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MULTILATERAL MEASURES TO PROMOTE FOREIGN DIRECT INVESTMENT

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ROLE OF INTERNATIONAL FINANCIAL INSTITUTIONS IN PROMOTING NON-DEBT CREATING FLOWS TO DEVELOPING COUNTRIES

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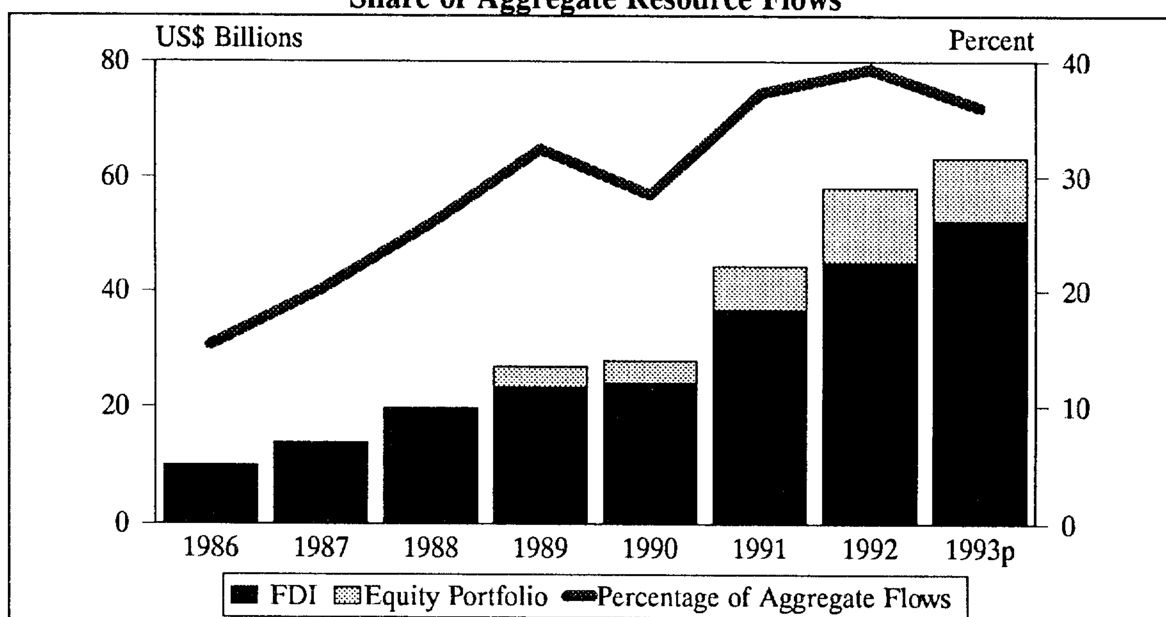
I. Introduction and Background

Aggregate net resource flows to al developing countries increased by 22 percent in real terms to reach an all-time high of US$148 billion in 1992. They are projected to increase further to US$176 billion in 1993, an increase of 17 percent in real terms. In 1992 for the first time since 1983, private flows --both debt (bonds and bank lending) and non-debt (direct investment and portfolio equity)-- have exceeded official source financing.

Figure 1: Non-Debt Creating Flows to Developing Countries and their Share of Aggregate Resource Flows

