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Briefing Paper

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FOREIGN INVESTMENT IN DEVELOPING COUNTRIES

Since the late 1970s, there has been a revival of interest in the role of foreign investment in development. This paper will summarise briefly the effects which are normally expected from foreign investment in developing countries and discuss some of the recent changes in policies and attitudes. The paper examines the characteristics of investment flows in recent years, their quantities and direction, and what appears to explain them, in order to be able to judge how practical are the proposals that are being made to increase their role in the future.

Whether an increase in the role of such investment is desirable must depend in part on judgements by policy-makers in developing countries about the proper role of the private and public sectors and of foreign participation in the economy. It also depends on the outcome of bargaining between a small number of investors and the countries concerned.

Recent Trends in Foreign Investment Flows to Developing Countries

This paper will concentrate on direct investment from industrial countries (see Box p.1). Investment by one developing country in another has been increasing, particularly by Hong Kong, India, Brazil, and Singapore, but the quantities are still very small. Such investment appears neither to be different from industrial country investment from the host countries' point of view, nor to be governed by different motives.

From 1973 until about 1981, foreign investment in developing countries rose in real terms at about 2-3% a year. Official flows also expanded too slowly to maintain their importance relative either to the growth in developing country trade (about 5-6% a year) or to the increase in their current deficits caused initially by the oil price rises and then by slow growth and rising interest rates in the industrial countries. OECD assistance did not increase in real terms, although OPEC aid did until 1980, and World Bank loans rose only 3-4% a year. In 1973, when official flows to the non-oil developing countries were about $9 billion, direct investment was about $4 billion. Their current account deficit was then estimated at about $8 billion. By 1981, when World Bank, OECD and OPEC flows had risen to about $33 billion, foreign investment was about $13 billion.

Although there was considerable year-to-year variation, foreign investment had maintained its position at around 40% of the level of the official flows. The deficit, however, had risen to over $73 billion. Although it is true that the *share* of financing provided by foreign investment has fallen sharply in recent years (and the depression of the early 1980s brought the level down further, to below $10 billion by 1983), the reason for the fall lies in the size of the deficit; foreign investment is only one of the flows that failed to keep pace while the gap was filled by the expansion of commercial bank lending. There has not been a prolonged shortfall in its performance from which it can now be expected to recover, and its existing role is already significant.

The Nature of Foreign Investment

Direct investment excludes purely financial portfolio investment, but includes investment in the form of providing a technical input, reinvested earnings, or even arranging loans abroad which all transfer resources to the host country. Involvement by foreign companies in production in developing countries is not confined to the combined ownership and management which is traditionally called 'direct investment'. There is a range of possibilities and combinations. Ownership can be shared, and the local share can be financial or active. A foreign firm can provide management, permanent or on contract, full or advisory. Products or processes may be licensed, with varying degrees of continuing control. A firm can buy part of the output or help to market the products or even unrelated products.

Technologically advanced companies (or ones with a known brand name) appear to be less willing to accept a local share in ownership, because it is difficult to define a share equivalent to their unique product or process. But cutting across this are other differences, among investors from different national traditions or with different degrees of experience in dealing with investors and governments in developing countries.

Its importance, however, has always been confined to a very limited number of developing countries. Under thirty middle income countries have accounted for over 90% of the total, and within this a very small number of countries, Brazil and Mexico, joined more recently by Singapore and Malaysia, dominate the figures. Of the 1973 total just over 50% went to these four countries; by 1981, their share was about 60%. Even among these, it was the largest source of finance only for Singapore and Malaysia. Foreign investors are, however, probably more important than this might indicate in manufacturing in most of the countries listed in Table 1, South Korea being a possible exception. A high proportion, frequently as much as 50%, comes from reinvested earnings. This and the evidence on the direction of flows suggest a serious limitation on foreign investment as a source of finance: its concentration in a very limited number of countries and the slowness with which any changes, in level or in distribution, are likely to take place.

For the last 25 years, the United States has been the major *source of investment flows* to developing countries, on average responsible for over half the total. Japan has increased its share, taking second place, while France and Germany have also increased their outflows. British investment (see Box p.2) has not risen, so that its share has fallen sharply. It is important to put these trends in the context of these countries' total foreign investment.

UK Investment in Developing Countries

British investment has grown less than that of the other major industrial investors, although the government has shown some interest recently in promoting foreign investment. The distribution by area has been very different, with an unusually high proportion going to Africa (28% of investment in 1979-83). The most important countries for the United Kingdom are Hong Kong, followed by Singapore and India. Brazil and Mexico are the most important in Latin America, and Nigeria and Zimbabwe are prominent in Africa. United Kingdom investment has been mainly in non-manufactures (58% in 1979-83), so that much of the discussion of the non-financial effects of foreign participation in industry would not apply to it. The share has been particularly high in the financial, distribution and transport sectors (16%, 16% and 11% respectively), and in food (13% 1978-82). These figures all suggest that there has been much less adaptation by British foreign investors to new conditions than by other foreign investors.

