors felt that the paper could have contained more analysis of some of the issues concerning investing countries, particularly the attitudes of transnational companies toward developing countries.

The third major policy question had two parts. Should the Fund, in its consultations and discussions with members, pay greater attention to developments and policies with regard to direct investment? Should the Fund take a view on a member's policies toward direct investment? There was no support for formal and detailed involvement of the Fund in these matters; in particular, no one supported the idea of including direct investment policy within the performance criteria of Fund-supported programs. However, the discussion made it clear that Fund missions cannot ignore a member's policy regarding direct investment. Most balance of payments scenarios discussed by the Fund with authorities incorporate rather precise assumptions on foreign direct investment. It was generally recognized that in its discussions with authorities, the staff should take up developments and policies with regard to direct investment, but there was some hesitation to move toward a more general and formal focus on an area in which the World Bank and the IFC obviously had more expertise than the Fund, especially regarding the supply-side aspects of direct investment.

APPROVED: April 11, 1985

LEO VAN HOUTVEN
Secretary