

SOME RISKS AND IMPLICATIONS OF FINANCIAL GLOBALIZATION FOR NATIONAL POLICY AUTONOMY

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The impact and form of international lending to developing countries has been varied over time. The current period is dominated by foreign direct investment (FDI). Just as syndicated bank lending in the 1970s and portfolio flows in the 1980s, FDI is currently considered to carry lower risks than prior forms of lending. This article assesses risks associated with the increasing reliance of developing countries on FDI and suggests some of the potential difficulties for domestic economic policy autonomy, exchange rate policy and domestic financial stability that might arise from excess FDI flows.

A. Globalization of finance leads globalization of trade and production

Despite the fact that world trade has expanded at rates which have exceeded global income growth over much of the post-war period, financial transactions have expanded at an even more rapid pace. Indeed, the factor which appears to distinguish the rapid international economic integration initiated in the 1980s is the globalization of finance. It is no exaggeration to speak of a global capital market which is in operation 24 hours a day, with financial service providers from the major developed and developing countries operating on a more or less continuous basis. Such conditions are not yet commonplace for manufacturing firms, and there is as yet no truly global market for manufactured goods. Nor is there truly global production in the sense that manufacturers are indifferent to the location of the production process, although there are some firms that have started to integrate their production processes and sales on the basis of regional geography. Although it is not difficult to imagine a process in which each individual step in the production process could be allocated to its

most efficient global location, and that location adjusted on a real time basis according to changes in relative costs and prices, that day has not yet arrived - and there are some compelling reasons to believe that it will not do so in the near future. Without going into all the reasons for this (Milberg, 1997), one has simply to recall that capitalistic production still requires a minimum of fixed capital, which creates certain "inefficiencies" because it is not spatially mobile without cost. Indeed, this spatial and temporal immobility of the physical production capacity is one of the reasons for the rapid growth of financial markets, for they provide an antidote for the "fixity" of productive capacity. Indeed, one of the reasons for the increased global dispersion of production facilities is to provide a more flexible response to global changes in interest and exchange rates. Just as Josef Steindl (1952) argued that excess productive capacity provided "liquidity" to a firm, a diversified portfolio of production sites provides liquidity to the firm in the sense of being able to respond quickly to changing cost conditions caused by flexible exchange rates and interest rates. Clearly, the computer and telecommunications revolution has contributed to increase the flexibility of production, and has to some extent substituted computers for metal presses and silicone for steel, thereby sharply reducing adjustment costs associated with shifting the global location of production. None the less, it is the increased variability in international costs and prices due to flexible exchange and interest rates that has been the driving force behind the financial innovations that currently dominate the globalization process.

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B. Some pitfalls in the analysis of the impact of global capital flows on economic policy

The problems that the increasing importance of international capital flows may cause for developing countries are evident from the experience of the past 20 years. The basic lesson would appear to be that too much foreign capital (the 1970s syndicated bank lending) is just as bad as too little (the withdrawal of private bank lending in the 1980s). But what is even worse is passing rapidly from one to the other (the rapid reversal of portfolio capital flows in the 1990s). These general lessons have given rise to some particular propositions for developing country borrowing. Not all of them seem to be soundly based.

1. *Is there good debt and bad debt?*

In response to the expansion of syndicated bank lending to sovereign countries in the 1970s, it is now generally considered prudent for a developing country to avoid private bank lending for its medium and long-term financing requirements. Instead, it is recommended that countries increase their reliance on what has come to be called "non-debt-creating" financing. This seems to be an oxymoron, since any and all financing creates repayment obligations. This statement refers to private portfolio and foreign direct investment (FDI) flows. The reason that these types of flows are considered preferable has less to do with the type of international lender than with the repayment conditions. While syndicated bank debt carried a foreign-currency denominated fixed-interest charge - which was reset periodically to reflect international capital market interest rates - private portfolio investment flows do not have these characteristics. Once acquired, they are denominated in the currency of the receiving countries; the returns payable are variable and can be adjusted on the basis of ability to pay; and payment is also in domestic currency. Finally, the value of the sum invested is a variable determined by domestic assets market and foreign exchange market conditions. Declining prices and/or market illiquidity may act as a strong deterrent to attempts to enforce repayment.