Developing countries account for about half of Japan's investment abroad, while for the United States and Britain, their share is under a quarter, with France and Germany even lower.

Latin America and Asia are important for both the United States and Japan. Recently, Japan has shifted more towards Asia; there its flows are approaching the US level. The distribution among host countries within Asia and Latin America is similar for the United States and Japan.

For the United States, excluding some special cases of banking centres, most investment in developing countries is in manufacturing or mining, with chemicals and machinery the most important. For Japan, mining also has a large share, particularly in Asia, in line with the traditional view of Japanese investment as a means of ensuring supplies of raw materials for Japan, and within manufactures metals, chemicals and textiles have been important. For France, commercial and, more recently, financial services and energy have been important.

Why Foreign Investment takes place

One obvious point must be emphasised: it is the investors, not the host countries, who take the investment decision. Investment abroad can take place to exploit a commodity or factor of production which is not as readily available in the home country, in which case the expected market need not be in the host country. Traditionally, such investment has been assumed to be in *natural resources*, agriculture and mining, although there have always been examples of companies seeking an ample supply of low cost labour. Alternatively, investment can look for a *market* opportunity in the host country (and perhaps its neighbours). In practice, the distinction is rarely clear cut, with investing companies looking for combinations of trading opportunities, investment in natural resources, and investment for marketing. In recent years investment for marketing reasons has been the motive which dominates every survey[1] of existing or potential investors, although the major part of the stock of existing capital is still in natural resources.

The *government policies* that appear most important to investors are general aids to all industry such as infrastructure, import tariffs or controls and efficient administration. Government stability, political and social, as well as economic growth and a general history of favourable attitudes toward foreign investment, are relevant, but investors' views of what is a good economic structure and what types of government intervention are desirable vary. In surveys, only a minority mention them at all. The role of special incentives is rarely very important for investors since they are not regarded as permanent.

Financial Effects of Foreign Investment

The effects of foreign investment depend on the empirical question, what is *the alternative*? If various sources of finance are available with the other foreign and local inputs freely available outside a 'package', the effect is the difference in financial costs. If there is no alternative source of finance, foreign or domestic, so that there would otherwise be no production or imports of the product, the additional domestic output, net of foreign costs, measures its effect. If a local firm could not substitute for the investor (whether for technical or patent reasons), the alternative is the cost of imports. If differences exist between the ways in which foreign and local investors organise production, the alternative could be local production with different mixes of foreign and local inputs, or different types of input or technology including different degrees of capital intensity. Measuring the effects in the last case is extremely uncertain, and the results depend not only on money costs, but on whether the country has preferences among the different characteristics of foreign and local production.

The surge of interest in the last two years in foreign investment can be attributed to financial effects: as an alternative source of capital to bank loans or as the only available finance if these decline in importance and the official flows (at best) do not rise. There is no measure of the *financial costs* of foreign investment to host countries which could be comparable with interest payments on loans. Investment tends to be more long-term and the outflow of capital precedes the resulting returns by several years. The data are difficult to collect and not always published because of confidentiality rules. Many countries do not compile data on profits that are reinvested so that both the stock and the profits become undervalued. For those countries for which data are available, payments on foreign investment rose much less than interest or other costs of capital during the last fifteen years, and particularly between 1977-80. Other payments rose sharply, in line with the increased deficits that needed to be financed, and later with rising interest rates.

A recent study by the IMF[2] that tried to compare the levels of returns on foreign investment with those on loans found that over the whole period from 1974 to 1982, the average cost of loans was lower. But from 1974 to 1979, a period of economic growth, the cost of investment was always higher; during 1980-82, when many economies were depressed, it was lower. Both these results support the view that such flows are more likely to vary with general economic performance and therefore with ability to pay.

In the 1970s, public sector financing through commercial bank loans became a possibility at least for some countries. Since 1982, not only has access to such loans been reduced, but even where it remains, it has frequently been dependent on favourable assessment by international agencies, particularly the IMF.

Structural Effects of Foreign Investment

Many of the costs that developing countries have feared in the past and also of the potential benefits which they now look for would arise from differences between foreign-

1. For example, Group of 30, *Foreign Direct Investment, 1973-1987*, New York, 1984, reports their reasons as markets: 87%, reducing costs: 13%.
2. IMF, *Foreign Private Investment in Developing Countries*, Washington 1985.

