TWN Trade & Development Series 21

Financial Effects of Foreign Direct Investment in the Context of a Possible WTO Agreement on Investment

David Woodward

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Third World Network

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NOTE:

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1 Introduction

AS enthusiasm for foreign direct investment (FDI) as a source of financing for developing countries grew in the 1990s, the parallels with lending to developing countries in the 1970s became increasingly striking.

In the 1970s, the "recycling" of the surpluses from high-income oil exporters to (mostly) oil-importing developing countries was actively encouraged by the source countries; and a myth grew up that they were risk-free because "countries can't go bankrupt". In the event, of course, they were far from risk-free, either to lenders or to borrowers.

The 1990s saw a very similar process in relation to FDI. Once again, countries had an urgent need for financial flows – this time because of the drying up of lending in the wake of the debt crisis and the continuing reduction of aid budgets.

FDI was hailed as the solution to this problem, and actively promoted by source countries and international institutions such as the IMF and World Bank. And again, this was based on a view that such flows were risk-free. This view was, if anything, strengthened by the Asian, Brazilian and Russian financial crises of the late 1990s.

The question is whether this optimistic view of FDI is as flawed as the myth of risk-free lending in the 1970s – and whether the same devastating outcome for developing countries will eventuate. And, in the present context, whether a WTO Agreement on Investment would help to avert such an outcome, or make it inescapable.

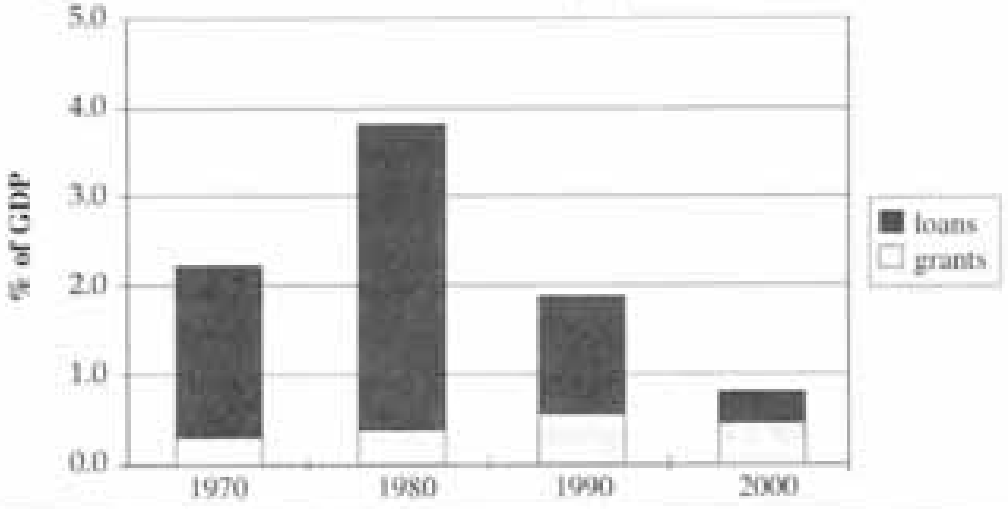
2 The Background: Financial Flows to Developing Countries

IN the 1970s, financial flows to developing countries were heavily dominated by loans from commercial banks, governments and international institutions, supplemented by aid grants (Figure 1). By 1980, these flows had risen to what proved to be an unsustainable level, at nearly 4% of GDP.

Following the beginning of the debt crisis in the 1980s, however, net lending fell sharply, and by 1990 was largely limited to the amounts creditors needed to lend to allow debtors to make interest payments.

Over the course of the 1990s, net lending fell further, as the need for interest refinancing declined; and grants also fell relative to GDP, as aid budgets were reduced still further below the target level of 0.7% of donor GNP, reaching around one-third of this level.

Figure 1: Grants and Loans to Developing Countries, 1970-2000



By 1990, loans and grants had fallen by around half from their 1980 peak, to a level below that which prevailed in 1970, before the "recycling" process began. By 2000 they were just one-fifth of their 1980 level, and one-third of the 1970 level.

Combined with the continued drain of foreign exchange associated with interest payments, and the collapse of export prices, particularly for primary commodities (itself largely a result of over-supply associated with the debt crisis), this led to an acute need for foreign exchange inflows.

Direct investment was seen – by developed countries, developing countries and international agencies alike – as the answer to this problem. While growth of these flows was relatively limited overall in the 1980s (faster growth towards the end of the decade off-setting the post-1982 decline), they took off in the 1990s.

By 2000, combined with portfolio equity investment, they had pushed overall financial flows to developing countries above 4% of GDP – and well above the 1980 level, which had ultimately proved unsustainable.