However, recent Latin American experience with the volatility of portfolio flows has led to doubts about the benefits of such flows relative to

direct investment, which is now considered as the preferred alternative source of foreign capital to support the domestic growth process. This impression is often supported with reference to the Asian development experience, which has been largely free from the problems experienced by Latin American countries. The idea has thus grown that FDI should be preferred to other forms of foreign borrowing as it does not have the foreign exchange denominated, periodically reset interest characteristic of syndicated bank debt, nor does it exhibit the volatility associated with portfolio investment. This is basically because FDI is considered to be investment in domestic bricks and mortar that, once physically installed, cannot easily be repatriated. It thus represents a permanent contribution to a country's resources.

In evaluating this idea, it is important to recall that bankers once considered sovereign country debt as virtually without risk since countries, in contrast to firms, could not declare bankruptcy. The question that should be faced is whether there are similar unanticipated consequences of excessive reliance on FDI by a developing country. For example, consider the distinction between portfolio and FDI. This distinction was initially created in order to distinguish between foreign and domestic control of productive assets. The presumption is that investment for the purpose of control over the decision-making processes of an enterprise will be of a more or less permanent character. The concern about excessive foreign control over domestic production was initially related to the problem of the effectiveness of economic policy on the domestic economy and the autonomy of domestic policy makers. The fear was that domestic policy measures to remedy, say a balance-of-payments crisis, would induce foreign owners to avoid them by closing down their plants and moving elsewhere. This would simply make the domestic difficulties worse and constrain the policy options available. Concerns of this sort were common in Europe in the 1960s. Although they concern the mobility of foreign investors, they are quite different from the policy concerns facing most developing countries today.

2. *The problems of definition and analysis of FDI*

As a result of such concerns, the official definitions of FDI emphasize the degree of management

control exercised by a foreign investor, and have nothing to do with the permanence or physical mobility of an investment or of its volatility.¹ These definitions seem to ignore the rapidly increasing facility with which developed country investors obtain and discharge control of companies through mergers and acquisitions in financial markets. Today, companies seem to have become commodities that are traded daily in markets for corporate control. They respect neither geographical or national distinction nor boundaries.

But even if FDI were redefined so as to include only investments in immobile bricks and mortar, deemed to be of a quasi-permanent nature, it is not evident that this would mean that FDI would have a substantially different impact on capital flows and exchange rate management than on other types of flows. The basic reason for this is that recent innovations in financial markets have gone a long way towards eliminating the concept of a "permanent" investment in plant and equipment in much the same way that they have eliminated the concept of the "maturity" of a financial investment. Buyers of consols (irredeemable British government securities) or 30-year US government bonds used to be considered as permanent or "long-term" investors with the intention of holding assets for their income. These investors are the proverbial "widows and orphans" of finance lore. But financial wizards can now re-engineer a 30-year bond to produce (a minimum of) 61 zero coupon bonds with maturities ranging from six months to 30 years. The purchaser of a bond may be an investor in some or all of them, or may buy and sell components to produce an instrument which has any number of different possible cash flows and maturities. The purchase of a long-term bond certainly need not indicate a "long-term" holding, and the holding may be converted into any desired time horizon without selling the original long-term bond. The availability of futures and options contracts provides other alternatives that allow investors to retain ownership of long maturity assets, but to reduce the permanence of the investment as well as the exposure to market risks, such as changes in interest rates or exchange rates. Rapidly developing sale and repurchase (Repo) markets allow substantial investment positions to be maintained with a minimal commitment of their own funds. Now, if this is the case for a 30-year bond investment, it will not be greatly different for foreign portfolio investments. And it should also

apply to FDIs. An investor can continue to own the bricks and mortar without retaining the foreign country risks, foreign exchange risks, etc., associated with their "permanent" or immobile nature. Indeed, today most financial assets never move, being located in central depositories, or simply as electrical charges in computers. There is no reason for plant and equipment to be considered any differently because of the difficulty of geographical movement.

This point has been recognized in a recent World Bank study which notes: "Because direct investors hold factories and other assets that are impossible to move, it is sometimes assumed that a direct investment inflow is more stable than other forms of capital flows. This need not be the case. While a direct investor usually has some immovable assets, there is no reason in principle why these cannot be fully offset by domestic liabilities. Clearly, a direct investor can borrow in order to export capital, and thereby generate rapid capital outflows" (Claessens *et al.*, 1993, p. 22).

