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EB/CW/DC/91/2

March 7, 1991

To: Members of the Committee of the Whole for the Development Committee

From: The Secretary

Subject: <u>The Role of Foreign Direct Investment in Development</u>

Attached for consideration by the Committee of the Whole is a paper, prepared jointly by the staffs of the Fund and the World Bank, on the role of foreign direct investment in development. Some issues for discussion appear on pages i and ii.

This subject, the paper on the impact of industrial countries' trade, agricultural, and industrial policies in developing countries (EB/CW/DC/91/3, 3/8/91), the progress report on the implementation of the debt strategy and its impact on the development prospects of all severely indebted countries (EB/CW/DC/91/4, 3/8/91), and the draft provisional agenda for the April meeting of the Development Committee (EB/CW/DC/91/1, 3/5/91), have been tentatively scheduled for discussion by the Committee of the Whole on Wednesday, March 27, 1991.

Ms. Meesook (ext. 4508) is available to answer technical or factual questions relating to this paper prior to the Committee meeting.

Att: (1)

Other Distribution:
Department Heads
Development Committee Secretariat

INTERNATIONAL MONETARY FUND

The Role of Foreign Direct Investment in Development

(Prepared by Staff of the World Bank and the International Monetary Fund)

March 6, 1991

Issues for Discussion

This note summarizes the conclusions of the attached joint Bank-Fund background paper and raises issues on which the Ministers may wish to focus.

(i) The main conclusion of the background paper is that the potential developmental contribution of foreign direct investment (FDI) is substantial. Efforts to promote FDI flows to developing countries should continue to be strengthened. However, flows are unlikely to be sufficient to play a major role in meeting the external financing requirements of many developing countries and other sources of external financing should be increased when warranted by strong economic reforms. Based on recent experience, the paper notes that the maintenance of adequate growth and macroeconomic and political stability are necessary conditions for attracting flows of the type of FDI likely to establish strong linkages with the domestic economy. Experience also shows that: (a) the development effectiveness of FDI can be enhanced by host country reform of the incentive and regulatory frameworks aimed at eliminating policy-induced distortions; (b) FDI flows to developing countries and their contribution to development can be increased by industrial country policies aimed at reducing barriers to trade and capital flows and by tax policies that do not discourage direct investment abroad; and (c) adequate financing to help support expansion of complementary infrastructure and social services are essential to growing FDI.

(ii) In the past, FDI to developing countries has been concentrated in those which have: (a) large, rapidly expanding domestic markets; (b) well established infrastructure and commercial and financial linkages to the global economy; (c) a strong natural resource base which supports exports of homogeneous commodities to world markets; and (d) fast-growing economies with a highly motivated, skilled labor force and responsive institutions--including open trade and capital markets, and an open exchange system. Ministers may wish to consider what supportive efforts are required by the international community to remove impediments to FDI flows to groups of developing countries which have not been major recipients in the past, including: (a) small, narrow resource based, low income countries, many of which are in sub-Saharan Africa; (b) countries in transition to market economies in which the private sector is at an early stage of development; and (c) highly indebted countries whose prospects for quickly restoring external viability are uncertain.

(iii) Do Ministers agreed that emphasis should be placed on removing impediments and distortions which inhibit the ability of countries to attract FDI, and that competition by developing countries in attracting FDI through tax holidays, investment credits and similar incentives may result in reduced net benefits to developing countries themselves? Ministers may wish to discuss what modifications in the tax systems of host and source countries could contribute to increased FDI flows and their benefits to developing countries. In particular, what changes to FDI incentives in developing countries would help to increase its net benefits without reducing these countries' competitive position. Should industrial countries enter into liberalized tax sparing agreements with developing countries to ensure these benefits?

(iv) Ministers may wish to comments on specific ways to further liberalize trade and payments regimes in source and host countries so as to stimulate FDI flows. Given the increasing trade orientation of FDI and the importance of developing country access to the markets of industrial countries in attracting FDI, are current measures being discussed at the Uruguay Round, especially regarding agricultural subsidies and the Multi-Fiber Agreement, adequate to address this issue?

(v) In recent years, the World Bank Group, the International Monetary Fund and the regional development banks have strengthened their efforts to support accelerated private sector development and to facilitate FDI flows to developing countries. Ministers may wish to discuss the effectiveness of this multi-faceted approach, the complementarity of its components, and specific ways to further foster the benefits of FDI to a broader range of developing countries.

## I. Introduction and Background

1. This paper reviews the role of foreign direct investment in development as background for discussion by the Development Committee at its meeting in April 1991. Reduced commercial bank flows to developing countries during the 1980s gave rise to increased interest in other sources of international capital including foreign direct investment, country funds, and quasi-equity arrangements. The focus of this paper is on foreign direct investment (FDI), the major source of nondebt private capital flows to developing countries. 1/ It first examines the experience of developing countries with foreign direct investment in recent years. It then considers some of the key issues related to the evolving nature of FDI. Special focus is placed on the problems faced by those low- and middle-income countries that have had difficulty attracting FDI. The third part of the paper considers host and source country policies to facilitate FDI flows. The last section of the paper looks at the role of the Bank Group and the International Monetary Fund in promoting FDI flows to developing countries.

### Recent trends in overall FDI flows to developing countries

2. The total amount of FDI flows to developing countries declined in the first half of the 1980s, then increased thereafter in both nominal and real terms (Tables 1 and 2). By the end of the decade the level of FDI in real

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1/ Foreign direct investment is defined as investment that is made to acquire a lasting management interest (usually of 10 percent of voting stock) in an enterprise operating in a country other than that of the investor (defined according to residency), the investor's purpose being an effective voice in the management of the enterprise. Sufficient share ownership and/or an effective voice in the management of an enterprise are prima facie evidence of direct investment. Data presented in this paper are investment flows based on the balance of payments statistics and not the total value of assets over which foreign investors have control. Deficiencies in the data on direct investment are briefly discussed in Section IV.

Table 1. Flows of Foreign Direct Investment, 1981-90

(In billions of U.S. dollars)

| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 Prelim. |
|---|---|---|---|---|---|---|---|---|---|---|
| Net flows 1/ | | | | | | | | | | |
| Developing countries (IBRD) | 10.9 | 10.7 | 7.4 | 8.2 | 8.7 | 8.6 | 11.4 | 15.7 | 16.2 | 20.1 |
| Africa | 0.5 | 1.9 | 1.1 | 1.7 | 1.2 | 1.4 | 1.2 | 1.2 | 1.5 | 1.7 |
| Asia & Pacific | 2.6 | 2.5 | 2.8 | 2.9 | 2.9 | 3.4 | 4.6 | 7.4 | 8.8 | 7.7 |
| Europe & Mediterranean | 0.2 | 0.1 | 0.1 | 0.2 | 0.1 | 0.1 | 0.1 | 0.4 | 0.8 | 1.1 |
| Middle East | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.0 | -0.2 | -0.2 | 0.1 |
| Latin America & Caribbean | 7.5 | 6.0 | 3.2 | 3.2 | 4.3 | 3.5 | 5.5 | 6.9 | 5.3 | 9.5 |
| Memorandum items: | | | | | | | | | | |
| Developing countries (IMF) 2/ | 18.1 | 19.7 | 13.4 | 13.4 | 11.2 | 9.8 | 13.0 | 13.0 | 12.1 | 18.9 |
| Seventeen heavily indebted countries | 7.5 | 6.3 | 3.4 | 3.1 | 4.4 | 3.9 | 6.1 | 7.9 | 6.6 | 10.7 |
| Gross flows 3/ | | | | | | | | | | |
| Total all countries | 62.3 | 53.7 | 48.9 | 53.4 | 48.0 | 76.0 | 109.7 | 138.0 | 181.8 | ... |
| Developing countries (IMF) 4/ | 20.7 | 24.1 | 15.6 | 15.3 | 12.2 | 12.1 | 14.1 | 14.9 | 18.5 | ... |
| Developing countries (IBRD) | 12.3 | 11.0 | 8.2 | 8.6 | 10.2 | 9.4 | 12.9 | 19.3 | 20.7 | ... |
| Flows to developing countries as share of total (in percent) | 19.7 | 20.5 | 16.8 | 16.1 | 21.3 | 12.4 | 11.8 | 14.0 | 11.4 | ... |

Source: International Monetary Fund, World Economic Outlook data base and Balance of Payments Statistics.