Figure 2: Financial Flows to Developing Countries, 1970-2000

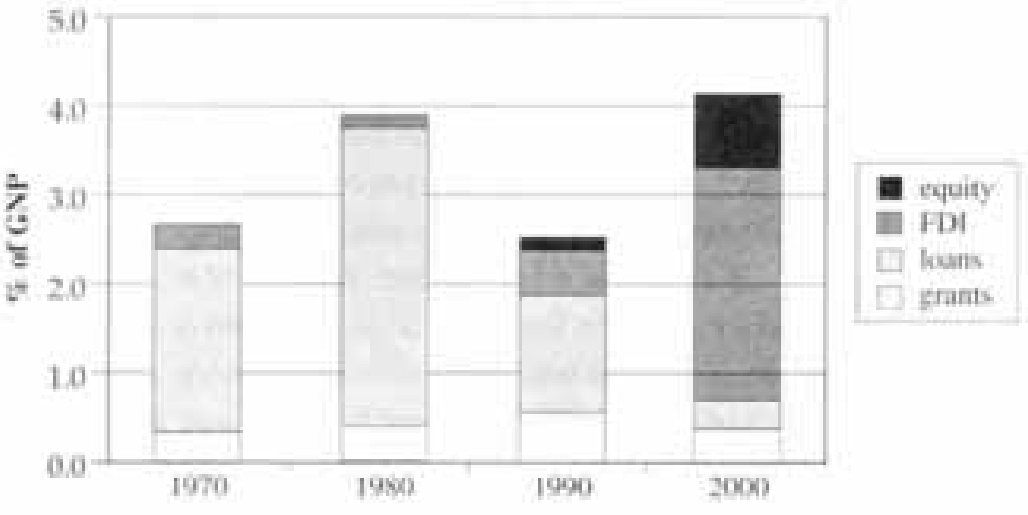
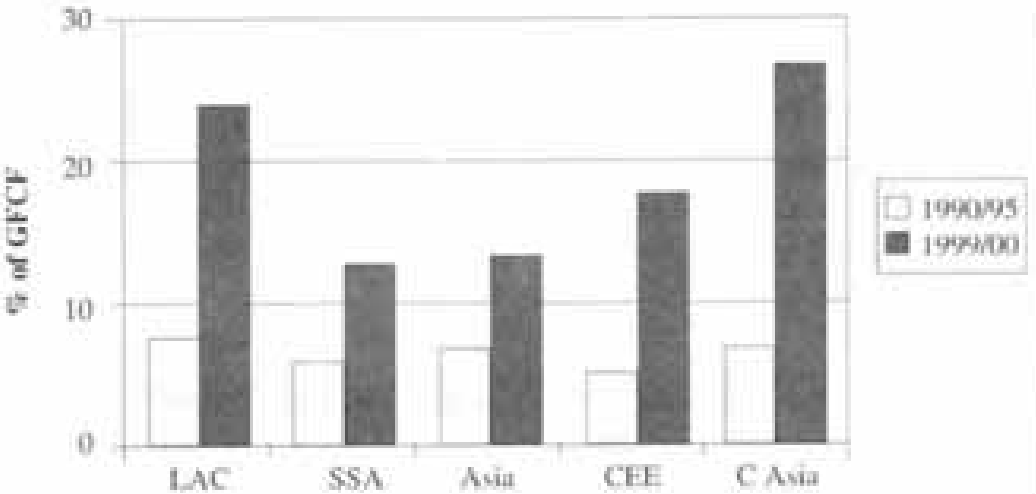


Figure 3: FDI Inflows as a Proportion of Total Investment, 1990-95 and 1999-00

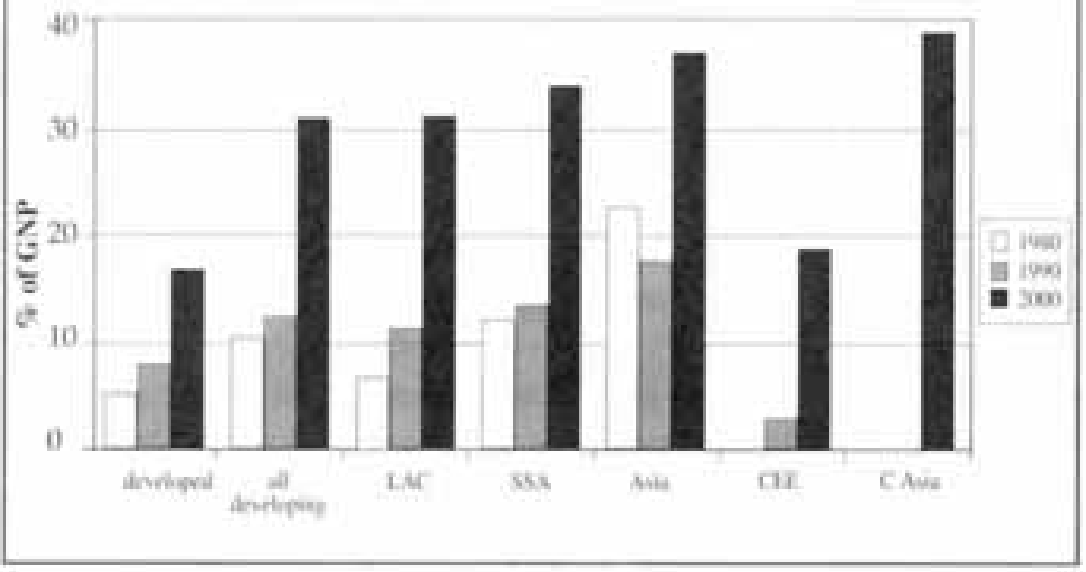


The scale of the increase in inflows in the 1990s can be seen by looking at the relationship between FDI inflows and overall investment in recipient countries. This is shown in Figure 3, for five developing regions: Latin America and the Caribbean (LAC), Sub-Saharan Africa (SSA), South, East and South East Asia (Asia), Central and Eastern Europe (CEE) and Central Asia (C Asia). The pattern is both strong and consistent: the ratio increases by a factor of between about two and four in each case, from 5-8% in the first half of the 1990s to between 12% and 26% by the end of the decade.