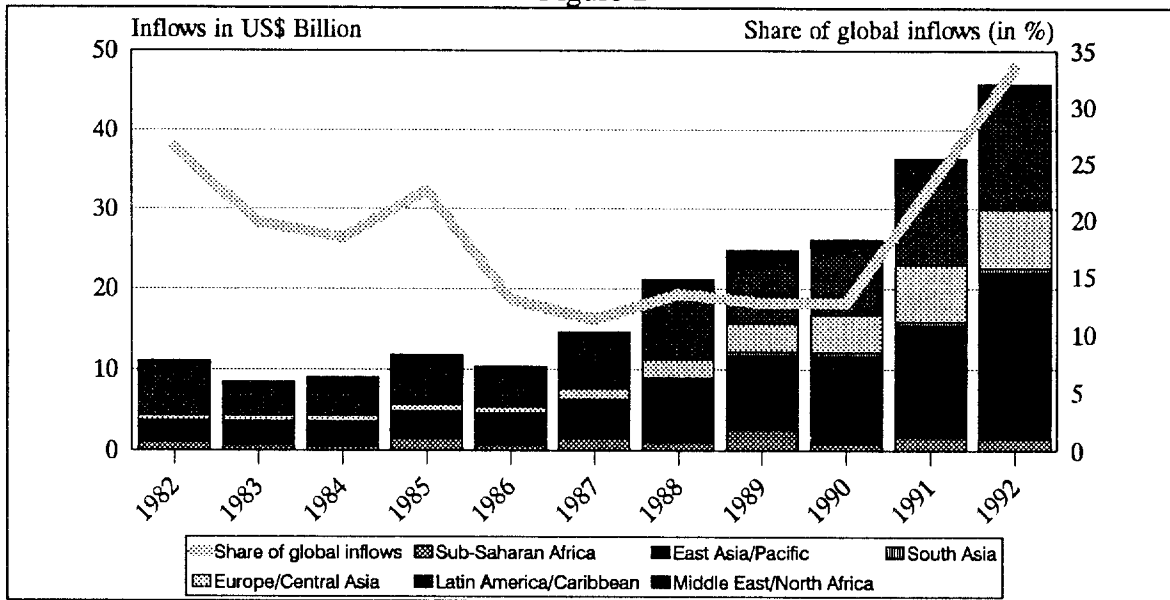


The projected surge in net flows is accounted for largely by sharp rises in private-source financing for many developing countries--record new bond issuance and foreign direct investment (FDI), the latter notwithstanding a downward global trend.

FDI alone is projected to top US$52 billion in 1993, surpassing ODA flows, after the previous record of US$45 billion in 1992. The strong growth projected in FDI reflects recession in industrialized countries and more welcoming investment regimes in developing countries, including privatization programs, relaxation of capital controls, and streamlining of administrative procedures. Equity portfolio investment is also projected to expand further (though at a slower rate than in 1992), thanks to an opening up to international investors of new stock markets and a growing appreciation on the part of industrial country investors of the diversification benefits of emerging stock markets. The volume of securitized flows (that is, flows in the form of financial securities, comprising bonds, stocks, or money market instruments) reached new heights as the range of developing country borrowers with access to international capital markets broadened further, and a growing number of institutional investors began to invest sizable amounts in developing country securities.

Private resource flows to developing countries have continued to expand over the past year; both portfolio investment and FDI flows recorded new highs. The volume of portfolio investment --particularly, in bonds-- reached an unprecedented level as institutional demand for developing country securities increased substantially. Since the mid-80s, FDI has become the single largest source of private financing, and in 1992, it was equal to nearly 80 percent of all official flows (on a net flow basis).

Figure 2



Source: World Bank staff estimates based on Balance-of-Payments data reported by the International Monetary Fund and data on net foreign investment reported by the Organization for EconomicCo-operation and Development.

In 1993, the pace of new international equity issuance by developing country companies has slowed and the outcome for the whole year is projected to be lower than that for 1992. But overall portfolio equity flows remain strong as market opening in some key markets has attracted substantial foreign interest. Diverse market performance and differing economic prospects in emerging market countries appear to have caused shifts of institutional portfolios between countries and regions, particularly from Latin America to East Asia.

The buoyancy in emerging stock markets has been supported by new investor interest in 1993, thanks to large privatization-linked deals like Argentina's state oil company (YPF); new listings of developing country equity shares in high-income country markets (for example, Chinese shares listed on the Hong Kong exchange); and further opening to direct foreign investments of developing country markets, such as Korea.

II. Economic Impact of Equity Investments on Developing Countries

Direct investment. FDI can contribute to the growth of host economies through various channels in addition to physical capital formation, including technology transfer, human capital (managerial skills) development, and promotion of foreign trade. Typically, however, FDI should not be counted on for medium-term balance of payments support, because of high profit remittances. And its benefits will be lost if the host economy is heavily distorted.

One example of benefits is that foreign-owned firms may stimulate local productivity through backward linkages to service suppliers and the labor force and by serving as a model of working practices and management techniques. It has been argued (Julius 1991)[1] that the best measure of FDI's impact is not simply the initial balance of payments transaction but additionally the foreign firm's local purchases from suppliers and sales to customers in the host market, because these are analogous to exports and imports. For the United States, for instance, total 1987 exports were less than half the sales by U.S.-owned firms abroad.