1/ Based on WEO data base, data are net of investment made abroad; flows are to low- and middle-income countries; data exclude flows to offshore financial centers.

2/ Based on WEO data base, data are net of investment made abroad; includes Bahamas, Bahrain, Barbados, Cyprus, Hong Kong, Israel, Kuwait, Netherland Antilles, Qatar, Saudi Arabia, Singapore, Taiwan Province of China, and United Arab Emirates.

3/ Based on the Balance of Payments Statistics; data include only investments made in a country by foreigners. Data are incomplete as those for several countries are not available.

4/ Includes Bahamas, Bahrain, Barbados, Cyprus, Hong Kong, Israel, Kuwait, Netherland Antilles, Qatar, Saudi Arabia, Singapore, Taiwan Province of China, and United Arab Emirates.

Table 2. Flows of Foreign Direct Investment, 1981-90

(In billions of constant 1985 U.S. dollars) 1/

| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 Prelim. |
|---|---|---|---|---|---|---|---|---|---|---|
| Net flows 2/ | | | | | | | | | | |
| Developing countries (IBRD) | 10.3 | 10.3 | 7.3 | 8.2 | 8.7 | 7.2 | 8.9 | 11.4 | 11.8 | 13.8 |
| Africa | 0.5 | 1.8 | 1.1 | 1.7 | 1.2 | 1.2 | 0.9 | 0.9 | 1.1 | 1.2 |
| Asia & Pacific | 2.5 | 2.4 | 2.8 | 2.9 | 2.9 | 2.9 | 3.6 | 5.3 | 6.4 | 5.2 |
| Europe & Mediterranean | 0.1 | 0.1 | 0.1 | 0.2 | 0.1 | 0.1 | 0.1 | 0.3 | 0.6 | 0.8 |
| Middle East | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 | 0.1 | 0.0 | -0.1 | -0.1 | 0.1 |
| Latin America & Carribean | 7.1 | 5.8 | 3.1 | 3.2 | 4.3 | 2.9 | 4.3 | 5.0 | 3.8 | 6.5 |
| Memorandum items: | | | | | | | | | | |
| Developing countries (IMF) 3/ | 16.9 | 18.8 | 13.1 | 13.5 | 11.2 | 8.3 | 9.9 | 9.3 | 8.7 | 12.6 |
| Seventeen heavily indebted countries | 7.1 | 6.1 | 3.3 | 3.2 | 4.4 | 3.3 | 4.7 | 5.7 | 4.8 | 7.3 |
| Gross flows 4/ | | | | | | | | | | |
| Total | 59.1 | 51.8 | 48.2 | 53.8 | 48.0 | 64.5 | 84.7 | 99.3 | 131.3 | ... |
| Developing countries (IBRD) | 11.7 | 10.6 | 8.1 | 8.7 | 10.2 | 7.9 | 9.9 | 13.9 | 14.9 | ... |
| Developing countries (IMF) 5/ | 19.3 | 22.9 | 15.3 | 15.5 | 12.2 | 10.3 | 10.9 | 10.7 | 13.3 | ... |
| Implicit deflator 1/ | 105.3 | 103.7 | 101.4 | 99.2 | 100.0 | 117.9 | 129.5 | 138.9 | 138.5 | 142.7 |

Source: International Monetary Fund: World Economic Outlook data base and Balance of Payments Statistics.

1/ Deflator used in converting data from current values (shown in Table 1) is the export unit value for manufactures.

2/ Based on WEO data base; data are net of investment made abroad; flows are to low- and middle-income countries: data exclude flows to developing country offshore financial centers.

3/ Based on WEO data base; data are net of investment made abroad; include Bahamas, Bahrain, Barbados, Cyprus, Hong Kong, Israel, Netherland Antilles, Qatar, Saudi Arabia, Singapore, Taiwan Province of China, and United Arab Emirates.

4/ Based on the Balance of Payments Statistics; data include only investments made in a country by foreigners. Data for several countries are not available.

5/ Includes Bahamas, Bahrain, Barbados, Cyprus, Hong Kong, Israel, Kuwait, Netherland Antilles, Qatar, Saudi Arabia, Singapore, Taiwan Province of China, and United Arab Emirates.

terms surpassed that of the early 1980s. 1/ Several reasons may have accounted for the decline during the first half of the decade. The period witnessed widespread economic difficulties in a number of developing countries which included declining real GDP growth rates, falling domestic investment, increased domestic imbalance and loss of international liquidity that adversely affected investors' confidence in them. The debt-service difficulties experienced by some countries raised questions about their creditworthiness and assurances that there would be no barriers to repatriation of returns on invested capital. The high real level of international interest rates made interest bearing securities more attractive compared with direct investment. Foreign investors generally deferred new involvement in countries implementing structural reforms until it was clear that these reforms would be maintained and effective. During this period, commercial banks reduced their exposure to developing countries, thereby limiting FDI flows to the extent that foreign investors used bank services for financial advice and transactions.

3. During the second half of the 1980s some of these inhibiting factors were reversed. A number of developing countries that have undertaken macroeconomic adjustment showed improved economic performance, particularly in Latin America. The real level of international interest rates fell sharply, increasing the relative attractiveness to investors of direct investment. However, the difficult economic prospects of developing countries as a group made industrial countries a relatively more attractive destination for direct investment. There were, in addition, strong incentives for direct investment in the United States (with changes in its tax code and the U.S.-Canada Free Trade Agreement) and in Europe (which has been moving toward economic integration), in many cases to circumvent tariff and non-tariff barriers to trade. As a consequence, the share of developing countries in total FDI flows world-wide fell from 20 percent in the early 1980s to 11 percent at the end of the decade.

4. For developing countries as a group, the relative importance of the different sources of external finance in the 1980s varied a great deal (Table 3). Net commercial bank borrowing collapsed by 1985, and has generally been negative even though FDI has since recovered. Policy adjustment in developing countries, while having the impact of reducing total financing requirements, may have encouraged spontaneous FDI flows in

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1/ In this paper, the World Bank's definition of developing countries (low- and middle-income countries) is used. This excludes a number of high-income oil exporters in the Middle East (Bahrain, Kuwait, Qatar, Saudi Arabia, United Arab Emirates), and offshore financial centers. Countries that are included in the IMF definition of developing countries are also shown in the tables attached to this paper. As a result of a decline in FDI flows to Middle East oil exporters after the mid-1980s, data based on the IMF definition of developing countries indicate a level of FDI at the end of the decade in real terms lower than that of the early 1980s.

