

***FOREIGN DIRECT INVESTMENT: ITS DETERMINANTS AND RELEVANCE TO  
DEVELOPING COUNTRIES***

by

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submitted in fulfilment of the requirements for  
the degree of

**MASTER OF COMMERCE**

in the subject

**ECONOMICS**

at the

**UNIVERSITY OF SOUTH AFRICA**

**SUPERVISOR: PROF D HODGE**

**NOVEMBER 2002**



## **ACKNOWLEDGEMENTS**

This dissertation is the result of in-depth research in the domain of international economics, focusing particularly on the impact of foreign direct investment on developing countries. This study could not have been completed without the valuable support of the staff of the Department of Economics of Unisa's Faculty of Economic and Management Sciences. I am grateful to Prof D Hodge of Unisa, who was tireless in supervising the work, chapter by chapter. I am especially grateful for his leadership, guidance, patience, constructive comments and sincere encouragement during the long process of formulating this dissertation.

The work received a useful edit from Ms Yvonne Kemp, the editor and proofreader of this dissertation, to whom I am greatly thankful. Thanks are also due to Ms Etrechia de Villiers of the Unisa Library for her unwavering patience and prompt attention to my requests.

I would also like to express my sincere gratitude to my Ministry, particularly the National Directorate of Planning and Finance and National Directorate of Human Resources, which made this study possible through the award of a scholarship that provided me with the necessary financial support.

Finally, I would also like to thank my family: my wife Paula, my children Ana, Ines and Aristoteles, as well as my mother and brothers, for their love, care, constant support and understanding.

**Johannesburg,**

**November 2002**

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## **SUMMARY**

This dissertation is divided into six chapters, as follows:

**Chapter 1** of this dissertation discusses the growing significance of FDI for developing countries. It compares FDI in developed and developing countries and analyses recent evidence of FDI flows to developing countries. **Chapter 2** analyses the (endogenous and exogenous) determinants of FDI flows into developing countries. **Chapter 3** discusses the importance of FDI flows, which are essential for new investments or for financing fortuitous deficits in host countries, and looks at the adjustment mechanisms for the equilibrium of the balance of payments. **Chapter 4** gives attention to FDI flows, the liberalisation of financial markets and the financial account of the balance of payments in developing countries in providing more opportunities and mechanisms for development and economic growth. Finally, **chapter 5** examines and compares FDI flows to South Africa and Angola – the biggest FDI recipients on the African continent.

## **KEY TERMS**

FDI; determinants of FDI; developing country; home country; host country; endogenous factors; exogenous factors; competitive advantage; investment and interest rates.



## INTRODUCTION

As the title of this dissertation, “Foreign direct investment, its determinants and relevance to developing countries” suggests, the main purpose of the study is an in-depth analysis of foreign direct investment (FDI) as a type of capital flow and as the largest single source of external finance of developing countries. This analysis emphasises the growing significance of FDI for development and economic growth in these countries. The methodology used combines a descriptive and theoretical analysis to explain the importance of FDI.

In carrying out the analysis referred to above, this dissertation attempts to answer the following questions:

- What has been the chief tendency of FDI? Related to this are questions about its largest sources, and how FDI has influenced growth and development in individual developing countries, in particular. Why do international investors prefer to invest abroad in host countries and how do these FDI flows affect the Balance of Payments in host countries.
- What will be the role of FDI as economies become increasingly globalised? Will it continue to be the largest portion of international capital flows?

The discussion is then narrowed to an examination of the nature and impact of FDI flows into developing countries, by means of an analysis of the experiences of South Africa and Angola.

Thus, the main hypothesis of this dissertation is that FDI benefits the economies of developing countries by promoting growth; another hypothesis is that FDI flows can be attracted by attending to a number of fundamental requirements.

The content of the five chapters of this dissertation is briefly set out below.

**Chapter 1** discusses the growing significance FDI and examines different theoretical perspectives on FDI. Both the complementary and the distinctive factors of FDI and foreign portfolio investment (FPI) are considered. The growing significance of FDI for developing countries is demonstrated by analysing comparative data on FDI into these countries. FDI into different developing regions (Latin America, Asian and the Pacific,

Central and Eastern Europe, and Africa) is also analysed. The improved performance of the developed countries is emphasised and the reasons behind their ability to attract greater flows of FDI are also considered.

**Chapter 2** provides a comprehensive exposition of the close relationship between the main determinants of FDI in home and host countries. The main structural forces driving FDI to developing countries are examined. The chapter also discusses the theoretical explanations of why foreign investors forego producing and exporting their products from home countries for the sake of investing abroad. This leads to an analysis of the main endogenous and exogenous factors as determinants of FDI.

General aspects of the determinants of international capital flows are distinguished and their effects on financial markets are examined. The reverse is also examined – how the development of domestic financial markets affects international capital flows. The connection between FDI and economic growth is emphasised, as are the effects of international capital flows on domestic financial systems.

In **chapter 3** the discussion turns to the implications of FDI for the balance of payments and capital formation. The effects of FDI on the balance of payments are analysed and the relationship between the main accounts of the balance of payments and FDI is also examined.

The link between FDI and the balance of payments adjustment mechanisms, particularly the income adjustment process, is considered. The direct effect of FDI on aggregate output, exports and imports are then examined. Finally, the chapter discusses the balance of payments constraint and the need for international capital flows in the face of a policy dilemma.

**Chapter 4** starts with an examination of the increasing need for developing countries to liberalise their financial markets. The best ways of organising financial markets in order to attract international capital flows are considered. The role of financial markets in matching saving with the dissaving of firms and households and their main economic function, of channelling funds from surplus units or regions to deficit units or regions, are discussed.

Attention is given to key aspects of the structural reforms required in the financial markets of developing countries and the management of the financial sector and public funds in these countries. The role of the multinational corporations (MNCs) and their merger and acquisition (M&A) activities is discussed. In conclusion, the chapter stresses the merits of liberalisation of the economy and financial systems in developing countries.

Finally, **chapter 5** provides a comparative analysis of FDI flows to South Africa and Angola. It is thus a practical application of part of the theoretical framework developed in chapters 2, 3 and 4. The chapter attempts to show that development in these two biggest FDI recipients of the Southern Africa region may spill over into other countries. The performance and potential of the African continent and the major constraints on international capital flows into Sub-Saharan Africa are discussed. The role these two countries may play in the Southern Africa region under SADC policies and programmes such as NEPAD is also considered.

## **CHAPTER 1**

# **THE GROWING SIGNIFICANCE OF FOREIGN DIRECT INVESTMENT FOR DEVELOPING COUNTRIES**

## **1.1 INTRODUCTION**

This chapter starts with a definition of foreign direct investment (FDI) and then analyses the different factors surrounding its growing significance for the world economy in general and developing countries in particular. This is followed by an explanation of the main categories of and reasons for FDI. A distinction is made between FDI and foreign portfolio investment (FPI) and attention is given to the ways in which they complement one another regarding short and long-term transactions. Empirical evidence of the increasing volume of FDI to developing countries is discussed, which shows the increasing importance of FDI to developing countries in comparison with developed countries.

Nowadays, international capital flows take centre stage in the news, and the contribution of FDI to the development of the world economy, especially to the economies of developing countries, is widely acknowledged. This chapter therefore provides a detailed analysis, using the most up-to-date data, of the impact of FDI on the performance of the four main developing regions (Latin America, Asian and the Pacific, Central and Eastern Europe, and Africa). The role of the major players in each region is emphasised as well as the spillover effects of regional crises. Particular attention is given to the poor performance of Africa and sub-Saharan Africa in attracting FDI. Recently, however, FDI inflows into the African continent have been increasing more quickly than at the beginning of the 1990s, mainly as a result of the substantial efforts of many governments to create a more business-friendly environment and to implement structural reforms and coherent, consistent macroeconomic policies after the turbulent 1980s. This is also discussed, and it is suggested that, in view of the expansion of international production, trade and finance over the past two decades, the challenge that lies ahead for developing countries is integration into the global economy and into regional networks.