Foreign affiliates of transnational corporations can make a direct contribution to technological advancement in host developing countries through a stimulus to research and development (R&D) expenditures, changes in product and export composition, and higher factor productivity. During the past decade, for example, data gathered by UNTCMD[2] for U.S. majority-owned affiliates in developing countries show that the

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[1] Julius, DeAnne S. 1991, "Foreign Direct Investment: The Neglected Twin of Trade," Group of Thirty, Washington, D.C.

[2] United Nations Transnational Corporations and Management Division (UNTCMD), World Investment Report 1992, New York: United Nations.

share of R&D expenditures in sales, albeit small, has increased. Technology may also be transferred by way of non-equity channels such as licensing and subcontracting.

Although direct employment by foreign-owned corporations in developing countries is small (less than 1 percent of the workforce), foreign affiliates accounted for more than a quarter of employment in manufacturing in more than half of a group of developing countries for which data were available. Much of this employment was engaged in production with high technological and industrial know-how, for example electrical and electronic equipment, non-electrical machinery, and chemicals.

Their presence in the manufacturing sector has also enabled foreign firms to generate a high share of manufactured exports. For example, foreign firms account for more than half of manufactured exports in Malaysia, Mexico, and the Philippines, and a recent survey of firms in Thailand found that the share was nearly three-quarters.

The macroeconomic impact of FDI varies considerably by region and country, a recent study (Fry 1992)[3] finds: outside the Pacific Basin developing countries, FDI has tended to substitute for other capital flows, whereas in Pacific Basin countries, it has-been additional to domestic investment and has not, therefore, financed the pre-existing balance of payments (that is, both domestic investment and the current account deficit have increased). Coupled with the empirical observation that profits on FDI often climb quite steeply after an initial period of unprofitability, this suggests that FDI should not generally be viewed as a means of financing balance of payments needs over the medium term.

[3]Fry, Maxwell J. 1993, "Foreign Direct Investment in a Macroeconomic Framework: Finance, Efficiency, Incentives, and Distortions," Policy Research Working Paper Series 1141, World Bank.

Box 1. Determinants of FDI flows

Political and economic stability are vital for attracting FDI. Beyond that, however, there is much that we do not yet know about what determines FDI flows. Aside from the primary determinants --sound macroeconomic environment and growth potential, creditworthiness, export market access, and an adequate and transparent regulatory regime--a number of other factors that could attract or deter FDI flows have been identified. One set emphasizes relative rates of return and portfolio choice. Another set emphasizes market imperfections and suggests that FDI is the result of some firms having special skills such as technological and managerial advantages. Yet another set emphasizes important complementary variables, such as political instability, government regulations, and tax policy. Recent work suggests that home (that is, source) country taxation matters as much as (if not more than) host country taxation in multinationals' investment location decisions. There is also evidence that financing opportunities in the host country could play a role in attracting FDI inflows.

A huge volume of literature--both conceptual and empirical--currently exists, providing alternative explanations for a wide range of factors that contribute to the flow of foreign investment to host countries. The most important determinants of FDI appear to be the firm-specific attributes that underlie the competitive advantages of transnational corporations, the ability of transnational corporations to gain from internalizing market relationships, the strengths of particular host countries as locations for foreign production by transnational corporations, and the policies of host and home countries.

Among these factors, certain firm-specific assets may be the primary determinants of whether FDI takes place, whereas locational factors-such as market size and the prospects for increased sales, labor cost, and tariffs--are important in determining where the FDI takes place. Host country policies provide a necessary precondition for attracting FDI, although effective policies by themselves may not be sufficient to stimulate large inflows of FDI. Although firm-specific factors are largely beyond the control of host countries, the macroeconomic environment can be improved by sound policies, and, as a result, country creditworthiness can be raised, thus influencing a multinational corporation's decision on location and size of direct overseas investment.

Traditional factors that determined FDI flows to developing countries in the 1970s and early 1980s, such as low labor cost, product life cycle, and the servicing of a protected market, although still important, have weakened. In many industries, the proportion of labor cost to total manufacturing cost has declined, and new patterns of the international product life cycle have developed. Changes in technologies in some sectors have altered the economic scale of production, weakening the case for offshore production in low labor-cost countries. In this new environment, FDI flows generally have been attracted to developing economies with an efficient and dynamic private sector, accompanied by responsive institutions and a highly motivated skilled labor force. The pattern of incentives and the extent to which various incentives are used to promote FDI have undergone significant changes over the past two decades (OECD 1989.) The general trend in recent years has been less frequent uses of microincentive measures. A reorientation or realignment of investment incentives has also taken place, with continuing emphasis on proactive (rather than defensive) measures. There also has been a noticeable trend away from horizontal, sectorwide schemes to vertical ones--for instance, promoting the use of new technologies.