Table 3. Foreign Direct Investment and Other Flows

(In billions of U.S. dollars)

| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|---|---|---|---|---|
| Developing countries (IBRD) | | | | | | | | | | |
| Current account deficit | 118.3 | 105.6 | 63.0 | 40.7 | 45.0 | 69.6 | 28.4 | 39.3 | 47.3 | 42.8 |
| Direct investment | 10.9 | 10.7 | 7.4 | 8.2 | 8.7 | 8.6 | 11.4 | 15.7 | 16.2 | 20.1 |
| Official transfers | 11.0 | 10.1 | 10.5 | 10.4 | 11.4 | 12.3 | 12.7 | 13.4 | 13.8 | 12.4 |
| Long-term official borrowing | 29.3 | 34.2 | 38.7 | 34.6 | 22.7 | 27.8 | 27.0 | 20.6 | 24.4 | 35.5 |
| Net commercial bank borrowing | 54.1 | 61.5 | 33.8 | 16.9 | 1.7 | -4.4 | -4.7 | -6.7 | -0.1 | -1.0 |
| Africa | | | | | | | | | | |
| Current account deficit | 31.8 | 29.1 | 19.6 | 15.4 | 6.7 | 19.5 | 13.7 | 21.6 | 19.5 | 17.6 |
| Direct investment | 0.5 | 1.9 | 1.1 | 1.7 | 1.2 | 1.4 | 1.2 | 1.2 | 1.5 | 1.7 |
| Official transfers | 3.7 | 3.4 | 4.2 | 4.1 | 5.2 | 6.1 | 5.9 | 6.4 | 7.0 | 6.7 |
| Long-term official borrowing | 10.4 | 13.7 | 12.2 | 9.9 | 5.7 | 10.8 | 10.3 | 8.9 | 6.3 | 11.2 |
| Net commercial bank borrowing | 6.7 | 5.6 | 3.3 | 1.1 | -2.2 | -1.8 | -1.4 | 2.5 | -0.8 | 1.6 |
| Asia & Pacific | | | | | | | | | | |
| Current account deficit | 17.2 | 17.6 | 18.5 | 13.1 | 26.3 | 15.3 | 1.2 | 5.7 | 19.0 | 16.7 |
| Direct investment | 2.6 | 2.5 | 2.8 | 2.9 | 2.9 | 3.4 | 4.6 | 7.4 | 8.8 | 7.7 |
| Official transfers | 2.7 | 2.6 | 2.6 | 2.8 | 2.7 | 2.8 | 3.0 | 3.4 | 3.4 | 2.8 |
| Long-term official borrowing | 9.1 | 10.5 | 8.8 | 9.0 | 4.0 | 4.7 | 3.2 | 7.0 | 6.4 | 7.5 |
| Net commercial bank borrowing | 11.4 | 14.1 | 11.2 | 6.2 | 8.1 | -0.7 | -4.0 | 4.4 | 2.6 | 5.3 |
| Europe & Mediterranean | | | | | | | | | | |
| Current account deficit | 9.3 | 3.3 | 2.8 | 0.7 | 1.0 | 2.0 | -0.4 | -6.3 | -3.2 | -2.7 |
| Direct investment | 0.2 | 0.1 | 0.1 | 0.2 | 0.1 | 0.1 | 0.1 | 0.4 | 0.8 | 1.1 |
| Official transfers | 0.4 | 0.1 | 0.3 | 0.3 | 0.3 | 0.3 | 0.4 | 0.4 | 0.5 | 0.3 |
| Long-term official borrowing | 3.2 | 2.7 | 6.6 | 3.2 | 4.0 | 3.9 | 1.5 | -3.3 | — | 3.4 |
| Net commercial bank borrowing | 8.2 | -1.2 | -2.9 | 2.0 | 0.7 | 2.3 | 0.7 | -3.3 | 1.3 | 1.0 |
| Middle East | | | | | | | | | | |
| Current account deficit | 18.9 | 15.1 | 12.5 | 9.9 | 7.7 | 14.8 | 2.1 | 5.7 | 1.5 | -0.3 |
| Direct investment | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | — | -0.2 | -0.2 | 0.1 |
| Official transfers | 3.7 | 3.4 | 2.6 | 2.3 | 2.0 | 1.9 | 1.8 | 1.5 | 1.4 | 1.1 |
| Long-term official borrowing | 1.2 | 1.9 | 2.8 | 2.4 | 2.3 | 0.6 | 1.2 | 1.2 | 1.6 | 1.6 |
| Net commercial bank borrowing | 0.1 | 0.4 | 1.2 | -1.1 | 1.3 | -0.1 | — | 0.2 | 0.4 | 0.4 |
| Latin America & Caribbean | | | | | | | | | | |
| Current account deficit | 41.1 | 40.5 | 9.6 | 1.6 | 3.3 | 18.0 | 11.8 | 12.6 | 10.5 | 11.5 |
| Direct investment | 7.5 | 6.0 | 3.2 | 3.2 | 4.3 | 3.5 | 5.5 | 6.9 | 5.3 | 9.5 |
| Official transfers | 0.5 | 0.6 | 0.8 | 0.9 | 1.2 | 1.2 | 1.6 | 1.7 | 1.5 | 1.5 |
| Long-term official borrowing | 5.4 | 5.4 | 8.3 | 10.1 | 6.7 | 7.8 | 10.8 | 6.8 | 8.1 | 11.8 |
| Net commercial bank borrowing | 27.7 | 42.6 | 21.0 | 8.7 | -6.2 | -4.1 | — | -10.5 | -3.6 | -9.3 |
| Seventeen heavily indebted countries | | | | | | | | | | |
| Current account deficit | 51.1 | 51.6 | 16.1 | 1.9 | 1.1 | 18.5 | 10.0 | 10.9 | 9.5 | 12.0 |
| Direct investment | 7.5 | 6.3 | 3.4 | 3.1 | 4.4 | 3.9 | 6.1 | 7.9 | 6.6 | 10.7 |
| Official transfers | 0.7 | 0.6 | 0.7 | 0.6 | 1.0 | 0.7 | 0.9 | 1.2 | 1.2 | 1.1 |
| Long-term official borrowing | 5.5 | 8.7 | 16.8 | 13.0 | 9.4 | 9.9 | 14.0 | 8.1 | 10.0 | 14.2 |
| Net commercial bank borrowing | 37.6 | 46.8 | 19.2 | 7.6 | -8.0 | -4.5 | -2.4 | -11.2 | -3.5 | -10.5 |
| Developing countries (IMF) | | | | | | | | | | |
| Current account deficit | 49.3 | 84.4 | 66.5 | 37.3 | 35.1 | 56.3 | 12.0 | 29.0 | 31.1 | 19.2 |
| Direct investment | 18.1 | 19.7 | 13.4 | 13.4 | 11.2 | 9.8 | 13.0 | 13.0 | 12.1 | 18.9 |
| Official transfers | 7.1 | 8.0 | 9.3 | 10.6 | 13.2 | 14.6 | 13.7 | 14.9 | 15.2 | 14.4 |
| Long-term official borrowing | 28.7 | 30.8 | 37.2 | 34.4 | 21.8 | 22.4 | 21.0 | 5.8 | 10.8 | 21.4 |
| Net commercial bank borrowing | 61.1 | 67.8 | 30.3 | 10.2 | -11.7 | -11.7 | -10.2 | -17.8 | -16.1 | 1.6 |

Source: IMF WEO data base.

addition to investment in the context of debt/equity conversions. 1/ During this decade, long-term official borrowing maintained a steadier trend, while official transfers increased gradually. Reliance on official financing remained high for all regions. Some of the official support was in the context of debt rescheduling or other exceptional financing to countries with severe economic difficulties. By the end of the decade, the most important source of external financing was official assistance.