## **1.2 WHAT IS FDI?**

The remarkable rate of growth achieved by the world economy, particularly the biggest emerging markets, and the crucial role played by the liberalisation of financial markets and international trade in that growth, have increasingly influenced FDI and FPI into developing countries. FDI is the largest component of long-term capital flows to developing countries. It has, therefore, contributed to their economic growth and is expected to remain their dominant source of external finance.

The present discussion focuses on neoclassical and mainstream analysis of FDI and refers, in particular, to the Heckscher-Ohlin-Samuelson theory of efficient allocation of resources and factor price equalisation (Petroff 1983: 10). It therefore ignores Marxist and radical perspectives on this topic. According to the Heckscher-Ohlin-Samuelson framework, factor endowments differ from country to country, and these determine comparative advantages between countries, which in turn influence international trade. Thus a country will export the commodities that intensively use its relatively abundant factor (Markusen, Melvin, Kaempfer & Maskus 1995: 106). This axiom is closely related to the evolving pattern of FDI in that foreign investors have generally based their decision to invest their abundant money abroad on higher rates of return compared to domestic investment and risk diversification considerations. Markusen et al (1995: 376) also suggest that unequal factor prices between countries, which provide incentives for factors (commodity or capital) to migrate, are based on the following:

1. If production technology differs between countries, it is unlikely that trade will equalise factor prices even if it equalises commodity prices.
2. If some goods are produced with increasing returns to scale (i.e. if doubling the amount of input more than doubles the amount of output) then trade will not equalise factor prices.
3. If tariffs or transport costs prevent trade from equalising commodity prices, factor prices will differ between countries.
4. If imperfect competition or production taxes exist in some sectors, marginal costs and therefore factor prices will not be equal between countries.

5. If there are more factors of production than traded goods, then trade in goods alone is generally not sufficient to equalise factor prices.

FDI is related to international capital mobility, international production and trade based on comparative advantage, and to a business-friendly environment and stable domestic macroeconomic policies, which attract different kinds of capital inflows. Aitken and Harrison (1994: 4) explain that the dominance of multinational corporations (MNCs) over companies in the developing countries in recent decades has come about because of their greater capital resources and non-tangible productive assets. These assets include technological knowledge, marketing skills, export contacts, coordinated relationships with suppliers and customers, and reputation.

Danziger (1997: 1) defines FDI broadly as an investment made by a foreign investor in order to acquire an ongoing interest in an enterprise operating in a country other than the investor's home country. The foreign investor intends to exercise some control over the management of the direct investment enterprise. Danziger goes on to distinguish two basic forms of FDI:

1. The foreign investor establishes a new venture in the host country. This is known as a "greenfield" investment.
2. The foreign investor makes an acquisition: all or part of an existing firm or project in the host country is purchased.

Burke (1985: 2), on the other hand, defines FDI as the purchase of the means of production with the intention of gaining management control of the assets and a claim on the income generated by the assets. According to Burke, FDI is designed to give foreign equity capital owners an active part in managing the assets of an organisation. A direct investment implies a controlling interest – generally 50% of a firm's common equity. In the United States, however, potential control and a strong voice in management are sufficient to classify a foreign investment as a direct investment. This would mean owning at least 10% of the voting stock of a US company. On the other hand, Lizondo (1991: 68) argues that to understand FDI it is essential to distinguish between FDI and FPI. (This distinction is discussed at length later in this chapter.) Despite the fact that it is not obvious what constitutes control of a firm, Lizondo classifies as FDI those

investments where the percentage of foreign ownership is above a certain limit, usually between 10 % and 25%.

In the same vein, the International Monetary Fund (1996:107) maintains that direct investment (FDI) is a category of international investment in which a resident entity in one economy (the direct or foreign investor) acquires a lasting interest in an enterprise resident in another economy (the direct investment enterprise). Whether the lasting interest is related to a controlling interest or to potential control is immaterial. The emphasis is therefore on the fact that FDI implies a long-term relationship between the foreign investor and the direct investment enterprise. Additionally, it implies a significant degree of control of and influence over the management of the enterprise in the host country by the foreign investor. A foreign investor may be an individual, an incorporated or unincorporated private or public enterprise, an associated group of individuals or enterprises or a government or government agency. However constituted, the foreign investor should own at least 10% of an overseas direct investment enterprise to control and influence the management of the investment (IMF 1996:107).

The different aspects of these definitions are set out below:

- FDI is about investment made beyond their national boundaries by domestic residents (individuals, companies, financial institutions and governments) who become foreign investors. They may invest in the foreign country by establishing an enterprise from scratch, or for the purpose of acquiring an ongoing interest in an existing enterprise. (Although this is not mentioned by the different authors, foreign investors also invest in foreign enterprises for the purpose of merging their holding companies with businesses operating overseas.)
- It is clear that the “greenfield” investment or the outright purchase of an enterprise is made primarily to take over the management of the enterprise in the host country. Other strategic objectives are the arrangement, exploitation and control of new markets for products from the holding company or home country with the aim of maximising the investor’s profits.
- It is also clear that FDI involves ownership or control of a business enterprise abroad

by an MNC. This implies long-term relationships between the foreign investors and the targeted direct investment enterprise.

- Danziger (1997: 1) states that the acquisition of equity in foreign companies should be at a level of shareholding, usually 25%, that enables the investor to influence the company's management and control; while Burke (1985: 2) points to a figure greater than 50% for the ownership of the firm's common equity, that is, for a controlling interest in the management of a direct investment enterprise. But Burke also stresses that for potential control (not effective or majority control), rather than a controlling interest, the foreign investor should own at least 10% of voting stock of a company. This is also the criterion used in South Africa according to the South African Reserve Bank (SARB) (2002: S-84, footnote 475). Lizondo (1991: 68), in full accord with the International Monetary Fund (1996), stipulates between 10% and 25%. However, Burke's definition best accommodates the observed behaviour and the main objectives of MNCs as regards their foreign investments. It is obvious that one of the basic goals of MNCs as foreign investors is to have a controlling interest in foreign companies, thereby making it easier for them to consolidate and improve their monopolistic or oligopolistic position in domestic or international markets.

Notwithstanding the similarities between the definitions of FDI, there are a number of different theories about *why* FDI takes place. The determinants of FDI are examined in more details in chapter 2. Briefly, however, Danziger (1997: 4-6) identifies six such theories:

1. **The capital arbitrage theory.** This theory emphasises the sensitivity of foreign investors to differences in rates of return on capital between countries and the concomitant importance of international capital mobility. This theory sees international capital mobility as the movement of capital from surplus to deficit countries in response to higher rates of return in the deficit country and to reduce risk through diversification. This movement continues until the rates between the two countries have been equalised. As international capital exporters, foreign investors are also capital arbitrageurs since they seek out better business opportunities and higher rates of return on their investments to maximise profits. Even if returns on the



domestic and foreign investment opportunity are the same, the foreign investment may be preferred to diversify the investment portfolio and thereby lower portfolio risk.