Portfolio equity. The benefits of international equity issuance can be substantial. From the individual issuing company's viewpoint, they include the following: (a) helps expand the investor base--which can lead to a higher stock price and a lower cost of capital; (b) provides further opportunities for raising new funds in developed capital markets; and (c) enhances the visibility of the issuing company and its products in international markets. From the investor's perspective, international share listing is beneficial because of the following: (a) allows dealing to be conducted and dividend payments to be made in readily convertible currencies; (b) provides means of international diversification to institutional investors who are prevented by their charters from investing in foreign securities (since ADRs, for example, are treated as domestic securities in the U.S.); (c) allows convenient and dependable settlement and custodian services; and (d) meets standard disclosure requirements. A potential drawback of offshore investment from the perspective of the issuing company's country, however, is that a concentration of trading in domestic equities abroad could slow down the development of domestic capital markets.

In addition to these direct benefits, the initiation of an international share listing program for even just one or two companies can produce an important economy-wide benefit for the home country. This arises from the "spill-over" effect of international trading of securities on the pricing of purely domestically traded securities in the home country. To the extent that internationally traded securities' prices are correlated with those of the domestically tradable securities, the firms represented by the latter could "free ride" and benefit in terms of higher security prices and lower cost of capital. This means that international trading of only a handful of developing country's securities--provided they correlate with some local (as distinct from international) risk--can magnify and transmit the benefit of integrated capital markets throughout the entire

economy. A recent study[4] found empirical evidence from the recent experience of Mexican and Australian issues, suggesting that listing foreign securities in a major capital market center contributed to the cost reduction of capital for the issuing company and to price discovery (that is, higher valuation) in the home country market.

A number of developing country stock markets have recently been opened directly to foreign investors, for example, the Korean stock market since 1992. Total foreign investment in the Korea Stock Exchange reached more than US$5 billion through the first half of 1993. According to a recent World Bank study,[5] foreign investment produced significant positive effects on the performance of the domestic capital market, with marginally increased market volatility and inconsequential macroeconomic disturbance. Cross-country studies[6] have also found that stock markets that have liberalized foreign investment rules--for example, Argentina, Brazil, Colombia, and Pakistan--have subsequently experienced huge price increases, although these have sometimes been followed by significant market corrections. In Chile, Mexico, and the Philippines, price-to-earnings ratios have risen continuously for several years after the market opening.

Stock markets in many developing countries have deepened considerably in the past few years. Market capitalizations have increased, and markets have become more integrated with the rest of the world. The degree of co-movement between returns in different markets, measured by the so-called beta coefficient, has increased for most

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[4]Eun, Cheol, Stijn Claessens, and Kwang W. Jun, "International Trade of Assets, Pricing Externalities and Cost of Capital," Proceedings of Conference on Portfolio Investment in Developing Countries, 1993 (forthcoming), World Bank.

[5]Jun, Kwang W., "Effects of Capital Market Liberalization in Korea: Empirical Evidence and Policy Implications", Proceedings of Conference on Portfolio Investment in Developing Countries, 1993 (forthcoming), World Bank.

[6]For example, Buckberg, Elaine, "Emerging Stock Markets and International Asset Pricing," Proceedings of Conference on Portfolio Investment in Developing Countries, 1993 (forthcoming), World Bank.

emerging markets: for all 20 countries in the sample, from an average of 0.239 in the period of 1975-85 to 0.373 the period 1986-92.[7]

III. The Role of IFIs in Promoting Non-Debt Creating Flows

International financial institutions (IFIs) encourage private investment flows to developing countries through the provision of policy advice and the financing of policy reforms in host countries; the financing of physical and social infrastructure; direct operations that deal with the private sector or catalyze private flows; technical assistance; and the dissemination of information.