This rapid increase in the inflow of investment is inevitably reflected in an increase in the stock – that is, the total value of assets owned by foreign investors. This is illustrated in Figure 4, showing the stock of inward FDI as a percentage of GNP over a longer period, from 1980 to 2000. Again, the pattern of rapid increases in the 1990s is pronounced and consistent, as is the acceleration compared with the 1980s. For developing countries as a whole, the stock of inward FDI increased by a factor of 2.5, from 12% of GNP in 1990 to more than 30% in 2000. This represents a growth rate relative to GNP of around 9% per year. It will also be noted that the ratio

for developing countries is both higher than that for developed countries, and increases more rapidly in the 1990s.

Figure 4: Inward FDI Stock as a Proportion of GNP, 1980-2000



3 Financial Effects of FDI: The Simplified View

ON the simplest level, FDI can be considered as if it were lending. This means looking at the inflow of FDI as if it were a loan; the subsequent repatriation of the capital invested as if it were a repayment of that loan; and the profits on the investment as equivalent to interest on the loan.

On this basis, the stock of inward FDI is analogous to debt; and the difference between the inflow of new investment and the outflow of profits can be considered as a net financial transfer into the country. The World Bank's Global Development Finance essentially takes this view, except that it does not report the value of the stock of inward investment. There are, however, a number of important differences with debt.

- FDI goes only to commercial investment, and cannot be used to finance government budgets or public services (unless they are privatised).

- There is no fixed schedule for outflows – rather, outflows depend (in principle, at least) on the commercial performance of the investment.

- The rate of profit on FDI is much higher than interest rates even on commercial loans, as investors require compensation for the commercial risks of the investment. In the late 1990s, the average rate of return on FDI in developing countries was estimated by the World Bank to be in the order of 16–18% per year.

- Moreover, profit rates are higher for poorer countries, where commercial risks are generally seen as being greater. The World Bank estimate for Sub-Saharan Africa in the late 1990s was 24-30% per year. This is in marked contrast with lending, where poorer countries have access to much cheaper loans from governments and international organisations.

- Whereas lending tends to be countercyclical (except in crisis conditions), increasing in response to growing demand, FDI flows tend to be procyclical, and fall when they are most needed. This was aparent in the early years of the debt crisis, and in the immediate aftermath of the Mexican and Asian crises of the 1990s.

Based on this simplified view, then, FDI can be considered as equivalent to borrowing foreign exchange at an interest rate of 16-18% per year – or more in poorer countries. In order to avoid a potentially damaging net outflow of foreign exchange, new flows have to cover the profits on the existing investment, so that these inflows themselves must also increase at 16-18% per year. This in turn increases the stock of investment at a similar rate. In effect, this is like borrowing at 16-18% per year, and allowing the interest to accumulate.

This rate of increase of the stock of FDI liabilities is far greater than any plausible assumptions about the possible growth rates of GDP, exports or overall productive investment. The result is that, if outward transfers are to be avoided, the stock of FDI liabilities will grow much faster than the capacity to service those liabilities, and will therefore inevitably exceed that capacity at some point. It also means that the proportion of the stock of productive capital which is owned by foreigners will increase rapidly over time. It can only be prevented from reaching 100% by a reduction in FDI well below the level of profits, implying a large outward net flow of resources.

4 Financial Effects of FDI: A More Complete View

IN practice, of course, the effects of FDI are more complex than this, as FDI also affects production, exports and imports. The overall effect on the balance of payments is a result of these effects combined with capital inflows and profits. The simplest way of considering this is to look at foreign owned investments as if the investors were part of the countries where they were based, rather than the host country. This is essentially the view of the GATS Agreement, under which direct investment enterprises in the services sector are treated as if they were exporting services into the host economy.

The question then becomes how much the local economy is "exporting" to FDI enterprises, in terms of labour and other inputs; and how much of their output it is "importing" from them. That is, the balance of payments effect of FDI is equivalent to the difference between the local spending of foreign-owned enterprises and their local sales (modified to the extent that local sales substitute for imports, thereby saving foreign exchange).

It is therefore critically important to consider the pattern of sales, as between exports, import substitutes and goods and services which are not internationally traded. The last category includes almost all services. A second critical dimension is the division between FDI which takes the form of the construction of new productive capacity and the purchase of existing capacity or companies. The latter accounts for some 75% of all FDI in developing countries, excluding China. This suggests a framework for analysis as shown in Figure 5.

Figure 5: A Framework for Analysis of the Financial Effects of FDI		
	Purchase	Construction
Exports		
Import substitutes		
Non-tradeables		

FDI by purchase does not in itself create new capacity, only a transfer of ownership – although it may change patterns of production, input use and sales. However, profits switch from being a local cost to a foreign exchange cost. For the overall effects to be positive, the increase in the local spending by the company or facility minus the increase in its local sales (net of import substition effects) must be greater than total profits after the investment.

This is virtually impossible in the non-tradeable sector. Even in the export sector, it will depend on the nature as well as the extent of the changes which take place in production. Even if output is increased, this will generate benefits only if this higher output is translated into higher spending on local inputs; and the overall effect will be positive only if this exceeds total profits. The likelihood of this is reduced to the extent that output per worker is increased, or imports are substituted for locally produced inputs. Thus, while the net effect may be positive, this is unlikely. The prospects are substantially worse for import substitutes, as local sales are likely at least partly to substitute, directly or indirectly, for sales by local companies.

