DEVELOPING WITH FOREIGN INVESTMENT

EDITED BY
VINCENT CABLE AND
BISHNODAT PERSAUD

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FOREWORD BY THE COMMONWEALTH SECRETARY-GENERAL

The chapters contained in this volume represent a condensation of a large amount of work carried out by and for the Commonwealth Secretariat over the last few years on the subject of foreign investment in developing countries.

The Commonwealth has a great variety of states: rich and poor; large and small. But meetings of Heads of Government and Finance Ministers have none the less been able to build a consensus on controversial issues. Few subjects have been more controversial in the past than foreign investment, and the role of transnationals in development. Yet within recent years there has been a broadly-based recognition that foreign investors do have a positive role to play in development within the general context of a stronger private sector. Reflecting this, the Secretariat has assisted with policy development in Commonwealth countries; its project in foreign investment policy has been at the centre of this activity.

Over a number of years the Economic Affairs Division of the Secretariat has organised a series of regional seminars for policy makers in the foreign investment field. The papers and proceedings of the meetings which have been published separately have aroused sufficient interest for us to believe that at least an edited selection of the papers would merit commercial publication: hence this venture with Croom Helm.

A similar collaboration with Croom Helm in 1982 led to the book Problems and Policies in Small Economies, which proved to be a timely addition to the growing literature on the economics of small states.

The chapters in this volume range from conceptual issues, through a series of country strategies to project-specific experiences. They contain several important messages. One is that the whole context of policy discussion has shifted away from the confrontational approach to transnationals and direct foreign investment of the 1970s. There is now a greater recognition that where foreign investors can contribute to development on reasonable terms by foreign exchange earnings, by sharing large project risk and by transferring technology, they should be welcomed or, at the very least, treated pragmatically.

But while this situation creates opportunities, it also has dangers. One is of exaggerated expectations of what foreign investment can accomplish in a short time; the case studies make it clear that investor perceptions change slowly and in response to the fundamentals of economic performance. Another is that foreign investors may be tempted to disregard the sensitivities of host countries in relation to sovereignty - especially in small states which are highly vulnerable to the power of big corporations - and to the need for a fair distribution of the returns from investment between shareholders in rich countries and the host developing country. Now is the time to put investor-host country relations on a sustainable long-term footing. To this end, the Secretariat is assisting developing countries through its Technical Assistance Group to bargain more effectively with transnationals.

I should like to express my appreciation to the substantial number of Commonwealth governments and Secretariat staff who have contributed to our work on foreign investment; to the World Bank and International Finance Corporation, which have given financial and intellectual support; and to those who have helped prepare these papers for publication; and rather specially to Mrs. Margaret Cornell for the editing work.

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Chapter One

NEW TRENDS AND POLICY PROBLEMS IN FOREIGN INVESTMENT: THE EXPERIENCE OF COMMONWEALTH DEVELOPING COUNTRIES

Vincent Cable and Bishnodat Persaud

Introduction

There is a growing recognition of the importance of the private sector and of direct foreign investment (DFI) in the development process. A considerable number of developing countries have become more receptive to DFI, and are exploring ways of increasing inflows(1).

Several considerations lie behind these changing perceptions. The first is an increasing preference for investment in equity form over commercial bank borrowing, which has proved to be unpredictable, onerous and inflexible in its servicing obligations, and unobtainable for many countries. Foreign investment provides not only an initial capital inflow but the subsequent outflow of profits is determined by the performance of the investment. Second, direct foreign investment is a means of obtaining not only capital but also technology, scarce management and skills, and improved marketing 'know-how' and outlets for non-traditional exports of manufactures, processed commodities and traded services.

The serious anxiety among many developing countries over their external financing position and the serious deficiency in development finance has heightened awareness of both these factors. Foreign investment is seen as assisting the balance of payments both through the initial injection of capital in the short run and the generation of foreign-exchange earnings in the long run. There has also been a heightened awareness of project risk and of the role which foreign investment might play in spreading risk beyond the host country. These views are, however, still subject to considerable controversy. Some question the net benefits of foreign investment. There are particular anxieties over the long-term balance-of-payments impact and over the employment and technological implications. Some governments are reluctant to risk the loss of domestic sovereignty.