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 policies help reduce the major sources of uncertainty faced by investors regarding exchange and interest rates, demand for their products, changes in the tax and tariff regimes, and access to foreign exchange. The two institutions also work with member countries to design policies that directly promote savings and investment through price liberalization including the freeing of interest rates, and the 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 include efforts to strengthen the role of the private sector.

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[7] Bekaert, Geert, "Market Segmentation and Investment Barriers in Emerging Equity Markets," Proceedings of Conference on Portfolio Investment in Developing Countries, 1993 (forthcoming), World Bank.

Fund-supported economic programs have the primary goals of correcting any macroeconomic imbalances and permitting liberal access to foreign exchange including payments and transfers of profits and dividends, which 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. All these elements contribute to a global environment conducive to unrestricted flows of financial resources, including FDI flows.

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 that it undertakes 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. Access by efficient firms to stable sources of finance has been improved by the Bank's financial sector loans, which are aimed at liberalizing financial markets (leading to capital market development) and reducing financial repression.

The Bank's investment lending has contributed directly to 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 facilitate joint private consortia of domestic and foreign contractors (build-own-transfer agreements, or BOT). Resources for private sector investment have also been increased by the provision of substantial amounts (in the

order of several billions of U.S. dollars per annum) in the form of Bank (including IFC) credit lines for financial intermediaries .

The World Bank Group supports privatization as a means toward achieving its broader goals of economic development and poverty alleviation. When it is correctly conceived and implemented, privatization can foster efficiency and encourage investment, outcomes which in turn spur increased economic growth and employment. Between the beginning of 1991 and mid-1992, the World Bank approved 59 investment operations and 42 adjustment operations with components addressing privatization or restructuring of public enterprises. The IFC, which has made privatization a central and expanding element of its investment program, undertook 11 privatization transactions in FY92 alone. The IFC is also involved in privatization advisory work, a substantial portion of which is in Eastern Europe.

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 FY93, the Corporation made 185 investments, investing US$2.1 billion of its own resources and mobilizing substantial additional resources from other investors, many of whom were foreign (for every $1 of financing approval by IFC for its own account, other investors and lenders provided $7). 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 small-scale projects. Furthermore, IFC has been particularly active in support of equity portfolio flows: for instance, IFC pioneered the introduction of country funds targeted at emerging stock markets.

Box 2. Role of privatization programs in facilitating foreign investment

During the period 1988-92, assets amounting to about US$210 billion were privatized globally, with developing countries accounting for 30 percent.

By far the most active region within the developing world was Latin America and the Caribbean, accounting for 66 percent of all developing-country privatizations, followed by Europe and Central Asia with 16 percent and Asia with 13 percent. Sub-Saharan Africa did not manage to benefit from the recent wave in privatization. Although minor transactions were completed, the only sizable ones occurred in Benin, Ghana, Nigeria, and Togo during this period, amounting to not more than US$240 million. Within the developing world the most intensive privatizer in recent years is Mexico, which, with almost US$21 billion, accounted for nearly half of all privatization transactions in the developing world in such sectors as airlines, banking, mining, steel, and telecommunications.

These often quite significant amounts of privatization transactions do not, however, imply an equal increase in foreign direct investment. First and foremost, a major share of these purchases are undertaken by domestic investors and thus simply represent a change in ownership without any balance of payments effects. Second, the use of debt-equity swap facilities results in a reduction of external debt rather than direct foreign exchange earnings. It is estimated that during the second half of the 1980s, Chile, the country with the most extensive and liberal debt-equity swap program in the developing world, allowed 80 percent of foreign direct investment into the country through swap financing, compared to almost 60 percent in Brazil and 30 percent in Mexico (United Nations 1992). Argentina recently stepped up the use of debt-equity swaps, and more than US$13 billion of external debt has been converted since 1990.

But still, about US$18.5 billion or about 30 percent of total privatization revenues were received in the form of foreign exchange. The bulk of this foreign investment through privatization sales went to Latin America. Eastern European privatizations were especially dependent on foreign participation due to the lack of domestic savings, and a total of about US$5 billion in foreign exchange was generated this way.

Besides these direct inflows, extensive privatization programs also showed a strong effect in attracting additional foreign investors, and further inflows are to be expected with a continued improvement in productive efficiency.

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 disputes would 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.

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 investments; active help in bringing together foreign investors with their counterparts in developing countries through organizing investment promotion conferences; and provision of long-term insurance against political risk. 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.