Where investment does create new capacity, the effects will be more favourable – but substantially less so than they may at first appear. In the short term, the initial capital inflow will be off-set by purchases of imported equipment, such as factory machinery, and any other foreign exchange costs associated with the investment (e.g., consultancy fees).

Again, the effective foreign exchange inflow is limited to the amount of the investment which is spent in the local economy on locally-produced goods and services. By reducing the initial foreign exchange inflow, this also increases the effective rate of return on the investment from the host country's perspective, in balance of payments terms.

In the long term, the effect is once again local spending less local sales; and again this is by definition negative for non-tradeables, including services. The effect of FDI in import substitution is ambiguous, depending on the extent to which sales substitute for imports rather than substituting for the sales of other local producers or representing an increase in consumption of the good concerned (e.g., due to increased availability, lower prices or marketing).

In the case of exports, the effects from the host country's perspective will necessarily be positive. However, the increase in output, at least in some sectors, will tend to reduce world prices, imposing costs on other producers. While these effects will be thinly spread, there is a strong possibility that they will be greater than the net benefits of the FDI to the host country; and where the market is dominated by developing country exporters, the net effect will be negative for developing countries as a whole.

This effect will be most pronounced for minerals, tropical agricultural produce and undifferentiated manufactured goods such as textiles – the main export sectors of most low and lower-middle-income countries. This suggests a picture of net benefits as shown in Figure 6, where the black cells in the table represent negative effects, white cell positive effects, dark grey ambiguous effects and grey reflecting a greater likelihood of a negative effect. The only clearly positive effect is for construction of new export capacity; and this will be off-set by any negative effect on world prices.

Figure 6: Financial Effects of FDI: A Balance Sheet		
	Purchase	Construction
Exports	?/-	+
Import substitutes	–	
Non-tradeables	–	–

All FDI in non-tradeable sectors is negative, as, almost certainly is the purchase of existing capacity in import substitution sectors. FDI by purchase in the export sector is also likely to be negative in most cases (although subsequent investment to increase capacity should be positive), while the effect of new capacity in import substition is ambiguous. In order for the overall effect to be positive, there must be sufficient benefits from the construction of new capacity for export production to off-set the negative effects of other types of FDI; and, from the point of view of developing countries as whole, this increased export capacity must take place outside their traditional export sectors.

As noted above, some 75% of all FDI in developing countries is in the purchase of existing capacity. Therefore, even if all FDI-financed construction of new capacity were in the export sector, it would still be only one-quarter of the total. In practice, however, the export sector represents only part of FDI, although this varies substantially between countries and regions, as illustrated by Figures 7 and 8. For US majority-owned foreign affiliates in developing countries as a whole, less than 40% of sales were for export in 1993, with figures of around 60% for Asia, but just 20% for Latin America. The variation between countries is still greater, from 4% in India to around 85% in Singapore and Malaysia.

It should be noted that the export-orientation of FDI is likely to have declined substantially since 1993, as FDI in services has expanded, particularly in public utilities such as water and sanitation, energy supply and telecommunications (due to privatisation, and the associated emergence of new transnational companies in these areas), and in retailing, fast-food outlets, etc.

Figure 7: Share of Exports in Total Output of US Majority-Owned Foreign Affiliates, 1993: By Regions

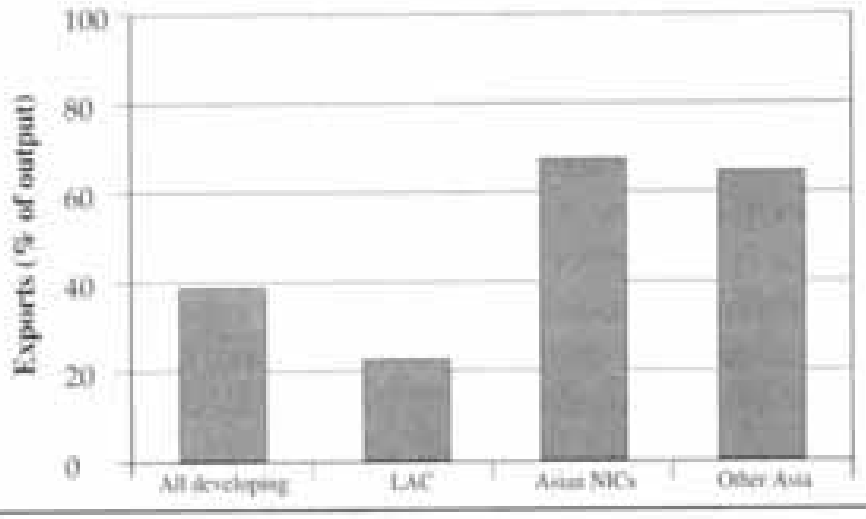
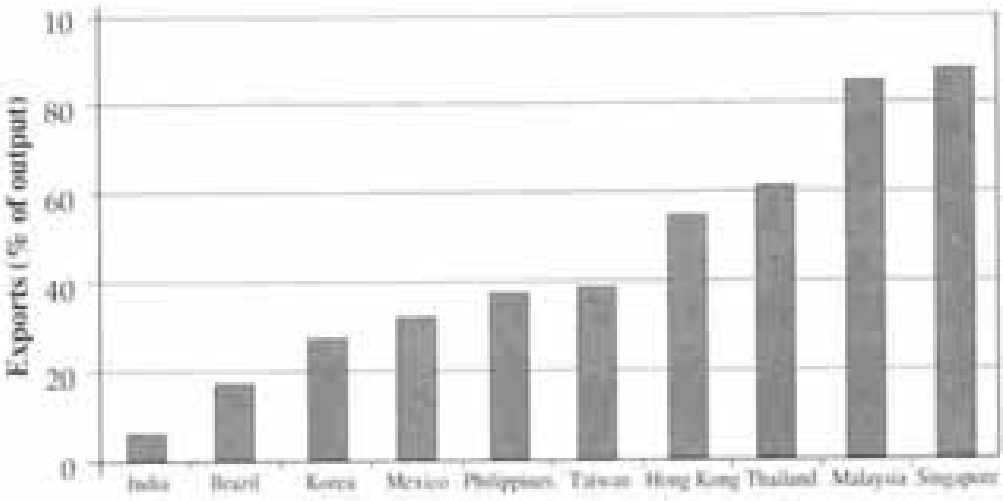