Generally, the methods available for hedging the risks of any investment, including FDI in bricks and mortar, do not lead the investor to engage in any direct foreign exchange or a capital market transaction. However, they will almost always require the financial intermediary providing the risk coverage to do so at some point in time. And, the financial flows associated with this coverage will usually be highest when uncertainty over the stability of the exchange rate or of domestic financial conditions is greatest. It is thus not generally the case, since it is difficult to find a final buyer for a bricks-and-mortar FDI at short notice, that investments of this type will not produce the same financial flows as portfolio investments when there is uncertainty over market conditions. Home country firms keep their balance sheets in their domestic currency, and foreign investments represent currency risks in the same way as any other use of company funds. This means they will be hedged in the same way. The fact that investments are in real productive assets does not mean that foreign currency risks and funding risks will be ignored. To the extent that risks are covered, they will produce cross-border flows that put pressure on the foreign exchange market or the domestic money market, which may reinforce other destabilizing elements. Indeed, this point is made in a slightly different way by the World Bank study

referred to above, which notes that "long-term flows are often as volatile as short-term flows, and the time it takes for an unexpected shock to a flow to die out is similar across flows" (Claessens *et al.*, 1993, p. 26). The study concludes that in general it is impossible to differentiate statistically between portfolio and FDI capital flows. Part of the reason for this is the wide range of financial instruments included in FDI.

Another aspect of FDI investments usually overlooked concerns the benefit of the absence of scheduled interest and principal repayments. This often leads to the belief that there will be no payments made to foreigners and no drain on foreign exchange reserves. Yet, foreign direct investors do not invest without the expectation of being repaid, with profit. For a developing country, FDI is not an unconditional gift; it is financing provided against the expectation of profit earnings and the eventual repatriation or relocation of the investment.

From the point of view of the individual lender of funds, the risks associated with bank-syndicated sovereign lending are the lowest, risks of portfolio investment higher, and those associated with FDI the highest. But this is not due to their being more permanent, but rather to the fact that they are less standardized and thus more costly to hedge. It is also due to the reduced amount of information concerning the assets themselves, the difficulties associated with operating in foreign cultures, and the simple factor noted by both Smith and Ricardo that investors have a preference for keeping their investments at home where they can keep an eye on them: "Experience, however, shows that the fancied or real insecurity of capital, when not under the immediate control of its owner, together with the natural disinclination which everyman has to quit the country of his birth and connexions, and entrust himself with all his habits fixed, to a strange government and new laws, check the emigration of capital. These feelings, which I should be sorry to see weakened, induce most men of property to be satisfied with a low rate of profits in their own country, rather than seek a more advantageous employment for their wealth in foreign nations" (Ricardo, 1951, pp. 136-137).

Consequently, normally the lenders' risk premia attached to FDI will be the highest of the various alternative forms of lending and investors

will expect to be compensated for these higher risks. Symmetrically, this implies that FDI is certainly the most costly method of borrowing capital from the point of view of a developing country. Indeed, most international companies carrying out FDI apply implicit hurdle rates of return in the range of 20 to 25 per cent per annum over relatively short capital recoupment periods. It appears contradictory that developing countries should be recommended FDI as the least risky form of foreign borrowing, when from the point of view of the foreign lender it is considered the most risky. If this much higher risk associated with FDI is expressed in appropriately higher rates of return for lenders, and thus in higher costs of capital for borrowers, then the correct approach would seem to be for developing countries to assess borrowing in terms of the risk-adjusted cost of capital.

This leads to another often overlooked aspect of FDI which is linked to the problems of the range of assets included in the FDI measures mentioned above. The available statistics suggest that in most countries that have benefited from foreign investment the greatest proportion of FDI is comprised of the reinvestment of profits on prior FDIs. As already noted, one of the basic reasons why FDI is considered a more attractive form of foreign borrowing than, say, bank borrowing, is that it does not represent a fixed or immediate charge on foreign exchange reserves. Reinvested profits nevertheless represent a claim on reserves, for they are first recorded as current account outflow, which are then automatically offset by an entry into the capital account as an FDI inflow.

In a banking framework, this is the equivalent of capitalizing the interest on a loan, and simply shifts the claim on foreign exchange reserves to pay the profits on the investment into the future. While the recipient country may consider these profit reinvestment flows as equivalent to direct investments, the foreign investor may consider them as a delayed return on the original investment. As such, they need not be invested in a bricks-and-mortar productive enterprise, but may instead be invested by the foreign-owned subsidiary in highly liquid domestic financial assets in anticipation of future repatriation. Thus, although they are recorded as FDI flows, they may in fact take the form of short-term portfolio investments in both fact and intention. This can make it very difficult to assess the real condition of a country's balance

of payments, for such action may produce bunching of the repatriation of earnings, thereby creating disruption in the foreign exchange market.