2. **The intangible assets theory.** The competitive advantage and dominance of MNCs over same-industry companies in developing countries is emphasised here. According to this theory, MNCs engage in FDI because the host countries' companies are at a competitive disadvantage compared with investors in the same industry as a result of market imperfections and cost differentials in the domestic economy or because MNCs possess valuable intangible assets. These intangible assets include technological knowledge, cost-minimising production techniques, patents, registered trade marks, designs, brand names, production or trade secrets, export contacts, coordinated relationships with suppliers and customers or skills in styling or promoting products (marketing). They are intangible because they have a goodwill value and can be exploited over and over again without depleting their utility. They have an initial investment cost, which is capitalised once the assets have been acquired, but the marginal cost of exploiting these assets abroad is almost nil.
3. **The industrial organisation or classical theory.** This theory explains FDI as a result (or function) of an oligopolistic or monopolistic market structure which is thought to give foreign investors an advantage over domestic industries and, therefore, the capacity to remove competition. The use of differentiated products based on intangible assets implies the existence of two different types of industrial organisations: horizontally integrated firms, which everywhere produce the same products made by the parent firm; and vertically integrated firms, which produce inputs into the production process of the parent firm. The latter normally develop as a result of oligopolistic market structures. This theory, says Danziger (1997: 5), suggests that foreign investors undertake foreign operations because of imperfections in the industrial and technology markets of the host country as well. This means that foreign investors cannot fully exploit the advantages without establishing and controlling their own foreign operations. In other words, ownership and control of foreign operations enable foreign investors to generate monopolistic returns by removing competition. FDI is thus explained by industry-specific advantages once

exports and licensing have been ruled out as possibilities for gaining any advantage. This theory also suggests that FDI is a strategy by which oligopolistic MNCs try to close out market competition by erecting barriers to entry, such as superior technological knowledge, product differentiation and easier access to domestic and international credit facilities.

4. **The internalisation theory.** According to this theory, a foreign investor allocates resources from one place to another without exchanging ownership and can do business in either the home or host country markets. This internalises production and sales. To achieve efficiency, a foreign investor can also use the external goods and factor markets. But because the markets for some intermediate products may be inefficient or difficult to organise, internalisation enables the corporation to bypass these inefficiencies or replace them with its own internal markets.
5. **The competitive advantage theory.** This theory holds that foreign investors locate resources and production where factor costs are lower than those of home country competitors. This lowers a firm's average production costs and gives it a competitive advantage over its competitors.
6. **The mixed theory.** According to this theory, a firm that undertakes FDI necessarily has organisational advantages in ownership, intangible assets, internalisation and location. Danziger provides a three-point summary of this position: First, the investor must own some firm-specific advantage, such as intangible assets. Second, in order to maximise its profit the investor must see advantages in structuring its operations within a single, vertically integrated organisation rather than contracting with third-party distributors or licensees. Finally, the prospective host country must offer some kind of location advantage, such as stable environment and tax incentives, over other potential production locations.

FDI has taken different forms in different countries. In industrialised countries, it has taken the form of mergers and acquisitions (M&As) of existing assets or enterprises rather than the construction of new facilities. In fact, M&As of assets and enterprises are the principal driving force of FDI in those countries, whereas cross-border M&As still account for a relatively small share of FDI flows in developing countries. Such flows

have been mainly the result of privatisations in Latin America and purchases of Asian companies in countries affected by financial crises (UNCTAD Press release, 2001b: 1).

Danziger (1997: 13-18) also defines four main categories of FDI based on the freedom of foreign investors to invest in host countries, as described below:

1. **Open FDI.** This kind of FDI allows foreign investors to invest in host countries without restrictions or limits, subject to some degree of reciprocity between the countries concerned. Normally concessions are made to link same-sector exports and imports between two countries; the cost of a concession is then assessed taking into account the level of transactions between them. Once a right of FDI access has been granted, a commitment to non-reversibility is made by the host country. This simply means that FDI accessibility cannot be withdrawn later and that a compromise should be reached, if necessary. Thus a host country that allows open FDI could retain the right to refuse some investments so that it can protect areas such as public health, education, safety and essential security interests. Examples of open FDI are those made in the European Union between member states.
2. **Managed FDI.** This system regulates inward FDI by liberalising investment conditions (not based on rules or treaties), rather than by granting a general right of establishment. Unlike open FDI, managed FDI involves regulations or restrictions on FDI, and investment access is granted on a discretionary, case-by-case basis by the host country. Consequently this takes into account various criteria, including the desirability of reciprocity agreements and the total effect of FDI on the economy. This system requires strict discipline, and active, efficient management by officials of both the holding company in the home country and the affiliates in the host countries. Since managed FDI focuses on developing good relationships between countries, governments normally engage in formal dialogue with the intention of securing mutual adjustments if necessary. The aim is to ensure adequate monitoring and evaluation of the costs and benefits of FDI. Thus, formal barriers can be relaxed on a negotiated basis. An example of managed FDI may be found in the United States-Canada Free Trade Agreement and the North American Free Trade Agreement, which provide for “national treatment” of foreign investors. Under these agreements,

existing FDI regulations in each of the member countries are kept in place and subject to a screening review, but new or greenfield FDI is not subject to screening and controls are limited as regards specific sectors. Alternatively, host countries may decline to grant national treatment to foreign investors and may evaluate new FDI on the basis of its impact on the aggregate economy (employment, training, technological knowledge, productivity and competitiveness).

3. **Trade barrier FDI.** Given that FDI and trade are naturally linked, this category of FDI arises as a response to trade barriers. It is therefore undertaken by an MNC so that it can avoid the tariffs or other barriers to its exports to the host country. Thus, such FDI is for production for the domestic market in the host country, rather than for export to other countries. Alternatively FDI can arise where there are no trade restrictions but where it is believed that restrictions will be put in place. It also takes place when the trade restrictions brought about by anti-dumping measures create pressures to liberalise FDI access. If a host country places restrictions on imports, a foreign investor still has various means of accessing markets in the host country. These include contract manufacturing, the licensing of technology and manufacturing rights to a host country producer, or FDI. The latter is the preferred alternative to induce foreign investors to stay in the host country market, when they are unwilling to license their technology to a host country licensee. The major benefits of trade barrier FDI for host countries are that local factor inputs are used to manufacture goods for the domestic market, thereby increasing employment.
4. **Relational FDI.** This takes place when a foreign investor buys and holds a significant or potentially controlling interest investment in a host country company. The foreign investor does not exercise or have a controlling interest over the host country business but monitors the company's operations and assets. This allows the host country company to retain control over such investment and to preserve its economic sovereignty. Consequently there should be a commitment by the foreign investor to the long-term economic future of the company and viability in terms of profitability.

## **1.3 COMPLEMENTARITIES AND DIFFERENCES BETWEEN FDI AND FPI**

As Lizondo (1991: 68) maintains, to understand FDI it is essential to distinguish between FDI and FPI (foreign portfolio investment). The following discussion of this issue is based mainly on the papers and reports on the topic prepared and issued by the United Nations Conference on Trade and Development (UNCTAD).

### **1.3.1 FDI AND FPI DEFINED**

As was stated earlier, **foreign direct investment** is an investment made by a foreign investor for the purpose of acquiring an ongoing interest in an enterprise operating overseas. It is made with the intention of exercising some control and influence over the management of the direct investment enterprise. It therefore involves a lasting or long-term relationship between the foreign investor and the direct investment enterprise.

**Foreign portfolio investment**, on the other hand, is a financial investment made by an investor from one country in the securities markets of another country, seeking purely financial gains in the form of income or capital. Generally this is a short-term investment in shares, bonds, notes, money market instruments and financial derivatives, and does not imply significant control over or a lasting interest in the enterprises concerned. It is therefore more prone than FDI to changes in investor sentiment and crisis in financial markets. Because it is not linked to any particular firm or sector, FPI plays a neutral role, in principle, in the allocation of resources, channelling finance to an investment that carries prospects of high financial returns.