Figure 8: Share of Exports in Total Output of US Majority-Owned Foreign Affiliates, 1993: By Countries



5 FDI and Financial Crises

FINANCIAL crises such as those of Mexico in 1994 and East Asia in 1997, like the 1980s debt crisis, arise because capital inflows are insufficient to cover current account deficits. When this point is reached, capital inflows fall sharply, compounding the problem.

The initial crisis is generally triggered by capital inflows drying up (as in Latin America in the 1980s) or being reversed (as in Mexico in 1994 and Thailand in 1997). However, vulnerability to financial crises is primarily associated with large current account deficits, the associated accumulation of foreign exchange liabilities (which in turn add to the deficits), and a resulting acute dependence on foreign capital to finance the deficits.

FDI is unlikely by itself to trigger a financial crisis, as the pipeline of existing projects means that it shows less volatility than lending or especially inter-bank transfers and other short-term transactions. However, it may contribute substantially to current account deficits, and thus to dependence on foreign capital and vulnerability to crises. It appears to have played a significant role in this respect in varying degrees in different countries in recent crises.

Figure 9: Contribution of FDI to Pre-Crisis Current Account Deficits
(Simplified View)

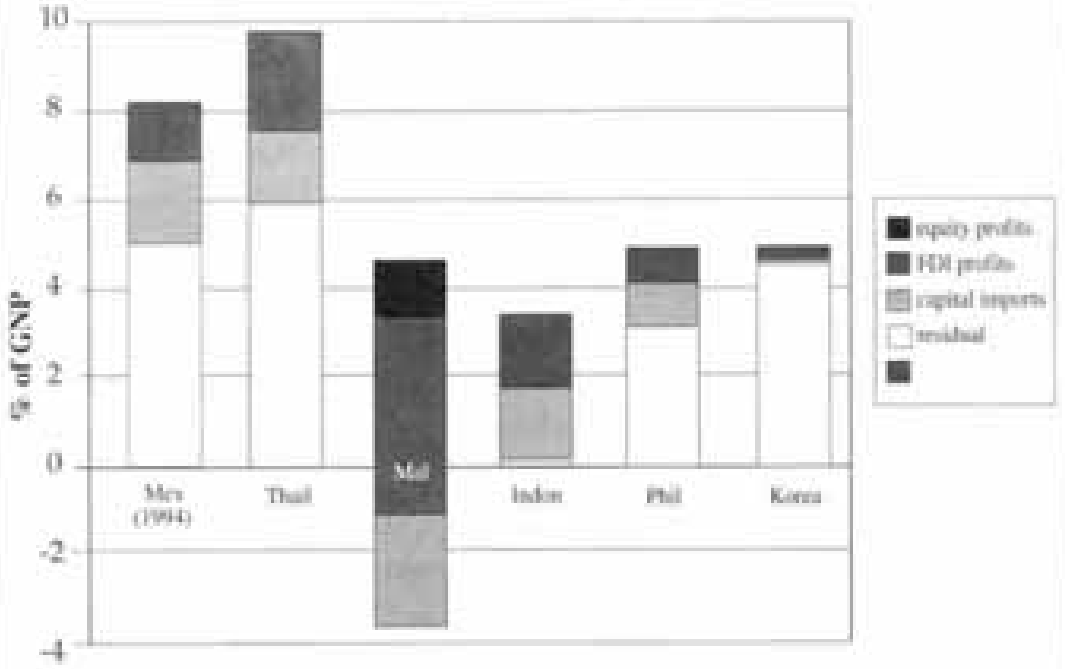


Figure 9 demonstrates this on the basis of the simplified view of FDI. It shows the contribution of profits on FDI and current account effects of FDI (assumed, arbitrarily, to be 50% of the amount invested) relative to total current account deficits in the countries most affected by the Asian crisis in 1996, and in Mexico in 1994.

It suggests that these aspects of FDI may have represented around one-third of the pre-crisis current account deficit in Mexico, the Philippines and Thailand, and the whole of the (smaller) deficit in Indonesia. In Korea, the effect appears to have been minimal; but in Malaysia, it is sufficient to have turned what would otherwise have been a substantial surplus into a large deficit.

As the more complete view presented above indicates, this is only part of the picture. And it will be recalled that Malaysia in the 1990s had one of the highest shares of exports in the output of FDI enterprises. One might

therefore expect the more complete view to be more favourable – and it is the only one of these countries where there are adequate data to make any assessment of this.