Box 3. The World Bank guidelines for the legal framework for the treatment of foreign direct investment

A set of guidelines for the legal treatment of FDI was prepared by the World Bank Group at the request of the Development Committee. The Guidelines provide an overall framework for the treatment of FDI covering the main issues arising in this area, namely the admission of FDI, general standards of treatment, transfer of capital and revenues, expropriation and compensation and settlement of disputes between host countries and investors. Overall, they represent a synthesis of general trends distilled from detailed surveys of existing instruments and some of the "best practices" that the experience of the World Bank Group has shown are conducive to promoting FDI flows.

There are five main Guidelines. Guideline I defines the scope of coverage in broad terms and emphasizes giving all investors favorable legal treatment, rather than giving only foreign investors privileged legal treatment. Guideline II, on admission, recommends the adoption of open admission policies, subject perhaps to a restrictive or negative list based on considerations which are exceptional, clearly defined and applied sparingly (e.g., national security). The Guidelines endorse the general standards of fair and equitable treatment, national and non-discriminatory treatment (Guideline III). In addition, the Guidelines elaborate on a number of specific treatment standards that are particularly important for foreign investors. These relate to timely issuance of authorizations, flexibility in relation to employment policy; facilitation of transfer of funds and repatriation of the investment; "best practices" in relation to fiscal incentives; and "best practices" by developed and capital surplus countries regarding the facilitation and promotion of FDI to developing countries. The provisions on expropriation (Guideline IV) recognize the right of a State to expropriate, but only if this is done in accordance with applicable legal procedures, in the pursuance in good faith of a public purpose, without discrimination on the basis of nationality, and against the payment of appropriate compensation. The Guidelines recommend the use of detailed and practical evaluation methodologies to assess the adequacy of such compensation. Guideline V provides that disputes between host states and private foreign investors should be settled through negotiations between them, and failing this, through national courts or through other agreed mechanisms including conciliation and binding international arbitration. In this respect, the Guidelines encourage recourse to the facilities of ICSID.

The Development Committee called the Guidelines to the attention of member countries and noted that they "serve as an important step in the progressive development of international practice in this area." They have been widely disseminated to governmental bodies, international business and public organizations and within the World Bank Group. The importance of the Guidelines is that they contribute to the development of customary international law, assist states in the review of national investment legislation, and provide standards which countries may find appropriate to follow in the absence of applicable treaties. In keeping with their intended purpose, the Guidelines have recently been consulted by several countries in considering the enactment of new investment legislation and the conclusion of new investment treaties.

The Foreign Investment Advisory Service (FIAS), created in 1986, is a joint facility of IFC, MIGA and the World Bank. 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 on FDI of domestic policies including the legal and regulatory framework; foreign investor's access to foreign exchange; the rules and procedures for screening FDI, granting incentives where appropriate, and strengthening institutions; regulations concerning technology transfer and protection of intellectual property rights; and the availability of loans and of local equity partners.

Since its establishment, FIAS has completed over 110 advisory projects in more than 60 countries. In the most recently completed fiscal year, FIAS completed 31 advisory projects in 28 countries. These included projects in 10 African countries and 7 Asian countries; the remainder were divided among Europe, Latin America and North Africa/Middle East. Among these projects, FIAS advised on: organization of an investment promotion agency in Cote d'Ivoire; regulation governing the allocation of foreign exchange to foreign investors in Tanzania; investment incentives in Jordan; and international conventions and investment treaties in Vietnam. FIAS gave several countries advice on the development of investment institutions, and in Venezuela and Sri Lanka, FIAS helped to formulate investment promotion strategies for promotion of institutions which it had earlier helped to create. FIAS has also initiated research to determine whether the policy changes in Central and Eastern Europe and former Soviet republics will affect the flow of FDI to other developing countries.

The Bank Group provides 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. Such conversion schemes appear to act as an incentive to FDI additional to which that might otherwise take place. The Bank assists 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 the improvement of creditworthiness.

The Bank also gives 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, with due attention to the simplification of procedures for the processing of applications by foreign investors. The Fund typically advocates greater transparency in the tax system and regulatory mechanisms so as to create a more hospitable investment climate. For instance, it provides legal technical assistance for the reform of company law, which 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, the Bank has directed greater efforts into research on FDI flows and their policy implications.