Bearing in mind this fundamental distinction between FDI and FPI, it is important to note, as UNCTAD (1999b: 8-9) emphasises, that their main characteristics reflect both complementarities and differences, as discussed in section 1.3.3.

### **1.3.2 IMPORTANCE OF FDI AND FPI**

As is shown later, both FDI and FPI have great importance for a country's balance of payments since together they represent the major portion of international capital flows. For instance, over the period 1991 to 2001, both FDI and FPI represented about 62%

(50% and 12.7% respectively) of net international capital flows of \$2,695.8<sup>1</sup> billion, to developing countries (World Bank 2002: 32). Notwithstanding the effects of the emerging markets crises of 1997 to 1999, the figures for the period from 1996 to 2000 show a proportionate increase in the levels of FDI. However, the distribution of FDI, FPI and official flows in developing countries show some interesting features. For example, countries in Latin America, the Middle East and Eastern Europe have relied mostly on FPI as a source of international capital flows, while Asia has relied on FDI and Africa more on official flows.

### **1.3.3 COMPLEMENTARITIES BETWEEN FDI AND FPI**

First, FDI can facilitate the transfer of technology and market access, which helps to develop and strengthen the domestic market, thereby consolidating investors' confidence. FPI can strengthen the process of domestic capital market development. New technology and improved market access increase the competitiveness of domestic enterprises, while a stronger domestic capital market makes funds available to finance their activities. Both types of investment thus develop and strengthen the domestic market, thereby consolidating investors' confidence.

Second, FDI can have a significant impact at the microeconomic level and can therefore help shape the productive structure of a host country. It can, for example, encourage the creation of domestic companies, which in turn would have recourse to FPI to finance their expansion. On the other hand, FPI may have greater macroeconomic impact on the economy through changes in asset prices and liquidity in the financial sector and may therefore encourage the development of domestic capital markets, which then would help to attract FDI.

A third complementarity is that, as mentioned above, FPI can help strengthen the local financial infrastructure, which can facilitate the operations of MNCs, most particularly when FDI is undertaken through M&As. Since the micro and macroeconomic environments are inseparable elements of the aggregate economy (as an integrated system), it is clear that FDI and FPI complement each other in their separate effects on

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<sup>1</sup> Dollar figures are in current US dollars unless otherwise specified. Billion is a thousand million.

these environments. These complementarities should lead the aggregate economy towards the main objective: general economic stability and growth.

#### **1.3.4 DIFFERENCES BETWEEN FDI AND FPI**

A number of differences may be identified, as follows:

1. The first difference identified is that FDI and FPI address different financing needs. While FDI is related to the productive sector, FPI is related to the financial sector. Consequently, FDI is owned by MNCs while FPI is more broadly based on individuals, fund managers and companies searching higher returns.
2. FDI is firm and sector specific, while FPI is more fungible (i.e. it can easily be exchanged for the same type of investment, or used instead for another investment).
3. Unlike foreign direct investors, foreign portfolio investors do not have managerial control over or responsibilities in their investments and very often do not have a physical presence in host countries.
4. The decision by MNCs to undertake FDI is generally influenced by socio-economic, financial and political determinants pertaining to the host country. On the other hand, FPI is often affected by factors external to host countries, such as financial and foreign exchange policies in capital-exporting countries, the state of liquidity on international markets, and changes in the pattern of diversification of international portfolio.
5. FPI tends to be more volatile than FDI. Consequently, hedging behaviour against expectation of devaluation by MNC subsidiaries can exacerbate and prompt balance of payments crises through outflows of FPI. Foreign direct investors hedge their exchange risks by matching their assets with liabilities in different currencies through bank loans and portfolio investment. Thus, although the physical assets remain in the country, MNCs can rearrange the financial aspects of their investment.

#### **1.3.5 PROBLEMS IN DISTINGUISHING BETWEEN ACTUAL INSTANCES OF FDI AND FPI**

Because of distortions in many economies, and the maladministration and inefficiency of their financial systems, it is often difficult to obtain data on FPI. It is also difficult to get a

precise indication of cross-border portfolio flows. There is no single source of data on FPI. According to UNCTAD (1999a: 6), the IMF seems to have the most reliable figures provided by recipient countries.

Apart from this problem of accuracy of estimates, there is also the problem of borderline cases where it is difficult to classify an investment as FDI or FPI. In countries where FPI is liberalised, a portfolio investor might buy more than 10% of the shares of a company without having a long-term or lasting interest in a company. Additionally, a portfolio investor may have no desire to control the management of a company in a host country, yet the portfolio investment might be classified as FDI. On the other hand, affiliates can issue bonds, which are for the most part purchased by a parent company. These transactions, which are in fact FDI, are often recorded as FPI. Thus, using the controlling interest as a dividing line, there are circumstances where FDI can become FPI through the dilution of ownership and loss of control. Conversely, FPI can be transformed into FDI if the investor decides to take a managerial interest in the company whose assets were earlier purchased as FPI.

In general, capital flows may assume an inward or an outward direction. Regarding developing countries, capital inflows are usually related to direct investments (FDI), which increase the gross domestic product, and to foreign portfolio investment (FPI) in the capital markets. In contrast, capital outflows are often related to the capital flight resulting from a developing country's financial system falling into distress or other financial problems. The reasons behind the capital inflows into various countries are based on internal and external factors, as is argued in chapter 2.

## **1.4 SOME EMPIRICAL EVIDENCE ON FDI**

### **1.4.1 GLOBAL AND REGIONAL TRENDS**

Accompanying the globalisation and liberalisation of the economies of many developing countries, there has been a remarkable upsurge in FDI flows to these countries since the early 1990s. These have been the least volatile form of capital flows to developing countries due to their long-term characteristics, which induce them to respond



undramatically to financial disturbances. FDI has thus proved to be remarkably immune to financial crises. It has tended to stimulate other investments and is associated with an overall increase in total investments in emerging markets.

According to the Economist Intelligence Unit (2001: 1), between 1990 and 2000 the US dollar value of world FDI inflows more than quintupled; growth has been especially strong since 1997, with an average annual growth in FDI inflows of 33% in the period 1998 to 2000. In 2000, FDI inflows, driven by a wave of cross-border M&As, reached a record total of more than \$1.1 trillion. This figure represented 84.6% of global FDI flows.

In addition, FDI has been the largest component of long-term capital flows to developing countries, which has made a significant contribution to the growth and development of those countries, especially where sensible domestic policies and macroeconomic stability prevail. Usually foreign investors have preferred to invest in a host country that has:

- prudent macroeconomic policies
- a well-managed banking system
- low or minimal regulation
- low production costs
- a flexible exchange rate system
- liquid capital markets
- a stable, democratic political system
- a noteworthy commitment to eliminating corruption
- an advanced telecommunications system
- a sophisticated industrial base.

Over and above these attributes, the size and openness of the domestic market, the profitability and the type of investment are the factors that determine the allocation and development of FDI.

The impact of FDI on the host country is likely to vary according to the development and performance of the economic sector (viz. manufacturing, services or extractive industries) in which it is intended to make the FDI.

As stated above, foreign investors prefer exchange rates and interest rates to be primarily market determined and to adjust to changing inflation rates. If exchange rates are not allowed to reflect cross-national differences in inflation rates, foreign investors, as well as other businesses, are exposed to price distortions in their costs and revenues. This can threaten their long-term returns and competitive positions. Generally, foreign investors prefer stable exchange rates in the short term, but in the long term they prefer exchange rates to be flexible and sensitive to changes in cost, prices and income trends. Despite the fact that foreign investors may enjoy the benefits of low, subsidised interest rates for their own projects, they prefer interest rates in general to reflect inflation rates: low domestic interest rates and capital flight may contribute to a deteriorating domestic economy and balance of payments position. Interest rates, foreign exchange rates, wage rates, national savings and investment rates, and other socio-economic and financial conditions that bear on an investment project's costs are important for attracting or deterring FDI.