Regional distribution and composition of FDI flows

5. FDI by country of source and destination is highly concentrated. During 1980-88, over 80 percent of total gross FDI flows to developing countries have come from five major sources: the United States (31 percent), Japan (25 percent), the United Kingdom (16 percent), Germany (6 percent), and France (5 percent) (Table 4). At the same time, 20 developing countries accounted for 90 percent of the total net flows between 1981-90; just five account for more than half: Mexico (14 percent), Brazil (13 percent), China (12 percent), Malaysia (9 percent), and Argentina (7 percent) (Table 5). 2/

6. Asia has been successful in attracting and maintaining FDI flows, even during the period of overall FDI decline in the first half of the 1980s. The experience may be attributed to comparative success of countries in East Asia in avoiding high inflation and high levels of external debt, to maintaining labor-cost competitiveness and to liberalization of the investment regime in China. The labor force in many Asian countries was seen by investors as disciplined and strongly motivated. Infrastructure and services in these countries were sufficiently developed to support international operations. The distribution within the region has shifted, however. China's share has increased rapidly, accounting for about 40 percent of total inflows to the region in the past 3 years, attracted to the country's availability of natural resources and the special incentives offered to foreign investors.

7. During the second half of the 1980s, there was a substantial decline in FDI flows to the Middle East in real terms, reflecting mainly the experience of major oil exporting countries. In the early part of the decade, investment in these countries was encouraged by the prospect of continued high oil prices. However, following their fall in the mid-1980s and a

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1/ Debt-equity conversions in themselves do not give rise to net capital inflows into the developing countries concerned, as they are merely balance-sheet adjustments reflecting a change in the composition of nonresident claims on the countries.

2/ In this report, flow data by source and host countries come from different sources. Data by source countries (OECD) are in gross terms, whereas data by host countries (WEO) are net of the countries' FDI in other countries.

Table 4. Major Sources of Direct Investment to Developing Countries 1/

(In billions of U.S. dollars)

| | 1980-81 | 1982-83 | 1984-85 | 1986 | 1987 | 1988 | Cumulative 1980-88 |
|---|---|---|---|---|---|---|---|
| Australia | 0.1 | 0.2 | 0.2 | 0.4 | 0.4 | 2.2 | 3.9 |
| Belgium | 0.2 | 0.1 | 0.1 | 0.2 | 0.2 | 0.7 | 1.8 |
| France | 1.0 | 0.7 | 0.4 | 0.6 | 0.7 | 0.7 | 6.2 |
| Germany | 1.5 | 0.9 | 0.3 | 0.4 | 0.7 | 1.3 | 7.7 |
| Italy | 0.2 | 0.6 | 0.4 | 0.3 | 0.4 | 1.1 | 4.2 |
| Japan | 2.8 | 2.1 | 1.4 | 3.0 | 7.2 | 7.9 | 30.5 |
| Netherlands | 0.2 | 0.1 | 0.5 | 0.2 | 0.3 | 0.5 | 2.6 |
| Switzerland | 0.3 | 0.2 | 0.3 | 0.5 | -0.3 | 2.1 | 3.9 |
| United Kingdom | 2.1 | 1.4 | 2.1 | 2.1 | 3.0 | 3.9 | 20.2 |
| United States | 4.9 | 3.9 | 2.7 | 3.1 | 8.0 | 4.2 | 38.3 |
| Other countries | 0.4 | 0.5 | 0.5 | 0.4 | 0.2 | 0.2 | 4.3 |
| Total DAC | 13.9 | 10.7 | 8.8 | 11.2 | 20.8 | 24.8 | 123.6 |
| Of which to: | | | | | | | |
| Caribbean offshore centers | 1.8 | 2.6 | 3.1 | 4.7 | 8.4 | 6.7 | 34.8 |
| Other offshore centers | 1.8 | 1.3 | 0.7 | 1.5 | 4.2 | 4.7 | 17.8 |

Source: OECD, 1990 Report on Development Cooperation.

1/ Data are in gross flows of direct investment, and include only investment by Development Assistance Committee (DAC) members.

Table 5. Major Destinations of Direct Investment to Developing Countries 1/

(In billions of U.S. dollars)

| | 1981-85 | 1986-90 | 1981-90 Amount | 1981-90 Share of Total (%) |
|---|---|---|---|---|
| Mexico | 5.5 | 11.4 | 17.0 | 14.4 |
| Brazil | 9.0 | 6.3 | 15.4 | 13.1 |
| China | 3.5 | 10.8 | 14.3 | 12.1 |
| Malaysia | 5.4 | 4.8 | 10.2 | 8.7 |
| Argentina | 2.6 | 5.6 | 8.2 | 7.0 |
| Thailand | 1.4 | 4.6 | 6.0 | 5.1 |
| Nigeria | 1.5 | 3.0 | 4.5 | 3.8 |
| Colombia | 2.7 | 1.8 | 4.5 | 3.8 |
| Indonesia | 1.2 | 3.1 | 4.3 | 3.6 |
| Philippines | 0.3 | 3.0 | 3.3 | 2.8 |
| Egypt | 2.2 | 0.7 | 2.9 | 2.5 |
| Korea | 0.2 | 2.1 | 2.3 | 2.0 |
| Turkey | 0.4 | 1.9 | 2.3 | 2.0 |
| Chile | 1.1 | 1.1 | 2.1 | 1.8 |
| Gabon | 0.5 | 1.1 | 1.6 | 1.4 |
| Tunisia | 1.1 | 0.5 | 1.6 | 1.4 |
| India | 0.3 | 1.2 | 1.6 | 1.4 |
| Venezuela | 0.6 | 0.9 | 1.6 | 1.4 |
| Papua New Guinea | 0.6 | 0.9 | 1.5 | 1.3 |
| Morocco | 0.4 | 0.7 | 1.2 | 1.0 |
| 20 largest recipients | 40.5 | 65.5 | 106.4 | 90.2 |
| Memorandum items: | | | | |
| Developing countries (IBRD) | 45.6 | 72.3 | 117.9 | 100.0 |
| Developing countries (IMF) 2/ | 75.8 | 66.8 | 142.6 | n.a |
| Other major destinations: | | | | |
| Saudi Arabia | 20.7 | 0.4 | 21.1 | n.a |
| Singapore | 6.1 | 5.8 | 11.8 | n.a |
| Hong Kong | 1.2 | 1.4 | 2.6 | n.a |

Source: IMF WEO data base.

1/ Data are net of the country's direct investment in other countries: the ranking excludes net creditor countries and offshore centers.

2/ Includes Bahamas, Bahrain, Barbados, Cyprus, Hong Kong, Israel, Kuwait, Netherland Antilles, Qatar, Saudi Arabia, Singapore, Taiwan Province of China, and United Arab Emirates.

scaling back of oil-related activities, FDI flows declined and negative net flows were registered in recent years. Excluding high-income oil exporting countries, FDI flows to the region have been negligible.

8. The decline in FDI flows to countries in Latin America and the Caribbean in the first half of the 1980s was a response to deteriorating conditions in many of the heavily indebted countries. Mexico and Brazil remained the two largest recipients of FDI in the region. Some recovery in real terms took place in the latter part of the decade as macroeconomic conditions in several larger countries in the area improved. In particular, FDI flows to Mexico and Chile have surged as progress has been made to stabilize, liberalize trade, restructure and privatize public enterprises, and attract foreign investors to export zones. A number of countries were also able to attract FDI inflows as part of their debt/equity conversion programs.

9. Flows to countries in Africa, which were already relatively small at the start of the decade, declined to even lower levels in 1987-88, then showed some modest improvement. A relatively large increase in 1989-90 was accounted for by Nigeria; if Nigeria is excluded, FDI inflows to Africa remained stagnant throughout the decade with significant flows limited to Gabon, Tunisia, and Morocco. In addition to smaller markets, economic growth in many areas of Africa was adversely affected by droughts and political instability. Many of the countries also have undeveloped infrastructure and a labor force with relatively low skill levels. Greatly overvalued exchange rates during much of the decade of the 1980s also reduced their cost competitiveness. In countries where there was an improved policy environment and incentive structure (such as Guinea, Mauritius, and Madagascar), there was a moderate upturn in FDI flows. In addition to traditional mining and natural resource-based investments, these flows have also been directed to manufacturing industries, such as textiles and food processing.