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 exist of FDI flow data from source and host countries. These are the result of differing national treatments of reinvested earnings, investment in offshore enterprises, gaps from non reporting 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." The report of this work suggested procedures that could enhance transparency and reliability of FDI data.

Box 4. Foreign direct investment : data issues and efforts towards harmonization

Traditionally, data on FDI flows (the most widely available measure of the operations of TNCs) have been compiled for the capital account of the balance of payments. Some countries also collect data on the stock of FDI (the total value of direct investment capital at any given time). FDI data, however, suffer from deficiencies relating to definition, coverage and cross-country comparability.

Presently, the only internationally accepted definition is that provided in the fifth edition of the Balance of Payments Manual of the International Monetary Fund (IMF), published in 1993. FDI is defined as "the category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy". The Manual suggests a threshold level of 10 percent of the ordinary shares or voting power of an enterprise to delineate foreign direct from other forms of international investment. The Manual does not recommend the "effective voice" in the management of an enterprise as a FDI criterion and urges countries that apply it to identify separately the value of such transactions.

In 1992, the Group of Financial Statisticians of the Organisation for Economic Co-operation and Development (OECD), in consultations with IMF, Eurostat and the United Nations, produced the second edition of the Detailed Benchmark Definition of Foreign Direct Investment. According to the Benchmark Definition,, FDI is an "investment that involves a long-term relationship reflecting a lasting interest of a resident entity in one economy (direct investor) in an entity resident in an economy other than that of the investor. The direct investor's purpose is to exert a significant degree of influence on the management of the enterprise resident in the other country." A direct investment enterprise is defined as "an incorporated or unincorporated enterprise in which a foreign investor owns 10 percent or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise". The threshold of 10 percent is suggested as one (practical) indication of the existence of a direct investment relationship; an effective voice in the management of the enterprise (say. - through representation on the board of directors), which need not imply absolute control, is still the principal criterion. The criteria put forth in the Manual and the Benchmark Definition represent a concerted effort towards a common definition of FDI. In practice, national authorities choose threshold from 10 to 25 percent in developed countries and from 10 to 40 per cent or higher in developing countries.

The way in which the stock of FDI should be valued has been a major issue of debate. The Manual recommends, in principle, the use of market values, although it recognizes that, in practice, book values (the value of assets in the balance sheet of a firm, usually at the time it was purchased) consolidated worldwide are more readily available than market values. Similarly, the Benchmark Definition encourages the use of market values in the valuation of FDI stocks, but recommends that countries also report stocks based on book values from the consolidated balance sheets of companies so as to facilitate comparisons with the overwhelming majority of countries that do not use market values.

FDI inflows and outflows consist of equity investments (including the equity component of those debt to equity conversions that qualify as FDI, but which do not necessarily add to the stock of capital), reinvested earnings and short- and long-term inter-company loans between parent firms and foreign affiliates, with each component reported on a net basis. Many countries (including Japan) report data on FDI that do not include at least one component of FDI, often reinvested earnings. Reinvested earnings are an important method of financing FDI and its omission can seriously underestimate the total value of FDI. In addition, the duration of "long-term" loans varies among countries, and some countries do not include short-term inter-company loans in FDI flows. Moreover, balance-of-payments FDI data do not include capital raised in the host country. The emerging financial markets in many developing countries and the alleviation of restrictions on foreign participation make this a potentially significant method of financing FDI.

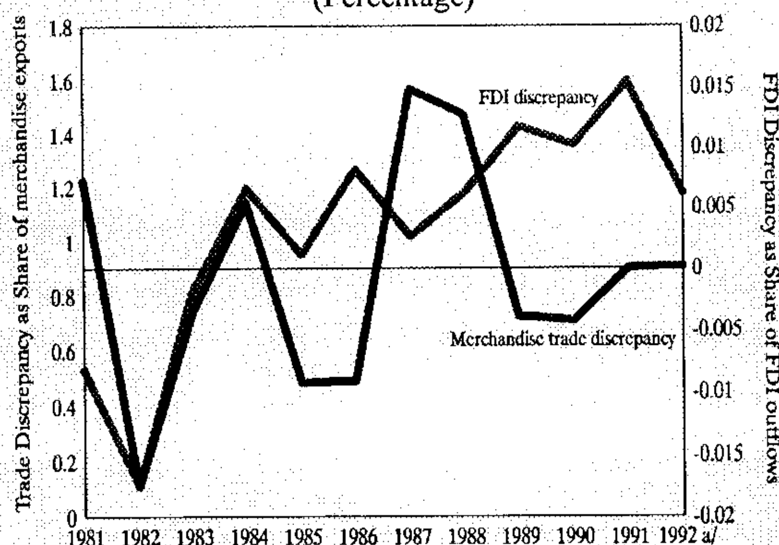
Box 4. (cont.)