However, the rapid expansion of FDI has unquestionably increased the worldwide role of MNCs and, consequently, of international production. As a result, FDI has become the main force in international economic and financial integration, despite the fierce and increasing criticism of the process of globalisation in recent years. The developed world has continued to attract the bulk of FDI, contributing over three-quarters of global FDI inflows from 1998 to 2001 - largely because of increasing M&A activities. Within the developed countries, the Triad (which comprises the European Union, the United States and Japan) in 2000 accounted for 71% of world FDI inflows and 82% of world FDI outflows. Following the trend of the 1990s, by the end of 2000 global FDI flows had soared by 18% to a new record of about \$1.3 trillion (UNCTAD 2001e: 9, and table 1.1).

In effect, as may be seen from table 1.1, from 1998 to 2001 developed countries accounted for an average of 83% of FDI inflows, while the developing countries accounted for only an average of 17%. In the same period, Central and Eastern Europe alone accounted for an average of 2.4%.

**TABLE 1.1 COMPARATIVE DATA ON FDI BY REGION, 1998-2001 (BILLIONS OF DOLLARS)**

Region	1998(a)	1999(a)	2000(b)	2001(c)
World	200.5	884.4	1,271.0	760.0
Developed Countries	176.2	699.0	1,104.3	591.8
Developing Countries	24.3	185.4	166.7	168.2
Sub-Saharan Africa	0.9	8.0	7.0	13.7
Latin America and the Caribbean	8.2	90.0	75.1	71.0
Asia and the Pacific	12.0	59.0	55.1	48.5
Central and Eastern Europe	1.1	27.0	28.5	28.5

Source: (a) World Bank 2001c. *World development indicators*. Washington, DC: International Bank for Reconstruction and Development: 342. (b) <http://www.worldbank.org/prospects/gdf2002/v...reg-aggregateflows>.

(c) World Bank. 2002. *Global development finance: financing the poorest countries*. Washington, DC: International Bank for Reconstruction and Development: 166 – 188.

It is interesting to observe that from 1999 to 2001 developing countries experienced some irregularities as regards FDI inflows, while until 2000 developed countries showed an increasing tendency. A possible reason is that the parallel paths of FDI flows and cross-border M&A activities are more pronounced in developed than in developing countries. Another explanation is that FDI flows in the developing countries are channelled to greenfield investments. In addition, many developing and Central and Eastern European countries lack developed infrastructure, macroeconomic stability, reforms and transparency in the management of public and private businesses. Although the figures for 2001 are only estimates, the decrease in FDI to developed countries for 2001 was due to a massive decline in cross-border M&As, which had until then accounted for the bulk of FDI. The value of cross-border M&A deals completed between January and early September 2001 stood at some \$400 billion, about one-third of the total value in 2000 (UNCTAD 2001b: 1-2).

#### **1.4.2 ANALYSIS OF FDI FLOWS INTO DEVELOPING COUNTRIES FROM 1991 TO 2001**

Data on FDI in developing countries are given in tables 1.2 and 1.3. As may be seen from these two tables, FDI to developing countries has climbed about fivefold since 1991, from \$35.7 billion in 1991 to \$168.2 billion in 2001.



**TABLE 1.2 NET LONG-TERM INTERNATIONAL CAPITAL FLOWS TO DEVELOPING COUNTRIES, 1991-1995 (BILLIONS OF DOLLARS)**

Items	1991	1992	1993	1994	1995
<b>Total</b>	124.2	153.7	220.9	222.4	260.5
Official flows	62.2	54.3	53.4	46.0	54.1
Private flows:	62.0	99.4	167.6	176.4	206.1
-Int.cap. market <sup>(a)</sup>	26.4	52.2	101.0	86.3	99.3
Debt fl.	18.8	38.2	50.0	51.2	63.3
Equity fl.	7.6	14.1	51.0	35.2	36.1
-FDI	35.7	47.1	66.6	90.0	106.8

Note: <sup>(a)</sup> Debt flows of International capital markets flows include: bond financing, bank lending flows and others; fl. for: flows

Source: World Bank. 2002. *Global development finance: financing the poorest countries*. Washington, DC: International Bank for Reconstruction and Development: 32

**TABLE 1.3 NET LONG-TERM INTERNATIONAL CAPITAL FLOWS TO DEVELOPING COUNTRIES, 1996-2001 (BILLIONS OF DOLLARS)**

Items	1996	1997	1998	1999	2000 <sup>(a)</sup>	2001 <sup>(b)</sup>
<b>Total</b>	306.6	341.4	336.7	271.8	261.1	196.5
Official flows	30.3	40.7	53.4	47.4	35.3	36.5
Private flows:	276.2	300.7	283.3	224.4	225.8	160.0
-Int.cap. market <sup>(c)</sup>	145.5	128.2	105.0	40.1	59.1	-8.3
Debt fl.	96.5	98.1	89.4	5.6	8.2	-26.8
Equity fl.	48.9	30.1	15.6	34.5	50.9	18.5
-FDI	130.8	172.5	178.3	184.4	166.7	168.2

Note: <sup>(a)</sup> Preliminary, and <sup>(b)</sup> Estimates

<sup>(c)</sup> Debt flows of International capital markets flows include: bond financing, bank lending flows and others; fl. for: flows

Source: World Bank. 2002. *Global development finance: financing the poorest countries*. Washington, DC: International Bank for Reconstruction and Development: 32

As a consequence, the share of FDI as a percentage of net long-term international capital flows rose from 29% in 1991 to an estimated 85.6% in 2001 (World Bank 2002: 32).

From 1991 to 2001, net international capital flows to developing countries were valued at \$2.695,8 billion. Annual flows peaked at \$341.4 billion in 1997, thereafter declining to \$196.5 billion in 2001 (see tables 1.2 and 1.3). However, FDI flows to developing

countries continued to be the major source of external finance, representing 50% of total net long-term international capital flows between 1991 and 2001. Following the emerging markets' collapse during the financial crises of 1997 to 1999, private capital flows to developing countries did not resume their growth until 2001, even in the wake of the strong economic and financial recovery of the emerging markets that began in 1999 (see table 1.3).

During the emerging markets financial crises of 1997 to 1999, FDI flows proved very resilient, while FPI flows proved more volatile. This volatility was expressed in a decline in FPI (equity flows) from \$48.9 billion in 1996 to \$15.6 billion in 1998, followed by a recovery starting in 1999 and reaching \$50.9 billion in 2000. But as a result of the global economic slowdown and lack of confidence in the international financial markets, this figure again declined to \$18.5 billion in 2001. By contrast, FDI continued to increase from \$130.8 billion in 1996 to \$184.4 billion in 1999, with a modest decline to \$166.7 billion in 2000 (see table 1.3). However, net FDI flows to developing countries have remained almost unchanged in the last two years, at an estimated \$168 billion in 2001, just 8.8% below the peak of \$184.4 reached in 1999. This shows the degree of stability of FDI flows to developing countries, despite the significant fall in world FDI flows shown in table 1.1. It is also a sign of the improvement in macroeconomic management within the main recipient countries, which has improved investor confidence.