10. FDI flows to developing countries in Europe have been modest, with Turkey and Hungary accounting for most of the more recent increase in these flows following their progress with economic restructuring. Little FDI has been directed to countries in Central and Eastern Europe. During the last two years, there have been regulatory changes in a number of countries (Bulgaria, Czechoslovakia, Hungary, Poland, Yugoslavia, and the U.S.S.R.) aimed at attracting FDI. The new legislation would allow majority or full foreign ownership in many sectors. Foreign investors have been reluctant to participate in privatization programs which could involve them in difficult industrial relations problems or hold them accountable for environmental liabilities incurred by the enterprise before it was acquired. If legislative changes can be implemented along with other reform measures, opportunity will be created for foreign investors in a very large market which has hitherto been closed or difficult to penetrate.

11. Significant changes in the relative importance of source country for gross FDI flows to developing countries took place during the past decade. There have been large increases since the mid-1980s in FDI flows from Japan, the United Kingdom, and Australia, and, to a smaller extent, France, Germany, Italy, and Switzerland. Flows from the United States have fluctuated widely although it remains one of the largest single investors. The increased flows from Japan occurred at a time when current account surpluses and a significant appreciation of the yen were observed. The weakening in the value of the U.S. dollar in the latter part of the decade may have accounted for some of the observed reduction in FDI flows from the United States.

12. During the 1980s, fragmentary evidence indicates that FDI flows from middle-income developing countries expanded rapidly, accounted for largely by the newly industrialized economies (NIEs). These flows were directed toward both industrial countries (by investors seeking to secure larger markets) and lower-income countries (to take advantage of lower labor costs in the production of parts for electrical and electronic goods or to establish capacity in countries that are not subject to textile import quotas of industrial countries).

Role of FDI in the development process

13. Beyond its role as a source of risk capital for investment, FDI can play an important role in development, by transferring new technology and business practice, stimulating innovation and investment in the recipient country through its linkage to domestic firms, and by securing access to international goods and capital markets. In a number of countries, FDI has been a driving force in the expansion and diversification of manufactured exports. In large, resource-based projects, foreign investors helped screen projects and provide capital, management and access to export markets. FDI projects may increase efficiency directly by producing at lower cost and indirectly by increasing competition in domestic goods and factor markets. Over time, it can have an appreciable impact on international competitiveness.

14. The relative importance of these different factors has changed considerably over time. Prior to World War II, most FDI in developing countries was concentrated in mining, plantation agriculture, and, to a lesser extent, public utilities. In the 1950s and 1960s, FDI switched to manufacturing. Most of this went to the largest developing countries (such as Argentina and Brazil); it was concentrated in processing of locally available raw materials or in the production of manufactured import substitutes by taking advantage of large, highly protected domestic markets. Throughout these periods, FDI contributed primarily capital and technology to the development process, but not management skills, access to external markets or exporting know-how.

15. In the 1970s and 1980s, policy reform in a number of developing countries was aimed at opening up their markets and shifting toward manufacturing for export. FDI in assembly and light manufacture of labor-intensive goods_-textiles, clothing, and electronics_-grew rapidly. There were also investment flows into service industries (banking, insurance, tourism), in response to the availability of specialized management and labor skills. In capital-intensive activities, large multinational companies (MNCs) increasingly sought to create production facilities in developing countries that would serve both local and export markets. This shift saw an increasing amount of FDI going to smaller countries, where openness to trade combined with efficient labor provided the lowest-cost sites for manufacturing export. In these activities, FDI provided access to markets and management techniques to achieve consistent, high quality output.

16. Changes in international capital markets had important effects on the development impact of FDI during this period. The ready availability of low cost finance in the 1970s enabled developing countries to "unbundle" FDI_-to buy technology separately, obtain management or export marketing under contract, or acquire specific expertise. This "unbundling" limited the dynamic transfer of technology which FDI could bring. Absence of continuous institutional linkages to global markets may have led to a loss in initial technological competitiveness. Since 1982 this has reversed. Commercial borrowing became more expensive and unbundling of FDI became relatively less feasible. For most countries, FDI remains the most effective way to acquire and maintain linkages with rapidly evolving technology. Likewise, management and export linkages, including access to distribution channels, may be maintained in a most cost effective way through FDI.

Determinants of FDI flows

17. There appears to be no simple explanation of the determinants of FDI. 1/ While it may be generally stated that firms tend to invest where the expected marginal return is highest, there are several aspects to such a return. Overall growth and macroeconomic stability in host countries are without doubt key factors in attracting foreign investment, which requires lengthy gestation periods before returns are realized. Besides low factor costs, proximity to resource inputs and market are important. Other factors influencing FDI appear to include industrial organization considerations, specifically some inherent technological or managerial advantages that foreign firms can exploit through direct investment. Such factors include the output size of the firm and the market size of the recipient country.

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1/ Discussions on this issue are found, for example, in the IMF report on the United States Recent Economic Developments (SM/90/159: 8/16/90, Appendix VII); Anand Chandavarkar Macroeconomic Aspects, Foreign Flows and Domestic Savings Performance in Developing Countries: A State of the Art Report, OECD, February 1990; and J. Saul Lizondo Foreign Direct Investment, IMF Working Paper, July 1990.

FDI flows could also be a consequence of actual or threatened protection. Firms' liquidity and credit availability as well as relative strength of currencies in host and source countries also appear to play a role. Finally, tax policies, labor organization and regulations, and other restrictions in both host and source countries influence the investment decision, a topic that is further discussed in Section III below.

18. Traditional forces that determined FDI flows to developing countries in the 1970s and early 1980s, such as low labor cost, product life cycle, the servicing of a protected market, while still important, have weakened. In many industries, the proportion of labor cost to total manufacturing cost has declined. New patterns of the international product life cycle have developed whereby first production of new products may take place in developing, instead of developed, countries. Changes in technologies in some sectors have altered the economic scale of production, weakened the case for offshore production in low labor-cost countries, and shifted production sites in some cases to capital-rich countries (such as the automobile sector to the U.S.) and in others to countries with small but highly skilled population (such as electronics to NIEs).

19. These changes have increased competition in global and regional markets, generating pressure on MNCs to adopt global production and marketing strategies consistent with comparative advantage of prospective host countries. While political and economic stability and tax incentives in host countries remain critical, other factors such as local manpower skills, modern infrastructure to support production flexibility required to adhere to quality and delivery specifications, and an international network of domestic business, have grown in importance. With the growth of export-oriented FDI, domestic market size has become less important relative to trade policy liberalization and rationalization of investment regimes. Globalization of production may have also permitted investors to switch readily from one host country to another. However, where adequate support industries exist and backward linkages are established, foreign investors are less likely to relocate.

20. In this new environment, FDI flows generally have been attracted to fast growing developing countries with responsive institutions and a highly motivated, skilled labor force. Experience in the past decade shows that *these tend to be economies with an efficient and dynamic private sector.* The strength of such a private sector is supported typically by liberal pricing policies and by stable and transparent tax and regulatory systems that neither discriminate against private sector activities nor distort the choice of factor inputs. These countries have also been able to maintain their access to other sources of financing--including to world capital markets--which enable supporting activities such as infrastructure buildup and trade. Owing to the relative macroeconomic stability and high rates of growth in these countries, domestic savings tend to be high, permitting high levels of investment overall.

## II. Major Issues in FDI Flows to Developing Countries

### Growth of the private sector

21. The effectiveness of FDI in the development process appears to hinge, in large part, on the efficiency and growth of the domestic private sector itself. The experience of the 1980s shows a close correlation in the behavior of private domestic and foreign investors. For most developing countries, the decline in foreign investment that took place from 1982-86 was accompanied by a slowdown in the growth of private investment. Since 1986, investment in developing countries has increased as a share of GDP. Private investment, both domestic and foreign, has also risen, both as a share of GDP and of total investment and now makes up 60 percent of total investment. This increase has been sharpest in East Asia and Latin America.