In fact, the results of the more complete analysis are no more favourable. As shown in Figure 10, despite their strong export-orientation, the trade balance (exports minus imports) of FDI enterprises in Malaysia was broadly neutral in the early 1990s, and is likely to have become more negative between 1994 and 1996.

Figure 10: Malaysia: Trade Deficit of FDI Enterprises, 1990-96

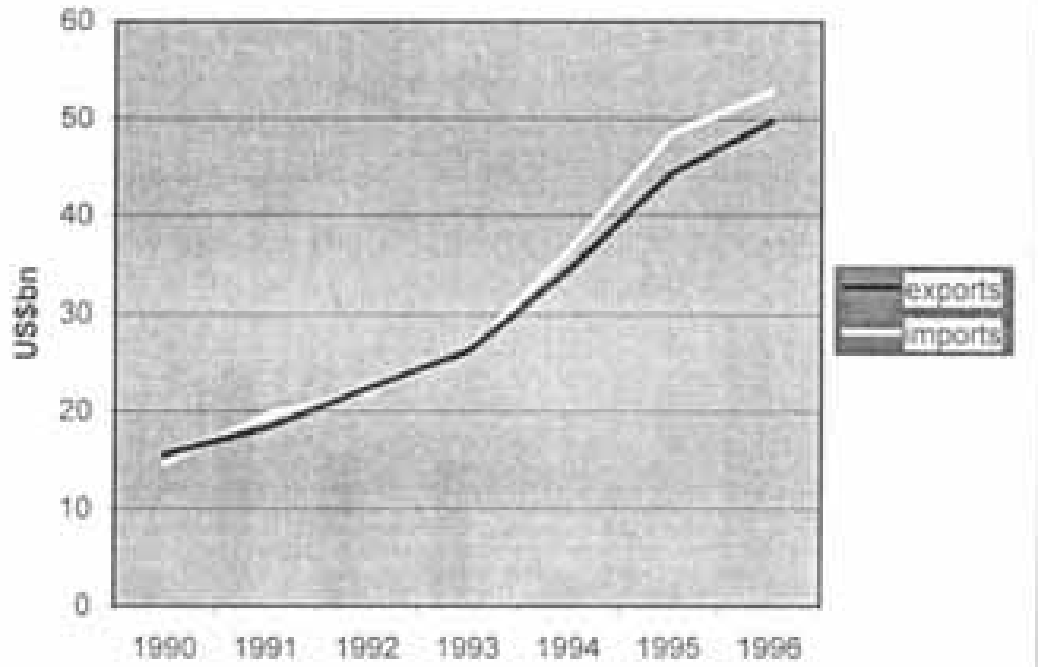


Figure 11 adds on outflows of profits and royalties, to give the total current account deficit of FDI enterprises. This was strongly and increasingly negative througout the period, reaching 11-13% of GDP in 1995-6, the two years before the crisis. While this may have been partly off-set by import substitution, it will be recalled that only around 15% of total sales were in the domestic market, and much of this will have been of non-tradeables or have substituted for local production.

Figure 11: Malaysia: Current Account Deficit of FDI Enterprises, 1990-96

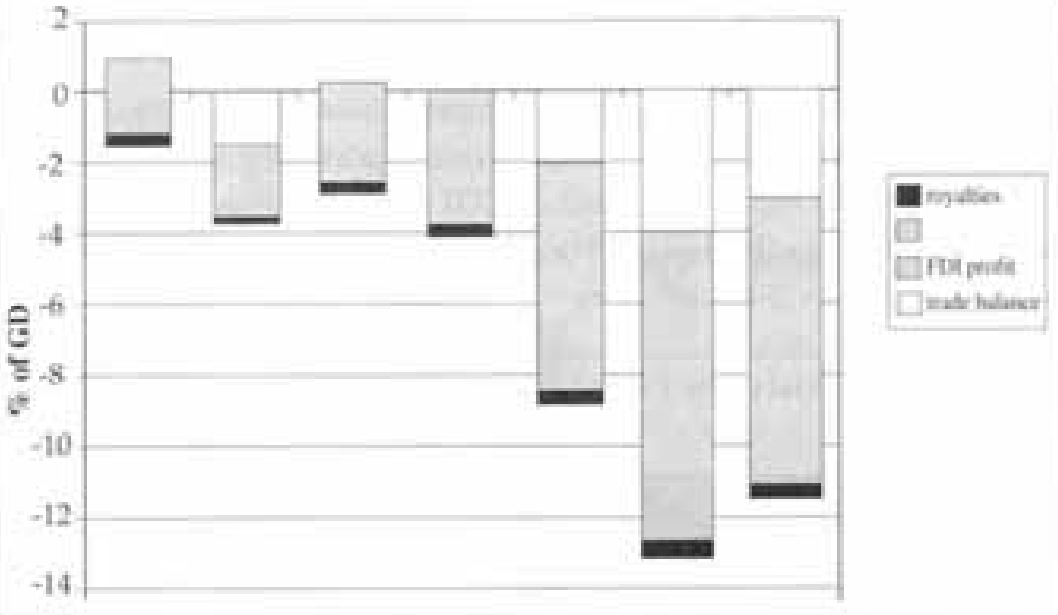


Figure 12: Malaysia: Current Account Deficit with and without FDI-Related Transactions, 1990-96