The significant liberalisation of capital flows has stimulated growth in the developing countries and helped them to enjoy higher standards of living. But this has required substantial reforms and improvement in macroeconomic policy and the management of financial institutions to avoid potential economic problems and financial crises. Serious concerns have, however, been expressed about the disruptive effects of large and sudden changes in capital flows to these countries which could – particularly if economic fundamentals are unsound or financial institutions and policy-making are distorted or weak – provoke crises in certain regions of the world, and indeed have already done so.

It is also important to emphasise that there have been substantial differences (compared to the developed countries) in the composition of inflows into the emerging markets. FDI and flows from international capital markets (including portfolio equity and debt flows

such as bond issues and bank lending) are estimated to have accounted for an average of 83.5% of net long-term inflows to the developing countries from 1999 to 2001 (see table 1.3). FDI alone accounted for an average of 72.3% of net long-term international capital flows to developing countries from 1999 to 2001. During that period official flows were observed at an average of 16.5%, and private portfolio equity at an average of 13% of net long-term international capital flows. The drastic decline in FPI in 2001 reflects the downturn that began before the events of September 11 and the aftermath of those events. This clearly demonstrates the growing importance of FDI to the growth and development of the economies of developing countries. In effect, global FDI flows have continued to grow rapidly and even accelerated somewhat from the second half of the 1990s. According to UNCTAD (2001e: 10), global FDI inflows reached a record \$1.3 trillion in 2000, a real increase of about 50% over the previous year, while global FDI outflows reached \$1.2 trillion. However, according to the same report, the share of world FDI flows to developing countries (excluding Central and Eastern Europe) declined to 18.7% in 2000, from 26.9% in 1998. But despite the downturn in late 2000 and throughout 2001, the share of world FDI flows to developing countries increased from 12% in 1990 to 22% in 2001 (see table 1.1).

#### **1.4.3 PERFORMANCE OF FOUR MAIN DEVELOPING REGIONS**

An analysis of the performance of the four main regions of developing countries and the principal trends as regards FDI reveals the following:

1. **In Latin America**, in the 1990s, flows reflected mostly portfolio investments. But privatisation and acquisitions of domestic firms also served as a source of FDI.

Net international capital flows into the Latin American region have continued their downward trend from a peak of \$143 billion in 1998 to an estimated \$102 billion in 2000 (World Bank 2001a: 202). These figures represent a substantial decline (28.7%) between 1998 and 2000, despite a significant recovery, particularly of FDI, to these countries in 1999. According to UNCTAD (2001c: 3), FDI inflows into the region registered a 5% slump to \$86 billion in 2000 after an increase to a record level of \$90 billion in 1999. This decline was due almost entirely to corrections of data on M&As from 1999 and lower flows from privatisation proceeds, from \$22 billion in 1999 to

\$13 billion in 2000 (World Bank 2001a: 202). The latter figure was, nevertheless, the largest recorded FDI inflow to developing countries. For example, in 2000 Brazil received \$34 billion, the largest FDI inflow, followed by Mexico with \$13 billion.

However, FDI inflows to the region continued to decline and reached about \$71 billion in 2001, with Mexico's inflows reaching \$25 billion, surpassing Brazil as the most favoured destination of FDI in Latin America. With this figure, Mexico was second only to China among developing countries in 2001 (World Bank 2002: 176). The economic and political situation in Argentina, however, deteriorated throughout 2001, culminating in a full-blown financial and currency crisis in December 2001. The situation in Argentina urged leading financial institutions to raise concerns over debt crisis prevention, and to call for a new market-based system to improve management of sovereign debt restructuring and investor confidence. This may help growth in the region and strengthen its capacity to attract more international capital flows. Finally, it is important to stress that FDI flows have become the most important source of financing for the current account in the region, as in many other developing countries.

2. At the start of the 1990s, the **Asian and the Pacific region** was believed to be immune from the problems that beset Latin America in the 1980s and 1990s, such as the large fiscal deficits, heavy public debt burdens, rapid monetary expansion and structural impediments that had made this region vulnerable. According to Aghevli (1999: 1-2), these countries did not deal in earnest with their emerging problems and none predicted the Asian crisis of mid-1997. The Asian crisis was basically a banking crisis, which spread worldwide and affected the whole international financial system. Following the "big nightmare", the Asian countries are now regaining their economic health, attracting more capital flows and consolidating market liquidity. As a result, says the World Bank (2001a: 195-209), net international capital inflows into the region have improved, with inflows in 2000 amounting to \$93 billion for East Asia and the Pacific, and \$16.2 billion for South Asia. This was mainly due to the role of newly industrialised economies (Hong Kong, China, South Korea and Taiwan) whose FDI inflows reached \$80 billion in 2000 (UNCTAD 2001c: 2). China has continued to receive the bulk of FDI in the region with an estimated record inflow of \$41 billion

in 2000.

Despite the fact that inflows to the region declined from \$123 billion in 1997 to \$96 billion in 1998 (World Bank 1999a: 171) owing to a lack of confidence on the part of private investors following the emerging markets crises, FDI into the region has shown a substantial increase, contrary to general negative expectations. FDI inflows into Asian (developing) countries reached a record level of \$143 billion in 2000, which represented an increase of 44% over the previous year (UNCTAD 2001e: 23). As already observed, the FDI flows have tended to be more resilient than other private flows. According to the World Bank (1999a: 153), in the above period total private loans showed the largest decline, falling from \$31 billion in 1997 to \$7 billion in 1998. The need for crisis lending has been diminishing, meaning that the banks' role in Asia has been changing, opening their doors to other ailing regions around the world. Although aggregate FDI flows to developing countries fell in 2000, the Asian region maintained its roughly 33% share of the total (World Bank 2001a: 195). But FDI inflows into the region declined in 2001, despite their continuing resilience. Thus FDI inflows into the Asian and Pacific region totalled \$48.5 billion in 2001, a figure which was considered a robust outturn in the context of global recession (World Bank 2002: 167).

3. With regard to **Central and Eastern Europe**, it is important to emphasise that in the years after achieving independence from the Union of Soviet Socialist Republics (USSR), countries in this region attracted large capital inflows in the form of FPI. Before the Russian financial crisis of 1998, Central Europe and Russian equity markets had performed well, benefiting from portfolio shifts of private capital from East Asia to alternative markets precipitated by the East Asian crisis during 1997. FDI inflows into the region increased markedly in the mid-1990s and FPI was shifted to safer and more attractive regions. However, during the Asian crisis, aggregate international capital flows into the Central and Eastern European region declined from \$59 billion in 1997 to \$49 billion in 1998 (World Bank 1999: 171).

Although badly hit by the Asian and Russian crises, most of the countries in the region managed to weather the storm. In fact, the region increased its weight of FDI



inflows for four consecutive years, reaching \$27 billion in 2000 (UNCTAD 2001e: 34). As in 1998 and 1999, the 2000 flows were concentrated in the Russian Federation, Czech Republic and Poland, which have benefited from strong FDI in recent years and have also continued to attract buoyant international capital flows. According to the World Bank (2001a: 199), net long-term international capital flows to the region increased marginally from \$52.5 billion in 1999 to \$54.8 billion in 2000. This represented a broad stabilisation of flows following the sharp 20% contraction in 1999 owing to the Russian crisis. In 2000, FDI accounted for 64% of total private international capital flows of \$45.2 billion into the region, with bonds and portfolio equity accounting for 22% and 12% respectively (World Bank 2001a: 199). However, FDI inflows into the region reached \$28.5 billion in 2001, the same level as posted in the year 2000, even though the majority of the countries in the region witnessed a decline in FDI flows from year-earlier levels (World Bank 2002: 171-172).