Table 1: Net foreign direct investment by area and major country recipients

	1969-73	1974-78	1979-83
All non-oil developing countries, *$ million*		28200	53300
Total for 27 middle and upper income countries included below	6674	20829	48645
	Percentage of total		
Newly industrialising countries	80	74	64[a]
Brazil	37	36	21
Mexico	25	16	16
Singapore	11	14	16
New NICs	17	23	27
Malaysia	8	10	11
Other middle income countries	4	3	9
Area Totals			
Africa	2	7	13
Asia	30	36	38
Latin America	68	57	50

a. Estimate.

Source: IMF, *International Financial Statistics*, IMF, *Foreign Private Investment in Developing Countries*, January 1985.

owned and local companies. Their *performance in trade* has been closely studied. Some developing countries now hope that they will provide a way through protectionist barriers. In general, their export performance appears to be similar to that of local firms in the same sectors, although there is only a small number of firms in most developing-country industries among which to make comparisons. The evidence on whether they import more than their local counterparts is mixed.

Their role in transferring advanced *technology* has received increased attention in recent years, and is now very important in determining developing-country attitudes to foreign investment. It is noteworthy that developing country policy-makers now definitely identify producing an advanced product or using advanced techniques as an advantage, not a disadvantage, of foreign firms. They no longer believe that technical progress only saves labour, so that there are advantages in taking a process or product that is out-of-date in the investing country. Alternative, more labour-intensive processes will be less efficient overall than the latest. Technical advances are looked for and applied because they are associated with quality control, and both countries and companies look on applying international standards as one of the necessary, and desirable, characteristics of a foreign investor.

There has been controversy over how technically advanced the processes actually transferred to a developing country are (especially when the most labour-intensive ones are moved to establish an export-orientated industry), and over what advantages may accrue to a manufacturing sector as a whole from the presence of advanced foreign firms. The companies and the countries now argue that the processes are as advanced as they would be for the same production, at the same level of output, in an industrial country, although some processes which depend on the existence of large supplies of a local input (which may be semi-skilled labour) have no industrial-country equivalent. The evidence of an association between high technology and investors' preference for 100% foreign ownership suggests developing countries may have to decide whether technology or local participation is more important to them.

Among the host countries that have attracted the largest share of investment, *labour training* is one of the most important objectives. They regard it as more significant, even in present conditions, than the capital input. There is growing evidence that it does spread outside the company, particularly in the form of backward linkages: ex-employees become suppliers or offer servicing or maintenance to the foreign company. ILO estimates[3] suggest that the number of jobs generated in this way may be at least as great as in the foreign subsidiary itself.

The influence of foreign ownership on other *labour conditions* and on *government revenues* is always subject to controversy. As with trading practices, it is difficult, when there are large firms in a small industry, to identify the impact of 'foreign-ness'. In principle, an inflow of capital should raise the return to other factors, including labour, but it is unlikely that any labour markets are sufficiently competitive for this to be observed directly. If the government offers more tax incentives than would be necessary for a local firm, it may reduce its own income. Tax policy and labour costs are areas in which it is difficult to allocate responsibility between the foreign firm and the government which permits, encourages or requires certain lines of behaviour.

Foreign investment may affect the *composition of output*. One important characteristic of direct investment is that it is normally *by private companies in private companies*. Publicly owned companies in industrial countries, such as utilities or public transport, are normally restricted from investing freely abroad, and a host country is unlikely to welcome foreign private participation in its administration or activities barred to its own private sector. If developing countries increasingly rely on direct investment as a source of external finance, the share of the public sector is likely to fall.

Policies toward Foreign Investment

In the last ten years, there have been interacting changes in the nature of foreign investment and in the policies adopted towards it in both industrial and developing countries. There have been attempts to develop *international codes of practice* for multinationals and for governments in their policies towards them, but these have failed to produce generally-agreed standards. The United Nations began its efforts in 1977, but although the process of negotiations has clarified the issues, no agreement has been reached. There have been more limited attempts to agree 'guidelines', for example by the OECD among industrial countries, or to develop general standards, for example among the Andean Pact countries in Latin America, but these have had only limited scope. The only results that can be definitely identified from these efforts are first a recognition that there is a legitimate international interest in the regulation of foreign investment and limits to any country's rights over either companies operating in it or its own companies operating abroad, and second a large growth of generally available information about what other countries have done in regulating foreign investment in general, and, through more informal contacts, individual multinationals. Companies have always exchanged information on different countries' policies.

The failure to agree on an international code has led to negotiation of bilateral treaties by all the *industrial countries*. Individually they have all offered some forms of insurance against such risks as expropriation, and assurance of non-discriminatory treatment, with the

3. ILO, *Technology Choice and Employment Generation by Multinational Enterprises in Developing Countries*, Geneva, 1980.

Japanese schemes the most comprehensive and widespread.