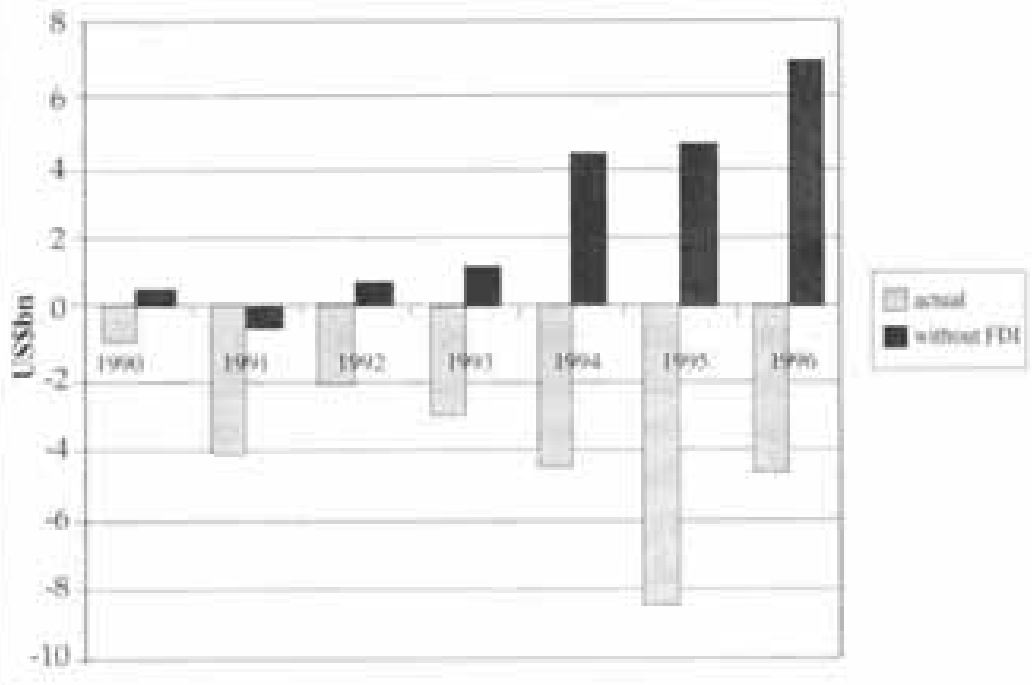
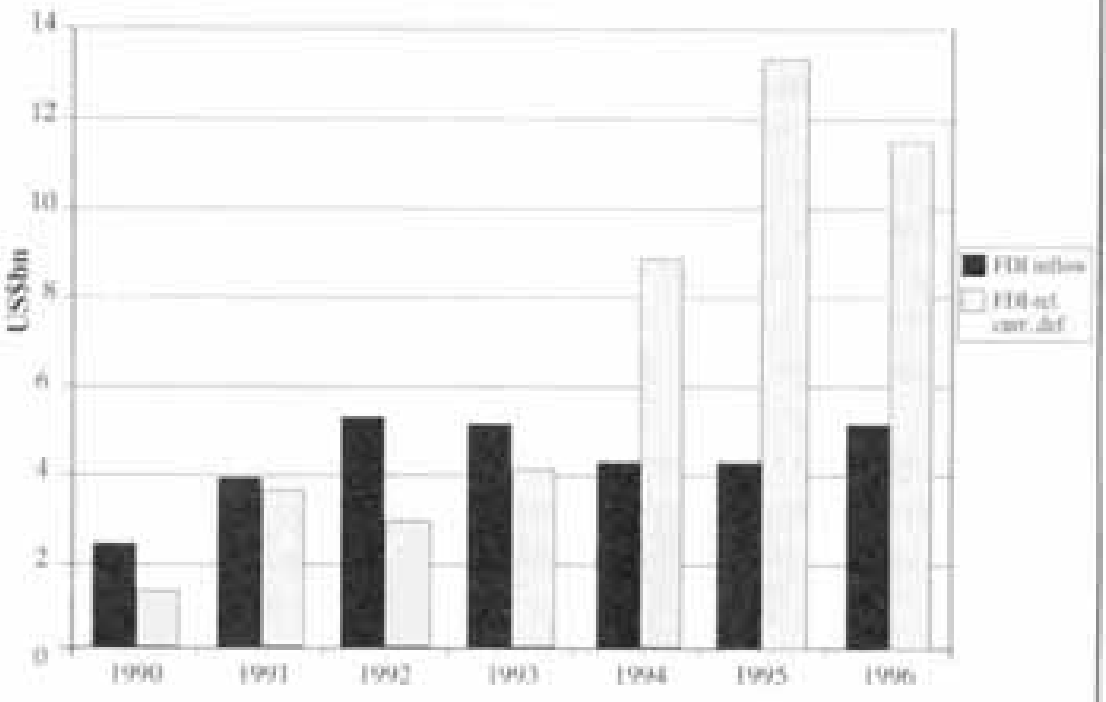


Figure 12 demonstrates the importance of Malaysia's FDI-related current account balance, by contrasting the actual deficit (in grey) with a notional "without-FDI" balance (in black).

This suggests that, except in 1991, FDI-related transactions were solely responsible for the deficit; and that the non-FDI economy had a progressively increasing current account surplus throughout the period, which was turned into a substantial (and in 1995 very large) deficit in 1994-6. Moreover, as shown in Figure 13, whereas FDI inflows were sufficient to cover the FDI-related deficit in 1990-93, in 1994-6 they fell dramatically behind. This suggests that the overall effect of FDI in these years was to increase the need for other capital inflows by between about 4% and 9% of GDP in each of the three years before the crisis.