True balance-of-payments conditions may be further complicated if FDI flows are used to finance investments in productive facilities requiring a large proportion of specialized imported capital goods and semi-finished goods for domestic assembly and sale primarily to the domestic market. While these imports may be offset by the creation of additional exports, the re-export of the assembled finished goods or the recorded reinvestment of profits, they may give rise to a net drain on reserves, since the portion of FDI flows created by reinvested profits need not represent actual foreign currency inflows. For example, the recorded foreign receipts may be used to meet claims of foreign investors, while imports will always give rise to claims on foreign currency reserves. This suggests that the proper assessment of the impact of FDI depends crucially on a number of factors, such as the proportion of reinvested earnings in current FDI flows, the destination of those earnings, the proportion of imports in FDI, and the proportion of exports in the output of foreign affiliates.

For example, if an FDI inflow gives rise to an equivalent amount of imported capital goods, then the net foreign currency contribution of FDI is zero. If the output from the new affiliate is all sold in the domestic market, then the annual profits represent an annual charge on foreign exchange, which accumulates as profits are reinvested. On the other hand, if the FDI inflow generates no additional imports, then it represents a net contribution of foreign exchange. If, in addition, the output of the affiliate is 100 per cent exported and the import content of the exports is zero, then the profits "finance themselves" from a foreign exchange point of view and there will be a surplus equal to domestic value added. The impact of FDI on the stability of the foreign-exchange rate will then depend on where actual flows fall between these two extremes.²

3. *FDI and financial fragility of the foreign account*

The greatest potential difficulties will be related to the reinvestment of the current cash flows from operations (which will represent not only

accounting profits, but also accruing depreciation allowances) of FDI investments as they will be accumulating at compound rates over time. At an annually compounded rate of return of 10 per cent, investment value doubles in a little over seven years, at 15 per cent it doubles in less than five years, at 25 per cent it doubles in just over three years. Consider a country with a tiger-like growth rate of 10 per cent per annum and an initial once-and-for-all net FDI inflow of 10 per cent of national income and full reinvestment of profits. If the FDI in fact returns the expected 25 per cent per annum,³ after 18 years it would find itself with an accumulated stock of FDI representing foreign claims equal to its national income. At a foreign earnings rate of return of 20 instead of 25 per cent per annum, this occurs in about 26 years; if the country's growth rate is 7.5 of 10 per cent and returns are 25 per cent, it falls to 15 years. And this is without any additional FDI except for the reinvestment of earnings on the original stock. Consider a country in which annual net FDI remains at 10 per cent of GDP, growing in step with GDP: the accumulated FDI stock now reaches 100 per cent of GDP in around 10 years; by the end of the 10-year period, foreign claims on currency reserves with respect to annual profits alone would be equal to 25 per cent of GDP.⁴

In such conditions, consider the effect of a decision by foreign investors to reduce country exposure when the ratio of FDI stock to GDP reaches 100 per cent through repatriation of 50 per cent of annual profit flows. Without any necessity for investors to liquidate any current holdings, this would mean that 12.5 per cent of GDP would be required to service the accumulated FDI. In the extreme case given above with 100 per cent import content of FDI and 100 per cent domestic sales of output (or 100 per cent import content of exports), this would mean that the country would require additional annual export earnings of 12.5 per cent of GDP to service the repatriation of profits, irrespective of the current level of imports. It would also mean that the export surplus would have to expand more rapidly than the domestic growth rate if an exchange crisis were to be avoided. This is clearly unsustainable, in terms of both the share and the rate implied. The share and the rate of increase in the export surplus which would be required to support even a 25 per cent profit repatriation ratio would be unsustainable, unless the country represented an intermediate case

between the two extremes outlined above and the net contribution of FDI investment to exports was equivalent to profit repatriation.

Aside from the latent instability that such a build-up of FDI from reinvested earnings might create in foreign exchange markets, consider a country which has settled into an equilibrium on its external accounts and accommodates the assumed FDI inflow in the form of a current account deficit. There will be a further inherent structural instability built into the system. Any national or international event which causes foreign investors to halt or reduce their current level of FDI inflows will be sufficient to provoke a foreign exchange crisis. There need not be any capital outflows through the sale and expatriation of capital invested in bricks and mortar. Just as a modern bank run - which occurs not because depositors withdraw their funds, but because lenders refuse to renew their loans to the bank - a developing country which has adjusted to the permanence of FDI flows will be increasingly exposed to a crisis caused by chance interruptions to those flows, which is completely independent of the use made of the foreign exchange resulting from those flows.