In this volume we review recent experience of foreign investment and foreign investment policy primarily in relation to Commonwealth developing countries, in order to seek out the lessons in policy terms. We recognise the dangers in seeking to generalise from among countries so different in population, resources, income level and political orientation but believe there are, none the less, useful insights to be drawn from comparative experience.

The Changing Character of DFI in Developing Countries

In the accompanying tables we have tried to give a flavour of the main trends over time, and the main differences between host countries, in relation to DFI. This analysis is based on statistics which, in relation to investment flows and (even more) stocks, are notoriously prone to error, inconsistency and misunderstanding(2).

The first point to note is that the revival of interest in DFI as a source of external finance occurs against a background of actual decline in its relative importance (Table 1.2). There was a pronounced fall in the share of DFI in the aggregate flow of external resources to developing countries from 24% in the 1967-73 period to 16% in 1974-80, while private commercial lending grew in relative importance from 11 to 28%. Even though net bank lending has since dropped sharply, so has foreign investment(3) and there is no evidence yet of any substitution effect at work, at least on a global scale (Table 1.3).

Even in countries where DFI has grown rapidly, its relative contribution to domestic investment has not necessarily risen. Thus, in Malaysia, the foreign share of corporate capital fell from 62% in 1971 to 34% in 1983 despite a quadrupling of its nominal value. Even in Singapore, where DFI increased over ten times between 1970 and 1981, local Singaporean investors maintained their share (about two-thirds) of total equity. The lesson is significant. It indicates the unlikelihood even of rapidly growing foreign investment acquiring a dominant position in a growing economy.

Secondly, DFI is increasingly concentrated in a small number of the relatively high-income developing countries. Five countries (four of them relatively high-income - Brazil, Mexico, Malaysia, Singapore - the fifth being Indonesia) now account for approximately 40% of the stock of DFI as against 25% in 1970. Table 1.4 shows that low-income developing countries account for a small share of both the stock and flow of foreign investment in relation to their combined GNP as well as their population, and almost half the stock and recent flow is accounted for by Indonesia. In 1984-5 there has been an increase in the importance of low-income developing countries in terms of the share of new flows, but this is largely attributable to China. It is important to note, however, that similar - possibly greater - concentration now exists in relation to commercial lending since only a few developing countries are now considered creditworthy by banks and capital markets.

It is not too difficult to hypothesise as to why these disproportions occur. For a given population, the domestic market of a low-income country is relatively small and thus has more limited attraction for foreign investors. In many low-income countries poverty is both a cause and an effect of poor infrastructure. And in sub-Saharan Africa there has been a multifaceted and prolonged economic crisis which explains the declining share of risk capital in capital flows to Africa and in Africa's share of foreign investment in developing countries. The IMF acknowledges: 'countries with small internal markets, few natural resources, a relatively underdeveloped infrastructure and limited possibilities for manufactured exports may not be able to attract substantial direct investment even with liberal regulations and generous incentives'(4). Cross-section analysis also suggests that per capita income is the most important single factor in explaining differences in the amount of (per capita) foreign investment as between countries(5). Least developed countries have a negligible share of foreign investment in developing countries and it accounts for a negligible share of their net resource inflows; by contrast upper middle income countries have the highest proportion on both measures (Table 1.5).

In general, foreign investment has a self-reinforcing character, being attracted to countries where development is already rapid and successful. But for country-level policy-makers such a general tendency is not a helpful indicator of national possibilities; we therefore look in detail at the experience of low-income countries which have been successful in attracting investors (Sri Lanka and Kenya) or which have been able to overcome infrastructure constraints (such as Papua New Guinea).

Thirdly, at a global level, there has been an increase in the importance, as a source of DFI in developing countries, of Japanese, German and Third World transnationals though the United States remains the predominant source with around 50% of the stock and flow. The different approaches of these transnationals to the organisation of production, to technology transfer, to joint ventures and to various forms of official intervention and support have proved significant in, for example, enabling Japanese companies to secure an important role in Indian industry following recent liberalisation. Third World transnationals from Hong Kong, India, Korea and Taiwan have been particularly important in

Singapore, Malaysia and Sri Lanka and are seen as conferring advantages in terms of 'appropriate' technology.