22. There has been a growing awareness of the importance of an efficient, expanding private sector. A number of countries_-most notably in East Asia and Latin America_-strengthened efforts to create a more supportive environment for private sector development. For some countries undertaking these reforms, external financial assistance in support of private investment facilitated privatization programs, such as in Argentina, Guinea, Madagascar, Mexico, the Philippines, Poland, Sri Lanka and Togo. Implementation of well-targeted public investment projects aimed at overcoming infrastructure deficiencies has also helped to re-establish and maintain growth of private investment. Legal and regulatory reforms and the correction of microeconomic distortions continue to be important.

### Complementarity between FDI and other types of external financial flows

23. FDI flows are but one source of external finance that helps sustain the development process. The potential developmental impact of FDI is substantial and efforts to promote it should be strengthened. However, FDI flows are unlikely to be sufficient to play a major role in meeting the medium-term external financing requirements of many developing countries and other sources of external financial support should be increased when warranted by strong economic reforms.

24. FDI has other characteristics which make complementary flows from other sources essential. Such flows are typically associated with plant and equipment investment, which requires investment in physical and services infrastructure. Thus, during a period of rapid growth of FDI, infrastructural investment is generally high and must be financed by complementary sources of financing, both domestic and foreign. To the extent that FDI is export-oriented, increased trade financing will also be needed. Officially-supported export credit finance is often an important factor in financing a project. For low-income countries, concessional financial assistance can be especially critical in helping to cover the buildup of infrastructure and to facilitate trade flows and is thus a necessary complement to FDI. In middle-income countries, market borrowing may also play an important role in supplementing investment in large

projects. Countries experiencing deterioration in their external position are unlikely to attract much FDI during the time capital inflows are most urgently required. In these countries, debt-creating flows_-and often limited to official assistance_-may be the main source for financing their external deficit.

25. Thus, different forms of external finance appear to be both complements and substitutes. In the period ahead, official support will continue to be the major source of financing the external imbalance of developing countries for lack of adequate private funds. At the same time, official assistance to low-income countries has strong potential for catalyzing private sector inflows; in these and in middle-income countries, official financing supports an environment more conducive to FDI and other types of private capital flows. The increased presence of other private creditors will have a positive impact on flows of direct investment since they provide advice and financial services to potential investors. Owing to this mutually reinforcing nature of different forms of capital, it is important that countries that want to attract FDI simultaneously re-establish their creditworthiness to commercial financial flows.

Development effectiveness of FDI

26. The effectiveness of FDI in supporting development depends critically on the host country's incentive structure. Like their domestic counterpart, foreign investors respond to existing incentives and they will frequently seek additional privileges including protection, subsidized financing and tax exemptions. FDI that relies heavily on highly protected domestic markets and imported inputs may generate large profits for the investor, but little domestic value-added and have relatively weak linkages to the domestic economy. If these profits are repatriated, both the developmental and the balance of payments impact may be low or even negative. Investment or credit subsidies that unduly encourage capital-intensive FDI create distortions in the host country's economic structure. The development effectiveness of FDI is generally maximized where the overall incentive system is unbiased, transparent and not subject to administrative discretion, both for foreign and domestic investment.

27. While foreign and domestic investors generally respond in similar ways to the same business environment and incentives, certain situations may require special consideration. First, in large, resource-based projects, negotiations for foreign participation, where substantial, need to take into account potentially enormous rents and government supportive action that is often required. Second, foreign firms with global perspectives are more inclined to withdraw from a country in response to changing conditions in the rest of the world. To the extent that FDI can be encouraged to take a long-term view of its presence in the host country, its development effectiveness is enhanced as it is more likely to undertake training of local staff, encourage technological transfer, strengthen linkages with domestic suppliers, and seek opportunities for increased local

participation. The conditions for foreign investment should thus be established in a way that supports such linkages and learning opportunities domestically.

Prospects for FDI in developing countries

28. Immediate prospects for increased FDI flows to developing countries are mixed. Throughout the 1980s there has been growing awareness among developing countries of the contribution FDI can make in meeting a country's long-term development objectives. As a consequence, the pace of policy reform aimed at creating an environment more conducive to private investment generally and at placing foreign investment on a more equal footing with its domestic counterparts has advanced. In support of this process there has been a substantial evolution and expansion of official support from bilateral sources and the international financial institutions. As developing countries continue to make progress with implementation of structural reform, better functioning markets and the generally improved economic performance which will follow can be expected to enhance the profitability of investment. In light of recent trends, it is likely that FDI flows will continue to grow in real terms in response to the increase in profitability of investment; however, FDI flows to developing countries are likely to remain highly concentrated and largely directed to middle-income countries with well-developed infrastructure, advanced support services and which have already established strong linkages to the world economy. Most small, narrow resource-based, low-income countries, many of which are in sub-Saharan Africa, are likely to continue to have difficulty, even among those that have carried out major reforms.

29. While interest on the part of foreign investors in the countries in transition to market economies is high, actual flows have been modest. These countries are addressing the difficulties stemming from macroeconomic imbalances and low growth, and have begun implementation of key structural reforms including privatization. The results of stabilization and structural changes would take time to be reflected in economic performance, and FDI flows to these countries could similarly take time. A number of highly indebted countries--especially low- and lower middle-income countries--are also unlikely to attract FDI until they are more advanced in their structural reform and debt reduction efforts. Moreover, the time lag between improved economic performance and actual investment decisions is likely to be considerable because of slowly changing perceptions of potential foreign investors.

30. Over the longer term, the prospects for further integration of countries in Eastern Europe and the Soviet Union with the world economy will likely increase the demand for foreign investment in the region, raising competition among all countries--industrial and developing--for FDI flows. Although developing countries with a supportive environment are likely to continue to attract FDI, they will need to pay increasing attention to policies aimed at raising its level and at enhancing its developmental effectiveness. Efforts on the part of industrial countries to reverse

growing protectionist pressures and allow developing countries greater access to their markets will also be required in order to strengthen efficient allocation or FDI world-wide.

## III. Policy Measures to Facilitate FDI Flows

### Host country policies

31. Host country policies have an important bearing on the amount and character of FDI received. Consistent and stable macroeconomic policies are the most important in determining incentives and risks for investors. Sector specific policies designed to regulate price, entry, location and distribution of output are also important. Frequently, such regulations are designed to achieve other objectives, but many unintentionally discourage foreign investment.

32. Controls on foreign exchange transactions are especially harmful. Foreign investors need ready access to foreign exchange for imported inputs and freedom to remit dividends and profits and ultimately to repatriate their capital investment. Much of the success of the export processing zones in Mauritius and Sri Lanka is due to easy access to foreign exchange, but establishment of such special zones do not necessarily reflect effective foreign exchange management. Furthermore, integration of foreign investment into the entire economy can be stimulated by an expansion of foreign exchange liberalization to other sectors.

33. Regulatory policy for private investment in general and foreign investment in particular is also important. Countries in which private investment is tightly controlled may have difficulty attracting FDI, even if there are no direct barriers. Foreign investors are discouraged by inadequate legal protection of property rights_-including intellectual property_-and possibilities of nationalization. Regulations specific to FDI frequently include restrictions on which sectors such investment is permitted, the proportion of ownership open to foreign firms, the number of expatriates that can be employed and the ownership of land. Finally, a number of countries impose performance requirements on specific foreign investment projects such as on the amount of output which is exported or the proportion of domestic value added in total output. Such regulations are generally intended to enhance the developmental impact of FDI, but care should be taken in their design so as not to impede foreign investment overall. 1/

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1/ The issues of intellectual property rights and investment performance requirements are currently under discussion in the Uruguay Round in the Group on Trade-Related Intellectual Property Rights (TRIPS) and Trade-Related Investment Measures (TRIMS).