The most important change has been in *United States policy*. Since the mid-1970s, it has become much more interested first in protecting investors from discriminatory treatment and more recently (under Reagan in 1983) in requiring certain minimum standards of treatment for foreign investors which may go beyond what is guaranteed to local investors (or what is demanded by other industrial countries). The policy on foreign investment has also been strongly affected by the preference for the private over the public sector characteristic of domestic United States policy. Countries must 'avoid the adverse effects that government intervention . . . can have on the United States and world economies'. The regional development banks are being encouraged to promote private investment. Foreign investment is now seen as better than official flows, and thus potentially a substitute for them, not only for other private flows.

There have been two recent general shifts in *developing-country policies* toward foreign investment, the first increased regulation, occurring around 1970, and the second, starting about 1977 and accelerating from 1983, towards much more favourable treatment. A much more important shift, however, has been away from general attitudes and biases altogether and towards a much more informed and discriminatory assessment of its advantages and disadvantages, in particular countries, circumstances, sectors, and cases. This was notably true of the shifts that occurred in the late 1970s. The powers to regulate foreign investment, and to control or encourage its access to specified sectors were preserved. The change was seen in greater willingness to give the required permissions when special advantages, especially as a source of capital or of training or technology, were perceived. Partly because of the greater information available, countries appeared more confident of their ability to use foreign investment, rather than considering it necessary either to reject it because of its dangers or to accept it without restraint.

There are few data on the quantitative importance of the arrangements described in Box p.1 which fall short of full direct investment. Even if it is still small, however, the increased awareness, on both sides, of the possibility of calculating the costs and benefits of each part of the investment package has increased the openness of the bargaining between investors and governments. Judging appropriate levels for transfer prices, intra-firm royalties, and the total value of an investment package is less of a black box. More local participation increases the information available within a country. On the other hand, a lower share of foreign ownership and fixed fees for services reduce the potential for benefiting from the flexibility in returns which should come from equity finance.

Future Prospects

There are now strong *pressures on the developing countries* to accept and 'encourage' foreign investment. In April at the IMF/WB meetings, the US and UK stressed it, and the World Bank has proposed a Multilateral Investment Guarantee Agency (MIGA) to supplement national schemes. Promotion of investment by the industrial-country governments is not new, but the stress on the advantages for the developing countries is. There are some important contradictions in the arguments for it. The pressure on developing countries to offer more guarantees and particularly the participation of the World Bank and the International Finance Corporation (IFC) seem inconsistent with investors' acceptance of risk which is one of its expected advantages, from both a financial and an efficiency point of view.

The emphasis in US policy on regulating government-investor relations may be inconsistent with some companies' preferences for close relations with, and even participation by, local governments. The only limit, but an important one, on US promotion of foreign investment is an obligation not to damage US interests. In particular, there can be no assistance to foreign investment that competes either in US home markets or in its export markets. This again may conflict with US company interests. These difficulties and the inability of private investment to finance any programmes within the public sector suggest that serious problems could arise for developing countries if the US policy of substituting investment for public sector flows becomes general.

The changing international political climate combined with the financial difficulties of the last three years does not seem to have affected the nature of the efforts of the countries that were already attracting investors, but may encourage countries with less experience to promote investment more indiscriminately. This risks producing either resistance or disillusionment, in particular in countries which in fact have no realistic hope of attracting it in significant quantities.

The absence of alternatives and the more favourable attitudes of some developing countries, combined with the revival of growth and therefore of the volume of all investment, suggest that foreign investment's relative importance may rise in the next few years. The IMF study suggests a rise of 5% p.a., greater than the 2-3% of the 1970s. The falls in 1982 and 1983 were such that this forecast only implies that the 1988 level will have returned to that of 1981, and that foreign investment will by then be financing 15% of the current deficit. This certainly does not imply a strikingly increased role. If investors share forecasters' expectations that the difference between growth in the developing countries and that in the developed will be smaller than in the last ten years, there is no reason for developing countries to attract a much larger share of total investment.

The investment that is made on past experience will go mainly to the countries to which it has always gone, with perhaps a very slow move towards the most advanced of the other countries. This means it will be negligible for all but perhaps a dozen countries. The evidence is that it is very difficult to attract foreign investment to new countries by means of tax concessions or any other policies under the control of national governments. The principal influence on all foreign investors is markets. Any move to encourage developing countries to 'accept' investment instead of other flows must take account of the fact that a country has very little freedom to influence it.

Foreign investment tends to change only very slowly, in quantity and in direction. This means that it cannot be seen as a short-term substitute for bank finance or public sector flows. Even in the medium term, it can only replace some of these flows because it goes only to private sector activities and because it will always be restricted to countries large and economically advanced enough to offer the necessary infrastructure, markets, or inputs to attract a profit-motivated investor.

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