Figure 13: Malaysia: FDI-Related Current Account Deficit and FDI Capital Inflows, 1990-96



The Malaysian story, as presented above, is profoundly worrying in the light of recent levels of FDI in developing coutries. While Malaysia had an exceptionally large stock of inward FDI for an economy of its size in the late 1990s (48% of GDP), the growth rate of FDI stocks in developing countries means that this offers little comfort. As noted above, FDI stocks in developing countries are at unprecedented levels (above 30% of GDP in 2000), and are growing rapidly relative to GDP (by 9% per year in the 1990s). If this growth rate continues, the average figure for developing countries as a whole will pass 48% in 2005, reaching 75% in 2010, and doubling every ten years thereafter. No fewer than 38 countries already had FDI stocks in excess of 50% in 2000.

Moreover, the particularly strong export-orientation of FDI in Malaysia suggests that a given stock of FDI should have had a more favourable or less unfavourable effect on the balance of payments than in almost any other country, while its relatively high income level and exceptionally good economic performance until 1996 suggests that the rate of return should have been relatively low. This suggests that the danger point for other developing countries may be significantly below 48%.

6 Summary and Conclusion

FDI is much less benign in terms of its financial effects than it is often presented as being. The stock of inward foreign direct investment (FDI) in developing countries has grown rapidly since the early 1990s, as FDI has expanded to fill the financing gap left by declining lending following the 1980s debt crisis and falling aid budgets.

Simplistically, FDI inflows may be seen as equivalent to borrowing at an interest rate of 16-18% p.a. for developing countries as a whole, and 24-30% in Sub-Saharan Africa, so that net outward resource transfers can only be avoided by allowing inward FDI stocks to grow at this rate. This implies a rapid expansion relative to the ability to meet the foreign exchange cost. Taking into account effects on exports and imports, the financial effects remain negative for investment through the purchase of existing productive capacity (except possibly in the case of export industries), which accounts for 75% of total FDI in developing countries, and through the construction of new capacity in non-tradeables, which accounts for a growing proportion as FDI in services increases.

Clearly positive effects arise only where new export capacity is created; but less than half the sales of FDI enterprises are exported, and in most traditional export sectors any benefits will be off-set by price effects on other exporters.

FDI played a significant role in increasing the vulnerability of several South East Asian countries to the 1997 financial crisis, particularly in Malaysia, where FDI-related transactions turned a strong current account

surplus into a large deficit and substantially outweighed the associated capital inflows, despite the strong export-orientation of FDI enterprises.

This suggests that the current levels and composition of FDI flows to developing countries are creating the conditions for further financial crises in the future; and the complacency which surrounds it is a major threat to development, and potentially to the global economy.

There is an urgent need for a different view of FDI, as a basis for prudent management of inflows. This means, in particular, a greater level of influence by governments over the composition of FDI inflows, in terms of the balance between the construction of new capacity and the purchase of existing capacity; the balance between export, import-substitution and non-tradeable sectors; and fostering backward linkages into the domestic economy, so as to limit foreign exchange costs for imported inputs.

There is a real danger that a WTO Agreement on Investment would prevent developing country governments from managing FDI inflows prudently so as to avoid financial crises.

In the 1970s, the major developed country governments actively encouraged commercial borrowing by developing countries. After the debt crisis began in 1982, they attributed it to the failure of developing country governments to manage the lending prudently. Since the 1990s, they have been actively encouraging developing country governments to seek inflows of FDI. Now, in seeking a WTO Agreement on Investment, they are seeking to take away the opportunity for prudent management. If they succeed, when the crisis comes – as it inevitably will – they will have no one to blame but themselves.

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FINANCIAL EFFECTS OF FOREIGN DIRECT INVESTMENT IN THE CONTEXT OF A POSSIBLE WTO AGREEMENT ON INVESTMENT

This paper presents a graphical presentation of the increasing flows and accelerating build-up of the stock of foreign direct investment in developing countries, and its likely financial effects in the long term.

It argues that the stock of inward investment, which has reached unprecedented levels, is equivalent to a large foreign debt at a very high interest rate; that it will have a strong negative impact on host countries' balance of payments over the long term; and that this effect was a major factor underlying the 1997 financial crisis in some South East Asian countries.

The paper concludes by emphasising the importance of selective policies towards FDI as a means of limiting the adverse financial effects, and warns of the danger that a WTO Investment Agreement will take away the policy space developing country governments need to manage FDI flows prudently.

DAVID WOODWARD *is an independent development economist. He has previously worked as an economic adviser in the British Foreign and Commonwealth Office, as technical assistant to the British Executive Director at the IMF and World Bank, and most recently as development economist in the Strategy Unit of the World Health Organisation. He has also written on a wide range of development issues for non-government organisations, UNDP, UNCTAD and the Institute of Child Health (University of London). He is the author of* Debt, Adjustment and Poverty in Developing Countries *(London: Pinter Publishers/Save the Children (UK), 1992), and* The Next Crisis? Direct and Equity Investment in Developing Countries; *and co-editor of* Global Public Goods for Health: Health Economic and Public Health Perspectives *(Oxford: Oxford University Press, forthcoming).*

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