However, the nature of capital inflows and the policy issues they have raised have been quite different for each country, partly because of their differing macroeconomic backgrounds. According to the World Bank (2001a: 199), some countries in this group had insignificant FDI because of a lack of profound macroeconomic or structural reforms. One might have expected huge imports of capital, both private and official, to finance the costly economic and political transformation required in the countries of this region during this transition period, particularly in view of the initial concerns that this situation could increase world interest rates at the expense of developing countries in general.

4. Finally, there is the **African region**. With the exception of South Africa, which is the most developed economy in the region, the global environment is very gloomy about this region, and Africa has been avoided by foreign investors. Wars, *coups d'état*, natural disasters, famine and diseases around the region have all contributed to the virtually permanent instability of the region, with direct negative repercussions on economic performance. Government maladministration in several countries and the attendant corruption and lack of transparency have made matters worse. As a result, the region is finding it increasingly difficult to attract official and private international capital flows.

The sub-Saharan region has ended up with the worst of all worlds: apart from the above-mentioned problems, low economic growth, high inflation, high unemployment and food shortages are also characteristic of the region. Naturally enough, these weaknesses and the volatility of most economies in the region mean that investors perceive the investment risks in the sub-region to be very high. They also face greater bureaucratic difficulties and other types of impediments in attempting to assess and exploit profitable business opportunities here than in other regions.

MNCs and investment promotion agencies identify the main obstacles to attracting FDI (or the high costs of doing business) to this region as the following: corruption, excessive bureaucracy (red tape), the poor state of physical infrastructure and difficulties in accessing capital in international markets. To invert this situation, apart from other macroeconomic measures aiming at stabilisation, the rate of return on investment should be high. In fact, the rate of return on investments in the region has indeed been high, at an averaged level of 24% to 30% in the region compared with 16% to 18% for most developing countries (World Bank 1997: 34). However, according to the World Bank (2000: 12), the rate of growth in sub-Saharan Africa (excluding South Africa) has been low in recent years, even though growth in the continent as a whole needs to be accelerated to over 7% a year to halt the spread of poverty and to halve severe poverty by 2015. According to the African Development Bank (2001: 5), from 1996 to 2000 the median African economy has grown at about 3.5%, which highlights how difficult it has been for many African countries to achieve a growth rate of 7% or more. The World Bank (2000: 10) calls attention to the fact that more than 40% of Africa's 600 million people live below the internationally recognised poverty line of \$1 a day, with incomes averaging just \$0.65 a day in purchasing power parity terms. In other words, almost half of the African population is classified as extremely poor along with high levels of income inequality.

In the aftermath of the emerging markets crises, negative effects spilt over to the African region. This region has seen the sharpest decline in private capital flows in recent years. First the decline was attributed to the Mexican debt crisis in 1982, and

later to the crises in East Asia, then Russia and finally Brazil, between 1997 and 1999. As these crises, together with the slowdown in developed countries and, in some cases, the poor quality of the region's products, have forced down world commodity prices, Africa urgently needs to diversify its production and exports. Although the handicaps referred to above should be taken into consideration, some African countries have been attracting huge international private capital flows in the form of FDI, generally as a result of efforts to adopt outward-looking policies and establish stable macroeconomic environments. Thus, throughout the 1980s and 1990s, FDI in the continent showed an upward trend. As regards the sub-Saharan region, official flows have dominated aggregate international capital flows, with 57% in 1995 and 2000, followed by FDI, with 19% and 38% in the same years. In effect, the sub-Saharan region has received mostly official flows since 1995 (see table 1.4).

**TABLE 1.4 COMPOSITION OF CAPITAL FLOWS TO SUB-SAHARAN AFRICA IN 1995 AND 2000**

ITEMS	1995	2000
Official flows.....	57%	57%
Private capital markets.....	24%	5%
FDI.....	19%	38%
<b>TOTAL (US\$ billions).....</b>	<b>24.8</b>	<b>19.1</b>

Source: World Bank. 2001a. *Global development finance: building coalitions for effective development finance*. Washington, DC: International Bank for Reconstruction and Development: 213.

As regards the whole continent, FDI declined in 2000 to \$9,1 billion, bringing down the continent's share in global FDI inflows to 1%. As is shown in table 1.5, FDI amounted to \$8 billion in 1998, \$10,5 billion in 1999 and \$9,1 billion in 2000. Initially this was in line with the faster growth generally experienced by some countries during the 1990s, as numerous governments sought to create a more business-friendly environment. But in 2000, the decline in inflows to the continent as a whole was due to a drop in FDI in Angola, Egypt, Nigeria and South Africa. In Angola the decline was attributable primarily to cyclical investment behaviour in its petroleum extraction industry, while in South Africa it was a result of reduced M&A and privatisation activities.



According to the World Bank (2001a: 212), net long-term international capital flows to the sub-Saharan region were down in 2000, from an estimated \$21 billion in 1999 to \$19 billion in 2000, while FDI fell from \$8 billion in 1999 to \$6,5 billion in 2000. The reasons for this decline are the same as those relating to the whole continent.

**TABLE 1.5 FDI INFLOWS TO THE TOP RECIPIENT AFRICAN ECONOMIES, 1998 – 2000 (MILLIONS OF DOLLARS)**

<b>ECONOMY</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
<b>AFRICA</b>	<b>8,080</b>	<b>10,500</b>	<b>9,100</b>
1. Angola	1,114	1,814	1,800
2. Egypt	1,077	1,500	1,240
3. Nigeria	1,051	1,400	1,000
4. South Africa	561	1,376	877
5. Morocco	329	847	Nd
6. Mozambique	213	384	Nd
7. Sudan	371	371	Nd
8. Tunisia	670	368	780
9. Côte d'Ivoire	315	279	290
10. Gabon	211	200	Nd
11. Lesotho	nd	nd	22
12. Uganda	nd	nd	19

Sources: United Nations Conference on Trade and Development. 2000. World investment report 2000. Press release: FDI to Africa rises in 1999, but continent must become bigger market player. Geneva. United Nations Publications: 3.

United Nations Conference on Trade and Development. 2001d. World Investment Report 2001. Press release: world FDI flows to drop this year. Geneva: United Nations Publications: 1 – 2.

United Nations Conference on Trade and Development. 2001e. World investment report 2001: promoting linkages. Geneva: United Nations Publications. 2001e:19-20.

According to data from UNCTAD (2001e: 19-20), the four traditionally largest FDI recipients in Africa – South Africa, Angola, Egypt and Nigeria – absorbed about 58% of global FDI to the continent in 1999 and 54% in 2000 (see table 1.5). This was a significant share of total inflows, and investments in natural resources continued to be the main focus of foreign investors' interest. Thus, for the third year in a row (1998, 1999 and 2000), Angola topped the list of FDI recipients in the African region owing to the exploitation of its oil fields. Its FDI inflows were estimated at \$1.114 billion in

1998, \$1.814 billion in 1999 and \$1.8 billion in 2000. These inflows took place following the discovery in 1999 (African Development Bank 2001: 14) of new oil fields yielding an estimated 1.35 billion barrels, in deep offshore waters not affected by the war. This means that Angola has one of the world's major oil reserves, second only to those of Iran and Saudi Arabia. The attraction of increasing FDI flows to oil-exporting countries such as Angola is clearly due to the opening of their extractive oil sectors to foreign investments, which demonstrates the importance of natural resources as a focus for foreign investor interest.

However, according to UNCTAD (2000: 3) South Africa and Egypt are still viewed as the most attractive African locations for FDI in manufacturing, mining and the oil industry.

According to the World Bank (2001a: 213), FDI flows into sub-Saharan Africa of \$7.3 billion in 2000 were distributed as follows:

- Angola 24%
- South Africa 17%
- Nigeria 15%
- others 44%.