Nevertheless, a particular feature of the countries studied in this volume is the very high share of foreign investment from traditional sources: Britain and (in the case of Fiji and PNG) Australia and New Zealand (Table 1.6). Moreover, there is a marked distinction between those cases where such investment was in the most dynamic sectors of the host-country economy - in Singapore, for example, the UK share of foreign equity has increased from 10% in 1970 to over 30% in 1981 - and those where the UK's DFI stock is predominantly in investments dating from the colonial period, and declining in importance, as in Malaysia. By focussing on Commonwealth countries this volume gives emphasis to important but neglected areas of foreign investment policy discussion: how to maximise new investment, through reinvestment, and obtain the best value from traditional foreign investors; how to attract new flows from new investors while preventing a drain of capital from existing investors (this being a particular problem for countries with a stock of 'settler' capital, such as Zimbabwe and Kenya).

Fourthly, there is a widely observed tendency for DFI in developing countries to gravitate increasingly towards manufactures and related financial services, rather than the traditional sectors: plantation agriculture, mining, retailing and utilities. This reflects, in large part, the preference of governments in the host countries for local ownership in these fields. The trend is evident both for countries which have become significant exporters of manufactures or services (Malaysia, Singapore, Sri Lanka) and for others where foreign investment has been attracted into manufacturing of an import-substituting kind (Kenya). For many of the open small island economies (Trinidad and Tobago, Papua New Guinea and Fiji), however, the traditional sectoral pattern of foreign investment remains. In this volume we recognise the quite specific issues involved in negotiating with foreign investors in different fields and particular attention is given to mining (Sims and Goss and Nellist) and manufacturing for export (Helleiner).

Fifthly, in the majority of the case studies, there were indications of the growing importance of 'new forms' of overseas investment reflecting the preference either of host countries or of companies for reducing the direct equity component of foreign investment. The process by which traditional majority-owned investment has given way to 'new forms' - notably joint ventures and licensing agreements - is impossible to quantify but is widely documented, especially in petroleum, mining and import-substituting manufacturing(6).

To take examples, India has, as a matter of policy, sought technology collaboration arrangements while restricting the role of foreign equity. In Malaysia, the case study notes: 'licensing and franchising arrangements and management contracts, which represent the new forms of foreign investment, are growing in importance'. Joint ventures, turnkey arrangements, and management contracts have been of rapidly growing significance in Trinidad and Tobago. In Kenya, management and technical agreements have proliferated, especially in import-substituting industry and in joint ventures with the government as a partner. In these instances, a host government preference for reducing the role of traditional DFI has been the main influence. But in some cases the initiative has come from the transnationals themselves, presumably to reduce risks and because also of other evolutionary factors such as the involvement of smaller transnational corporations. In Fiji, for example, foreign investors - especially the Australians - have followed a strategy of withdrawal but coupled with this has been 'the harnessing of local enterprise through subcontracting', designed to retain control without ownership involvement.

There are, however, other cases where governments have pressed for a higher foreign equity stake. This is a central feature of recent minerals negotiations in Papua New Guinea. And in Singapore new forms of investment are 'not common, given the government's willingness to allow foreign firms to form wholly owned subsidiaries. Firms with little or no foreign equity but that have licensing or other arrangements with foreign technology supplies account for less than 10% of recently established firms'.

DFI As a Source of Development Finance

Increasing Capital Inflows. As we noted earlier, the importance currently attached to foreign investment in development derives from two considerations: the need developing countries have in general for additional external finance in order to raise their rate of growth, and the advantage of foreign investment over external commercial borrowing mainly arising from the closer link between financial return and project performance.