In most developing countries, FDI data are collected by several institutions following different practices. Central banks typically collect FDI data for the balance of payments based on records of cross-border flows of foreign exchange. This does not allow the collection of data on reinvested earnings generated within the country and, hence, not captured by cross-border transactions. In a few developing countries, this method is supplemented by company surveys (widely recognized as the most comprehensive method of FDI data collection), which allow the collection of data on reinvested earnings, the estimation of FDI stocks, as well as the collection of additional information on TNCs. Investment promotion agencies, authorities of export processing zones and "one-stop" centers usually collect FDI data based on approvals and, in some cases, on implementation, often by country of origin and industry of destination. Statistical offices of ministries or national statistical offices also collect a variety of data on FDI and sometimes carry out surveys of TNCs. The diversity of data sources has led to an assortment of FDI data for a single country often based on widely different definitions and collection methods. Despite these drawbacks, such data are invaluable in analyzing FDI.

At the global level, FDI inflows and outflows do not balance and the size of the discrepancy (as a share of outflows) reached a peak in 1991 (see figure). This is attributed to asymmetries in the definition of inflows and outflows arising from differences in the treatment of unremitted branch profits, real estate and construction investments and unrealized capital gains and losses; differences in the recording of reinvested earnings; and differences in methods of data collection and coverage between inward and outward FDI, including the presence of offshore banking centers.

Figure: The discrepancy between global FDI outflows and inflows, and between merchandise imports and exports, 1981-1992

(Percentage)



Sources: World Bank staff estimates, based on balance of payments data reported by the International Monetary Fund, data on net foreign direct investment flows reported by the Organisation for Economic Co-operation and Development; and merchandize trade data reported by IECAP.

Box 4. (cont.)

There is an increasing awareness that FDI data are limited because they capture only cross-border investment flows involving equity participation and omit non-equity cross-border transactions. In recent years, there has been a growing interest in data on non-equity inter-firm relationships (for example., strategic alliances); intra-firm flows of goods and services (intra-firm trade for instance), and on the performance and activities of TNCs (profits, sales, employment, value-added, and so on). Such data are usually scarce (they are not compiled for the balance of payments) and deficient in terms of cross-country comparability. In view of the recognition of the benefits associated with FDI for the economies of both host and home countries, there is a growing awareness of the need to improve further the quality of the data, to ensure greater cross-country comparability and to expand the range and systematic collection of data on meaningful indicators of the activities of TNCs.

Sources: International Monetary Fund, Balance of Payments Manual, Fifth Edition (Washington, D.C., International Monetary Fund, 1993); Organisation for Economic Co-operation and Development, Detailed Benchmark Definition of Foreign Direct Investment (Paris, OECD, 1992); and OECD, Group of Financial Statisticians, "Record of the 43rd session held on 16-18 June 1993", Paris, DAFFE/MC/STAT/M(93)453.

a/ In an effort to arrive at a single internationally accepted definition of FDI, the Benchmark Definition will be amended further so as to be aligned with the fifth edition of the Manual.

IV. Concluding Remarks

Resource flows to developing countries have increased substantially in recent years, spurred by large private capital flows that have risen two and half times since 1990. Within private-source flows, non-debt creating flows --primarily foreign direct investment and equity portfolio investment-- have expanded greatly as the major sources of funds continue to shift from banks to non-bank investors. The World Bank Group (and other IFIs) has helped facilitate private investment flows to developing countries through the provision of policy advice, the financing of policy reforms and investment projects, technical assistance, and dissemination of information.

While the rise in private flows is a welcoming development, the major beneficiary has been limited to a handful of largely middle income countries. IFI support should continue to further promote non-debt creating flows to countries that have not yet sufficiently benefited from the current trend.