34. Transparency and stability of FDI regulations are critical. Efforts to attract FDI by streamlining the approval process (Yugoslavia), by increasing the number of sectors open to foreign investors (Korea), and by reducing ownership limits (Eastern and Central Europe) may be helpful in signaling a change in government perception of the benefits of FDI. Yet such changes are unlikely to be successful in attracting potential investors if they are done in a piecemeal fashion.

35. Special FDI incentives such as tax concessions, investment allowances, training subsidies and subsidized credit are frequently unnecessary for attracting FDI and may make it more difficult for the country to achieve its other developmental objectives. Furthermore, certain tax incentives for FDI may simply result in a transfer from the host country to source country treasuries without benefiting the foreign investor, such as when the source country taxes residents on their world-wide income and allows a tax credit against foreign taxes paid by their residents (Germany, Japan, United Kingdom, and United States).

36. Only a few capital exporting countries which tax their residents on income earned world-wide have entered into tax sparing agreements with a number of developing countries, whereby taxes forfeited by the host country as investment incentives are treated as tax liabilities in source countries. Where such agreements exist, differential tax rates between host and source countries will have an important impact on after-tax profitability of FDI. Although differential statutory corporate income tax rates based on ownership would maximize tax revenue for host countries, they are not desirable owing to their distorting effect. In general, a stable, low tax, no subsidy regime is the most effective way to induce FDI without distorting the tax structure. In recognition of this principle, corporate tax rates have been reduced in many countries in recent years (notably Argentina, Hungary, India, Indonesia, Korea, and Pakistan) and a few countries have either eliminated tax holidays and/or streamlined tax incentives (India, Korea, Pakistan, Indonesia, and Venezuela). In addition to corporate income tax, investors' net returns can be affected greatly by other tax treatments such as taxation of remittances, treatment of foreign gains and losses, and adjustments for inflation.

Source country policies

37. Increased dependence of developing countries on international markets means that changes in economic policies in the industrial countries now have a greater impact on developing countries. At the general macroeconomic level, the industrial countries have a responsibility to maintain appropriate demand management policies in order to contain inflationary pressures and promote savings and investment, creating favorable conditions for FDI flows. Such policies would entail fiscal and monetary balances that would also prevent real interest rates from reaching excessively high levels that could create an imbalance in investors' preferences between debt instruments and FDI.

38. The level and type of FDI can be affected by the extent of the access of developing countries' products to markets in industrial countries, and can be enhanced by the removal of trade barriers. The changing nature of FDI toward export-oriented activities underscores the importance of open trade and payments systems in capital-exporting countries as a way to encourage FDI flows to developing countries; in addition it would help expand the volume of international trade and capital flows overall. 1/

39. A number of industrial countries provide subsidies for outgoing FDI. While this may encourage direct investment from these countries, it creates policy-induced distortions which discriminate against host country investors and other foreign investors who do not have access to subsidies. Despite efforts to eliminate them, they are still in use by many countries. Industrial countries have also worked to develop guidelines for foreign investors aimed at increasing the responsiveness of FDI to host country development objectives and general rules against subsidizing foreign investment. 2/ Such efforts have been useful in alerting MNCs to the legitimate concerns of host countries regarding protection of the environment, disclosure of information, technology transfer, competitive business practice, employment and export market penetration by their subsidiaries.

40. Source countries can promote FDI more directly by encouraging private sector competitiveness on a global basis through their fiscal and regulatory policies. Tax regimes, subsidy policies, and measures that affect output and trade patterns in source countries have an equally important impact on investors' decisions as do those of host countries, and should be structured such that direct investment abroad would not be disfavored. In this context, coordination between source and host countries on tax sparing arrangements to ensure benefits to developing countries would be desirable. Care should be given in the current efforts to standardize banking regulations and practices among industrial countries so as not to bias banks in these countries against lending to developing countries, which, in addition to restricting resource flows to these countries directly, deters FDI flows to them. Efforts to provide greater protection for intellectual property rights, while necessary, should not unduly discourage technology transfer. More generally, programs to promote FDI flows from industrial to developing countries and to strengthen their benefits should be closely coordinated among the parties involved, taking into consideration the various aspects of such programs and the many factors influencing the level and nature of FDI.

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1/ As a separate item on the agenda of this meeting, the Development Committee is to review a progress report on industrial countries' trade policies.

2/ OECD, Declaration on International Investment and Multinational Enterprises, Paris, 1976.

## IV. The Role of the Bank Group and the Fund in Promoting FDI

41. In their policy dialogue with member countries, both the Bank Group and the Fund emphasize the implementation of sound macroeconomic policies and maintenance of an appropriate, non-distortionary price and incentive structure. These help reduce the major source of uncertainty faced by investors regarding exchange and interest rates, demand for their products, changes in the tax regime, and access to foreign exchange where economic policies are inconsistent. The two institutions also work with member countries to design policies that directly promote savings and investment through price liberalization including interest rates and strengthening of financial intermediaries. These policies increase the potential for investment, whether financed by domestic savings, foreign borrowing, foreign portfolio investment, or foreign direct investment. Furthermore, policies supported by the two institutions typically include efforts to strengthen the role of the private sector.

42. Fund-supported economic programs are with the primary goals of correcting any macroeconomic imbalances and permitting liberal access to foreign exchange including payments and transfers of profits and dividends that are critical to the flows of FDI. Where necessary, the programs also specifically address the problem of debt servicing difficulties so as to help countries re-establish access to foreign capital, including direct investment. In exercising surveillance over the policies of its members in the context of both the Article IV consultations and the World Economic Outlook discussions, the Fund analyzes inter alia members' exchange rates and restrictive systems. In addition, the Fund stresses the need for major industrial countries to pursue the objective of strong expansion of world output and of international trade, and the importance of policy coordination to maintain a stable world economy. The Fund also focuses on the need for structural adjustment on the part of industrial as well as developing countries: improved productivity of investment by giving wider scope to market forces, continued efforts at financial liberalization and tax reform, and reduction of trade barriers. All these elements contribute to a global environment conducive to unrestricted flows of financial resources, including FDI flows.

43. In its adjustment lending, the Bank continues to place emphasis on an appropriate macroeconomic framework and incentive system, on market discipline and private initiatives. The majority of adjustment loans now include regulatory reforms to ease entry, operation and exit by private firms. Access to imported inputs and to export markets has been enhanced by trade policy loans. Improved access by efficient firms to stable sources of finance has been achieved by the Bank's financial sector loans aimed at liberalizing financial markets and reducing financial repression.

44. The Bank's investment lending has contributed to directly strengthening infrastructure and human resource development which supports private sector development as well as encouraging private ownership in areas where the public sector has traditionally been dominant. Since 1983, the Bank has

supported divestiture by the public sector in many countries, including through direct investment by the International Finance Corporation (IFC). The Bank has promoted private participation in infrastructure investment and operation by use of innovative financing and contracting mechanisms that allow joint private consortia of domestic and foreign contractors (build-own-transfer agreements, or BOT). In FY90, resources for private sector investment have been increased by the provision of US$2.8 billion in the form of Bank credit lines for financial intermediaries; an additional US$250 million have been contributed by IFC credit lines.