These are examples of the different types of structural impacts which excessive reliance on FDI flows may produce on the payment flows of the economy in extreme conditions; these examples highlight the potential for FDI flows, based on the high reinvestment of profits, to turn into the equivalent of a Ponzi investment scheme. The structural instability that arises is independent of any short-term instability of FDI flows resulting from the financial innovations mentioned above, and would arise even if FDI were embodied in investments which are as permanent as is traditionally supposed. Unless FDI flows are truly permanent - in the sense that neither profits nor principal are repatriated - the more successful a country is in attracting FDI and FDI is in terms of generating returns, the greater the risk of FDI flows producing fragility in a country's current account position and thus also in its exchange rate. Both of these factors will increase the currency risk of the FDI and lead to the increased probability of repatriation or hedging through the foreign exchange market. If success also increases domestic incomes and costs - thus reducing the rates of return offered to foreign investors - this will not

only reduce the size of FDI reinvestment flows and take pressure off the current account, but will also lead to greater inducement to shift investments to other locations, and thus to a higher probability of shifts in invested capital.

Developing countries may thus find themselves in a position resembling that of the United States in the 1960s with respect to its gold reserves. European countries had built up large investments in dollar reserves on the understanding that they were convertible into gold. But the outstanding dollar claims soon exceeded the United States' gold supply. The US balance-of-payments accounts were redefined several times in order to better reflect the potential pressure on the gold value of the dollar by trying to assess the "permanence" of foreign investments and thus the likelihood that they might be converted into gold or foreign exchange and cause a collapse of the dollar. Some of the claims were clearly of a long-term nature and represented no risk of being converted, while others could be converted quickly. Most holders recognized that it was in their interest to continue to hold dollars, for any single holder's attempt to convert would trigger a mass of sales and a large capital loss on their dollar holdings if gold convertibility had to be suspended. Nevertheless, in the end, even the permanent claims started to be exercised, and the result was a collapse of the dollar and the suspension of gold convertibility.⁵

The difficulty for a developing country is to assess what proportion of FDI flows is indeed permanent, and what the short and long-term impact on trade flows and foreign exchange reserves will be. It is probable that the higher the return on investment and the higher the proportion of reinvested earnings in total FDI stock, the less permanent the FDI stock will be, and thus the greater the threat to the balance of payments and exchange rate stability. In this respect, the choice between FDI and other types of foreign borrowing is one of degree, and the amount of foreign investment, whatever its nature, cannot be a matter of indifference to government policy.

Thus, while portfolio flows may have a more direct impact on short-term reserve management and exchange rate policy, FDI may have both a short and a longer-term structural influence on the composition of a country's external payment flows. While financial innovation allows FDI to have an

impact in the short run which is increasingly similar in terms of volatility to portfolio flows, the more important aspect is the way it may mask the true position of a country's balance of payments and the sustainability of any particular combination of policies. Just as accumulated dollar claims on gold represented a Damocles sword hanging over the gold-dollar exchange rate, accumulated foreign claims in the form of accumulated FDI stocks may create a potentially disruptive force that can offset any domestic or external policy goals. During the 1960s and 1970s it was common for countries, such as Germany, to place direct controls on capital inflows in order to prevent disruption of exchange rate stability, just as it was common to regulate the raising of capital in domestic markets by the United States, Switzerland, the Netherlands, and other developed countries. Current conditions do not suggest that developing countries should be prevented from using the same types of regulations to protect their domestic and external stability.

C. Policy problems created by portfolio flows

The impact of FDI flows on economic policy is independent of the problems arising as a consequence of the response of short-term portfolio flows to traditional stabilization policies. Here, the problem has clear aspects of the winner's curse. Macro stabilization policies based on liberalization of trade flows, reductions in government deficits and control of money supply growth, as well as stabilization of the exchange rate, also have an aspect of the fallacy of composition about them. Successful reduction in the rate of inflation usually involves an appreciation of the real exchange rate, making the adjustment of domestic producers to foreign competition more difficult and causing deterioration in the trade balance. The rise in interest rates produced by the monetary contraction in conjunction with the fall in inflation produces an increase in real interest rates, making it more difficult to support domestic investments to provide adjustment. In addition, if there has been a good deal of indexing, the fall in the inflation rate may produce the equivalent of a wealth effect, as consumers attempt to take advantage of what may appear to be a temporary lull in inflation. Consumption expenditures may thus rise, putting increased pressure on domestic prices and drawing