As regards the first, there is a large gap between the magnitude of developing country current-account deficits which can be predicted if growth in these countries is to achieve reasonable levels, and the likely availability of finance(7). In the 1986 World Bank World Development Report, the difference between the 'high' and 'low' growth scenarios for developing countries is mirrored in, respectively, a $9 bn and $64 bn deterioration in the current-account balance from 1985 to 1995. Foreign investment (net) has a modest but positive role to play in financing this gap, increasing from $11 bn in 1985 to $19.1 bn in 1995 (in 1985 prices) in the high growth and to $14.2 bn in the low growth scenario, these representing an annual real growth of respectively 5.7% and 2.6%. The difference between the 'high' and 'low' figures partly reflects the response of foreign investors to higher or lower growth in developing countries, and partly the policy orientation of host countries.

<u>Substitutability</u>. Foreign investment cannot be treated entirely as additional to other commercial flows. At the project level, there is a choice between different combinations of loan and equity finance. Part of the argument for emphasising foreign investment is that it can substitute for loan finance, especially where the latter is constrained, but even where it is not.

Some of the expansion in bank lending over the past decade was a substitute for private direct investment. This trend was encouraged by the relatively low interest rates throughout most of the 1970s and by the restrictions which host countries placed on direct investment. The question now arises as to how to reverse this process of substitution when the real cost of borrowing has risen and the benefits to host countries of equity capital as compared to commercial borrowing are more clearly perceived.

The papers in this volume highlight the need for caution about overstating the potential for substitution. Most obviously, the scope for substitution is largely limited to the private sector; direct investment cannot be used to finance more development infrastructure. But even in private sector projects, substitution may not be easy. Simply as a matter of fact, much of what is described as foreign investment is, in fact, lending. DFI conventionally defined (by the IMF) includes borrowing from parent companies and affiliates. Helleiner, in his paper, describes a survey of DFI projects in which half of the new capital led to debt obligations. And he points to a more general tendency for transnationals to act as intermediaries in international capital markets, thus generating external debt obligations (activities which may in fact be desirable in boosting overall capital inflows, even if not in equity form).

In several of the countries studied, there is evidence that what is described as foreign investment may have only limited equity characteristics. In Sri Lanka, 'a noteworthy feature was the substantial role played by long-term loans - chiefly long-term suppliers' credits in financing investment in fixed assets'. And in a separate study of export-oriented investment (in Africa) it is observed that 'there is a general shortage of equity capital and investors prefer to use loans (or retained profits) rather than new equity for investment'(8). In countries where DFI is centred on raw material extraction there have been strong corporate pressures to reduce equity risk.

However, in one or two cases of countries with a long record of attracting DFI - notably Barbados and Singapore - the predominantly 'equity' character of foreign investment is preserved, for two related reasons. First, there is a good expectation of high returns to equity (the average return to foreign investors in Singapore is around 18%); so assets are held predominantly in this form by choice. Second, where earnings are rapidly increasing this provides substantial capital expansion from firms' own profits. But for many other countries - with less well established investor confidence - it can prove difficult to attract DFI in equity form other than through the growth of retained profits in existing undertakings, and rather easier to raise loan finance. This suggests a need for looking at policies, and new instruments, which can introduce a greater foreign 'equity' element into projects.

Financial Terms. Equity financing through DFI now looks attractive to developing countries relative to loan financing because of high real interest rates (just as borrowing appeared attractive when real interest rates were negative). But, if it is to grow substantially, the expected return to investors will need to be high in relation to the return on lending. Some profits will be reinvested but some will be remitted. This will create a negative flow of investment income to set alongside capital inflows. As Table 1.7 shows, in overall terms, net transfers on foreign investment are currently negative for developing countries as a whole.