45. IFC has embarked on new initiatives to catalyze FDI and broaden access to it. About 40 percent of IFC's operations have been joint ventures between foreign and local partners. In FY90, the Corporation made 122 investments, investing US$1.5 billion of its own resources and mobilizing substantial additional resources from other investors, many of whom were foreign. These projects have facilitated the transfer of technological, managerial and marketing know-how. Moreover, IFC's presence has been important in a number of cases, particularly in Africa and Eastern Europe, in encouraging entry of other investors, sometimes as its competitors. Finally, in order to stimulate FDI, IFC initiated the Africa and Caribbean Project Development Facilities (APDF), which offer advisory services to private entrepreneurs in the preparation of projects in the range of US$0.5 to US$5.0 million.

46. Other institutions established by the Bank Group to directly promote FDI include the International Center for Settlement of Investment Disputes (ICSID) and the Multilateral Investment Guarantee Agency (MIGA). ICSID, established in 1966 and currently with 91 member countries, provides facilities for the voluntary conciliation and arbitration of investment disputes between governments and foreign investors. The Bank sponsored ICSID's establishment in the belief that the availability of a neutral international forum for the resolution of such disputes could promote an atmosphere of mutual confidence conducive to increasing international investment flows. There are now clauses providing for ICSID conciliation and/or arbitration in many individual investment agreements, in the national investment legislation of at least a dozen countries, and in well over 150 bilateral investment treaties. To further its objective of encouraging greater investment flows, ICSID has for some fifteen years undertaken research and publication activities in the area of foreign investment law. Its collection of investment laws and treaties, which is continuously updated, makes it one of the few sources of systematic information in this field.

47. Since its establishment in 1988, MIGA has worked towards enhancing the flow of FDI to its developing member countries by offering a wide range of support services, such as advisory assistance on how to create an attractive environment for foreign investment; active help in bringing together foreign investors with their counterparts in developing countries; and provision of long-term political risk insurance. The strength of MIGA lies in its ability to combine its advisory and promotional services with political risk

insurance as an integrated package. It provides long-term investors with insurance against political risks, including currency inconvertibility, expropriation, war and civil disturbance. MIGA's insurance activities supplement existing political risk insurance schemes that are available in the private insurance market and from a number of national insurance programs.

48. The Foreign Investment Advisory Service (FIAS), created in 1986, has been jointly managed by IFC and MIGA for the last two years. It provides advice and technical assistance to governments on specific measures to attract FDI while meeting their own developmental objectives. While the Bank and the Fund concentrate on the macroeconomic and pricing aspects of the business environment, FIAS' work is focused more specifically on helping governments formulate FDI promotion strategies and evaluating the impact of policies on FDI including the legal and regulatory framework; FDI's access to foreign exchange; the rules and procedures for screening FDI, granting incentives where appropriate, and strengthening institutions; regulations concerning technology transfer and intellectual property rights protection; and the availability of loans and local equity partners.

49. The Bank Group and the Fund provide assistance to governments on debt/equity conversions. In recent years, debt/equity conversions have increased for several countries and played an important role in bringing major privatization projects to a conclusion. In addition, such conversion schemes could be an incentive to FDI that otherwise might not take place. The two institutions assist concerned governments in the analysis of the macroeconomic implications of debt/equity conversions, both in the context of the design of economic adjustment programs and of overall debt management. Additionally, the Bank provides assistance in the design of swap mechanisms, and the drafting of regulatory guidelines for such conversions. More generally, it gives technical assistance to governments on strategic financial issues, focusing on market access strategies and improvement of creditworthiness.

50. The Bank and the Fund also give advice and technical assistance in the formulation of tax policies that will be most effective in supporting increased investment by domestic and foreign private investors and that would simplify the procedures for the processing of applications by foreign investors. The Fund advises transparency in the tax system and regulatory mechanism to create a more hospitable investment climate. For instance, it provides legal technical assistance for the reform of company law that can clarify the legal status of foreign-owned enterprises in the domestic economy and increase the confidence of potential investors with regard to the security of their investment. In support of technical assistance and in

view of the increasing role that FDI plays in development strategy and finance, the two institutions have directed greater efforts into research on FDI flows and their policy implications. 1/

51. Data on FDI flows present serious problems for policy analysis. There are two primary sources of data: the OECD and the IMF. Data from these two sources frequently differ. OECD estimates are source country based and include FDI flows from OECD countries only. IMF data are based on balance of payments reports from its member countries and thus have a broader country coverage. In addition, substantial statistical discrepancies of FDI flow data from source and host countries exist. These are the result of differing national treatments of reinvested earnings, investment in offshore enterprises, gaps from nonreporting countries, failure to distinguish between short- and long-term transactions, and methods of collection. A meaningful analysis of the impact of FDI often requires information on stocks of assets held by foreigners (including assets controlled through leveraging of their own resources) as well as on FDI flows; such data are generally not available. The interpretation of data on flows to offshore financial centers that do not engage in significant production activities is difficult. With a view to harmonizing global FDI statistics, the Bank and the Fund along with other international institutions (BIS, OECD, and Eurostat) and national authorities established the "Working Party on the Measurement of International Capital Flows." An objective of its continuing work is to suggest procedures that could enhance transparency and reliability of FDI data without incurring excessively high costs.

## V. Conclusions

52. The 1980s first witnessed a decline in FDI flows to developing countries, then recovery and expansion. However, low-income countries_-especially in Africa_-continue to be marginal recipients of such flows. FDI has evolved considerably in the post-World War II period. During the past decade it has become much more export-oriented as foreign investors increasingly adopted global production and marketing strategies consistent with comparative advantage of host countries. To the extent that FDI induces employment, export opportunities, and transfer of technology and management skills, policy actions to induce foreign investment to these

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1/ Such studies include: The World Bank Industry Series Paper No. 11, Managing Entry into International Markets: Lessons from the East Asian Experience, June 1989; The World Bank Industry Series Paper No. 22, Foreign Direct Investment from the Newly Industrialized Economies, December 1989; IFC Discussion Paper No 3, Prospects for the Business Sector in Developing Countries, 1989; The International Monetary Fund, WP/90/70, Tax Policy and Reform for Foreign Direct Investment in Developing Countries, July 1990; MIGA, Review of Policies of Industrialized Countries Affecting the Outflow of Private Investment to Developing Countries, forthcoming.

countries remain an important item on the development agenda. In the period ahead competing demand for funds by Eastern Europe could exacerbate the difficulty of this challenge.

53. In addition to prudent macroeconomic policies, developing countries that have successfully attracted foreign investment have generally maintained relatively open trade and capital markets, an open exchange system, and a tax structure that is not overly burdensome to investors. The development effectiveness of FDI has been greatest in countries which have succeeded in encouraging foreign investors to take a longer term perspective of their involvement and to establish deeper linkages to the domestic economy. This serves also to strengthen the private domestic sector and the overall competitive environment of the economy. FDI is promoted in several countries through special incentives but these tend to have a distortionary impact and, to the extent that they are based on inward-looking development strategies, could substantially reduce the potential developmental effects of such investment. A simple tax regime with low tax rates but no tax holidays or other subsidies is generally viewed to be optimal in encouraging FDI and simultaneously stimulating domestic investment and improving efficiency.

54. Policies of source countries also need to be supportive of FDI flows. Barriers to trade and capital flows would not only reduce overall growth and investment demand but could as well inhibit specific investments through regulatory restrictions or market inaccessibility. It is important that tax policies in these countries should not discourage direct investment abroad. A harmonization of the tax regimes among industrial countries themselves and with developing countries, particularly in respect of tax sparing agreements, could help stimulate FDI flows and ensure that intended benefits from such measures fall mostly on host countries.

55. Steady flows of official development assistance to complement and support the developmental effectiveness of FDI will continue to be required. Such assistance to low-income countries currently attracting little FDI could, in the face of the countries' correction of their incentive system, catalyze new flows of FDI. It is also important that developing countries are able to re-establish access to commercial sources of financing to further enhance the benefits of FDI flows, and that such access not be impeded by source countries' policies.