in additional imports. The mirror image of this behaviour is to be found in the banking system, which may find that lending made on the expectation of continued inflation now cannot be repaid and that the increase in bad debts leads to a reduction in the banks' ability to lend. In conclusion, a too rapid short-term improvement in inflation may thus impede the longer-term process of adjustment of productive capacity to a more open and competitive market environment. These factors may be aggravated if the increase in interest rates and the improving fiscal position and inflation outlook attract portfolio capital inflows. These will simply aggravate the problem of the foreign balance, although they may temper the negative impact of rising real interest rates. However, this will be countered by the upward pressure on the exchange rate. Revaluation will hurt domestic competitiveness and investment, while it further encourages imports and consumption. On the other hand, if the central bank intervenes to stabilize the exchange rate, this will require purchasing foreign assets and be accompanied by increased money base growth. If a money supply target has been agreed as part of the stabilization programme this may place the government or the central bank in the position of having to sterilize capital inflows. Aside from the impact on interest rates and possibly encouraging additional capital flows, it implies buying foreign assets, whose return is usually far lower than the rates that have to be paid on the domestic assets which are issued to complete the sterilization. This creates an endogenous deterioration in government accounts, thus increasing the interest burden and offsetting policies to restrict government deficits.

The foreign balance may continue to deteriorate, supported by capital inflows attracted by the success of the stabilization policy, while little real adjustment takes place. Part of this adjustment should be increasing investment at the expense of imports and consumption, but this is made doubly difficult by the fact that imports are subsidized by the improving exchange rate, and investment is penalized by both the financing costs and the decline in foreign competitiveness. This is more or less the Tequila syndrome; it is telling that when the crisis hit, it was estimated that no more than 20 to 30 per cent of Mexico's production could be reoriented towards export markets. The restructuring, which was supposed to have been underway as a result of the domestic stabilization policy in

operation since 1989, in fact only started after the collapse of the exchange rate in 1994.

D. Globalization of capital flows and policy autonomy

In the conditions just described the government has clearly lost control over monetary policy, after having voluntarily relinquished control over fiscal policy as part of the stabilization programme. It bears emphasis that it is the government which has adopted increased globalization as an integral part of the stabilization policy. Thus, while there is little question that increased globalization of the economy has sharply reduced policy autonomy, the loss of sovereignty is not wholly due to the impact of globalization itself. It is in part also due to the acceptance of a particular type of economic stabilization, based on market liberalization and monetary targeting, that has increased volatility in both money and foreign exchange markets.

Notes

- 1 The IMF (1993) defines FDI 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 OECD (1992) benchmark definition of FDI is "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". Both adopt the rule of thumb of US balance-of-payments accounting that a 10 per cent equity share represents lasting interest and control.
- 2 There are a number of secondary effects which may also be of importance, such as the import content of the increased expenditures resulting from the increased domestic incomes generated by the FDI flow, the extent of import substitution which may result from the domestic sales of the foreign affiliate, the import content of exports, and the use made of any net contribution by FDI profits to foreign exchange reserves, i.e. whether they are invested by the monetary authority, and at what rates relative to the return on FDI, or used to finance current account imbalances.

- 3 As a means of comparison, average annual reported rates of return on United States transnational companies' FDI in South, East and South East Asia and in the Pacific region for the period 1980-1993 averaged 27 per cent, with a 7.6 per cent standard deviation. In manufacturing production the return was 20.8 per cent, with a 3.9 per cent standard deviation, and in services 21.7 per cent, with a 4.3 per cent standard deviation. The return for FDI in Africa was 22.5 per cent (8.9 per cent standard deviation). For all developing countries the average annual return realized was 16.8 per cent (3.4 per cent standard deviation). See UNCTAD (1995, p. 94).
- 4 This rate of accumulation of FDI is roughly equivalent to the annual increase in FDI stocks reported for Malaysia between 1983 and 1994.
- 5 This loss of capital value through a fall in domestic asset prices, or a depreciation of the exchange rate, is the same inducement which is thought to make withdrawal of investment undesirable in a period of crisis. However, this depends on the expectation of a return to the prior equilibrium. When this expectation has a very low probability, it is always rational to sell, and the earlier the better. It is thus unclear whether the risk of loss owing to exchange depreciation is any greater for FDI investors than it was for central banks with respect to their dollar holdings. The counterpart to this loss for the investor is a gain for the recipient country in terms of a reduced domestic cost of foreign resources. It is not clear, however, that such gains are always fully realized or that they offset the overall long-term losses caused by financial and/or exchange market instability.

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