Among the countries studied, Singapore enjoys a large excess of new foreign investment inflows over net investment income payments. Since Sri Lankan policy changed in 1977, there has been a positive balance of DFI inflows over profit remittances. In Barbados, total private sector remitted profits and interest have almost exactly balanced private inflows over the past decade. On the other hand, despite generally rising inflows of foreign private capital to Kenya, there has been a consistently negative net flow overall. Zimbabwe since independence has experienced net disinvestment of private investment as well as a net outflow of investment income. These two cases illustrate the rather special problems of post-colonial economies in which a large part of the foreign-owned capital stock is held reluctantly by former residents with limited commitment to reinvestment. But in other cases too (Trinidad and Tobago for example) net flows are consistently negative. Where this occurs, the fear of outflow of existing capital and/or the repatriation of profits may be sufficiently high relative to the promise of new inflows to make DFI seem unattractive as a source of external finance, especially at times of balance-of-payments difficulty. This may in turn lead governments to introduce exchange restrictions which will make new inflows of DFI even more difficult to attract. But where a government has a politically favourable attitude to DFI a more positive approach would be to explore the possibility of policies which would increase inflows of direct investment rather than to set up a vicious circle by restricting the remittance of profits.

There are, in particular, two ways in which a simple calculation of net transfers seriously understates the benefits of DFI. Foreign investment should give greater stability than commercial lending: it is generally tied up in illiquid fixed assets while loan finance has been, by contrast, often short-term and requiring continual refinancing (though a major disinvestment could, of course, be highly disruptive for a small economy). Table 1.2 shows that both gross flows and net transfers from foreign investment are more stable overall than those from commercial borrowing.

Second, as discussed in detail in the Helleiner paper, there has been a recognition that foreign investors are well placed to generate foreign exchange from export-oriented projects. Transnationals enjoy an advantage over indigenous and public sector operations, deriving from their scale, specific market knowledge and distribution chains in creating markets, especially for non-standardised goods and services requiring marketing expertise. Furthermore, alternative arrangements - such as management contracts in mining and tourism, and subcontracting for manufacturing exports - have some disadvantages. They do little to reduce external control while removing risk from the private investor. And both theory and experience have combined to show that, other things being equal, countries pursuing export-oriented strategies, rather than import substitution, are likely to attract more DFI and in more economically valuable ways(9). Several of our case studies support the proposition that foreign investors can make a major contribution to exporting. In Singapore, wholly foreign-owned firms in manufacturing export 71% of their output, as against 32% for wholly local firms. In Barbados, foreign-owned firms are shown to be relatively highly export-oriented and fast growing. Much of the increase in foreign investment in Malaysia in the 1970s occurred in the two industries which are predominantly export-oriented (electronics and textiles). The export growth experienced in Sri Lanka since 1978 can be largely attributed to non-traditional products originating in DFI enterprises.

There is, however, some less positive evidence. In Fiji, foreign investors have, in recent years, contributed a lower share of their output in the form of exports (in manufacturing) than domestically owned firms. Foreign companies are described as having become 'peripheralised' as a result of mergers and take-overs: 'peripheralisation is associated with the adoption of narrow regional marketing strategies .... (and) may jeopardise export-led growth'. In Trinidad and Tobago, too, examples are cited of transnational companies apparently contributing little in terms of marketing (refined oil or fertiliser) which nationals could not do with equal facility.

The considerations which apply in marketing raw materials are somewhat different, but the potential of foreign investment for generating exports is recognised by most governments. The Papua New Guinea experience of export-oriented mining suggests that 'a company with major equity at risk, and thus a strong interest in project profitability is likely to perform more efficiently and to place greater value on the long-term stability of its relations with the host country than a minor shareholder, management contractor or mere supplier of technology'.

For a good many host countries - India and Zimbabwe for example - there is a wish to attract foreign investment on a selective basis, limiting its role to export-oriented enterprises, especially in manufacturing. This selectivity - expressed, for example, in 'performance criteria' - has begun to arouse some concern among companies because it suggests a direction of capital towards relatively high-risk and possibly low-profit activity. Thus a broad consensus on the desirability of more DFI has to be qualified to the extent that host countries and investors may have quite different, possibly conflicting, expectations of it.

Host Country Policies

Given that countries wish to attract more foreign investment - usually selectively - how is this to be done? How do host governments influence the climate for investments? What particular policy instruments are crucial? What are the realistic possibilities of using inducements to attract new flows to countries whose size, location, resources and history are not otherwise attractive from the standpoint of investors? We have tried in these studies to cast some light on the perceptions and expectations of both investors and official decision-makers.

<u>General Business Climate & Investor Confidence</u>. DFI decisions