Official flows rose slightly by \$0.2 billion, which raised the sub-Saharan share of global official flows. In addition, the share of global private flows compared to the aggregate resource flows declined significantly from 4.8% in 1999 to 3.3% in 2000. However, despite the global tendency towards decreasing international capital flows owing to the global slowdown, FDI inflows into the sub-Saharan Africa region jumped sharply in 2001, doubling to nearly \$13.7 billion from the 2000 figure. Almost all of this increase is accounted for by inflows to South Africa and Angola. The increased inflows to South Africa reflected mainly a financial restructuring, namely the purchase of De Beers by Anglo-American, which shifted ownership from South Africa to the United Kingdom (London) without generating any substantial new investment. If this transaction is ignored, FDI shows a decline to \$6.2 billion in 2001. As regards Angola, it is important to bear in mind that 60% of the total FDI inflows into the sub-region went to oil producers and exporters (World Bank 2002:

188).

According to UNCTAD (2000: 1), direct investments by MNCs into Africa still represent only 1.2% of global FDI, and just 5% of such investment in developing countries. The major recipients of FDI flows in Africa fall into three broad groups, as follows (Bhattacharya, Montiel & Sharma 1997: 13):

- The first group consists of the longer-term recipients and includes Botswana, Mauritius, Seychelles, Swaziland and Zambia.
- The second group consists of countries that recorded large increases in FDI flows during the 1990s: Egypt, South Africa, Morocco, Angola, Nigeria, Tunisia, Côte d'Ivoire, Cameroon, Gabon, Ghana, Guinea, Lesotho, Madagascar, Mozambique, Namibia and Zimbabwe. It is important to stress that most of the FDI flows to these countries have been attracted by the oil and mining sectors.
- The third group consists of countries where FDI flows have been low and declining for most of the 1980s and early 1990s. However, countries like Uganda have begun to turn this around in recent years, partly, it should be noted, because of the reclassification of private transfers, substantial economic reforms, liberalisation of the economy and greater openness.

FDI flows into Africa stabilised modestly at much higher levels in 1998/1999 than those registered in the early 1990s. As noted above, this was in response to the sustained efforts of many countries to create more business-friendly environments. But for most sub-Saharan African countries, FDI has declined because they are only now beginning to improve their creditworthiness. The decline in FDI is also related to the reductions in FDI that have been registered by the major sub-Saharan African recipients such as South Africa, Angola and Nigeria. On the other hand, these countries have not yet restored their access to financial global markets; while other developing countries have shown macroeconomic stability and improving creditworthiness ratings since the 1990s. The United States has been the main source of FDI in Africa, followed by the European Union.

## **1.5 CONCLUDING REMARKS**

By the third quarter of 2000, prospects for the developing countries as a whole seemed very hopeful and encouraging as regards FDI and progress with economic development. This was after substantial growth for most of the 1990s, together with marked recovery and progress in some developing regions, such as Asia, Eastern Europe and Latin America, after the emerging markets crises. This improving economic health takes on greater significance where the need for financial integration and the globalisation of economies and markets are the chief issues.

However, prior to the events of 11 September 2001 in the United States, global economic conditions had been deteriorating for over a year. This deterioration was due mainly to the slowdown in demand in the major industrial countries, accompanied by general downturns in economic activity in developing countries and a less favourable environment for international trade (with falls in commodity prices) and financial flows (with the search for alternative financial markets for prospective profits). The recent financial crisis of 2001/2002 affecting Brazil and Argentina – the first and third largest economies in Latin America – particularly the uncertainty over its debt payment/restructuring or possible default, may also affect other emerging markets and lower the level of foreign investment into those countries.

The prospect for FDI growth has therefore also deteriorated worldwide. Trade growth has slowed considerably and widespread uncertainty and negative sentiment have been depressing investment flows. Any prolongation of the world economic crisis may well result in depression and a fall in capital flows (including FDI flows) into the developing countries.

## **CHAPTER 2**

# **DETERMINANTS OF FOREIGN DIRECT INVESTMENT TO DEVELOPING COUNTRIES**

## **2.1 INTRODUCTION**

This chapter discusses the main determinants of FDI and the theoretical issues surrounding them. The determinants of FDI in developed and developing countries are discussed separately, and theories about the determinants in host countries (endogenous factors of FDI) and the determinants in source countries (exogenous factors of FDI) are analysed in depth. The chapter also looks at the development of the main structural forces that drive FDI to developing countries. FDI flows are the single largest source of more stable and reliable longer-term development finance for these countries.

International capital flows cross international borders because investors seek and expect higher rates of return on their real or financial investments and opportunities for diversification of risk. This expectation also comes under discussion.

Attention is then given to the main reasons for the trends in international private capital flows to emerging markets discussed in chapter 1. These trends have been evident in the growing importance of foreign investments in developing countries and the transfer of knowledge capital through FDI.

Next, the adequacy and role of the financial system and financial markets (as macroeconomic determinants) in attracting FDI are briefly analysed. Broadly, the main economic function of a financial system is to channel funds from surplus or saving units to deficit or investment units. These transactions take place in the light of fundamental determinants of international capital flows or FDI.

Finally, the chapter discusses the importance and effects of exchange rates, interest rates, taxation and incentives as determinants of FDI in recipient countries.



## 2.2 THE DETERMINANTS OF FDI TO DEVELOPING COUNTRIES

In studying the determinants of FDI it must be kept in mind that the nature of FDI in developed countries differs from that in developing countries. In the industrial countries, FDI flows increasingly to the manufacturing and service sectors, especially the high technology and information-intensive industries (knowledge-based resources), while in the developing countries FDI flows mostly to greenfield investments in a handful of countries and reflects a search for new markets and the desire to secure supplies of natural resources. According to Oh (1982: 12), the determinants of FDI may be established under one of three approaches:

1. **Evaluative approach.** This approach identifies determinants of FDI from data supplied by individual businesses through interviews or questionnaires. Evaluation of such data reveals the main domestic and external factors that influence the decision to invest in a particular country or industry. The dominant factors here seem to be reduced costs, size of profits, concern about the possibility of losing markets to rivals by not being close to the source of demand, and barriers to trade in host countries. Other factors relevant to FDI are a good investment climate in general, tax factors and incentives, and the development and maintenance of new markets abroad.
2. **Explanatory approach.** This approach attempts to explain why FDI is preferred to other forms of resource allocation. Reference is made to the oligopolistic or monopolistic behaviour of MNCs and to the product cycle hypotheses. The approach links location theory, industrial organisation and international trade to explain FDI, and divides the development of a product into three stages:
  - The first is the *new product stage*, where a firm gains monopolistic export advantages from product innovations in the source or home country. Production may, however, be limited to the home market because it is not standardised and changes in design, marketing and processing may occur.
  - The second stage is the *growth product stage*, which begins with product standardisation by FDI. This standardisation is at a low cost to maintain a market share or to prevent the loss of an export to local producers.

- Finally, there is the *mature product stage*, where the producer competes on a cost basis and in seeking lower costs invests in additional foreign locations.

Clearly, the nature of FDI will be influenced by the product development stage, which must therefore be taken into account when establishing the determinants of FDI.

3. **Macro-oriented approach.** The third approach takes such published data as are available on FDI by one country, either in various countries abroad or in particular industries, and seeks to establish some kind of relationship between these data and the possible macroeconomic determinants, many of which are common to domestic investment. However, the importance of each will differ according to specific economic circumstances.

Sound macroeconomic variables imply coherent monetary and fiscal policies, favourable business operating conditions, an export-oriented economy, socio-political and military stability, transparent governance and the elimination of corruption. Other important factors relate to the impact of interest rates, the tax system and incentives on inward international capital flows in general and FDI in particular.

To make this explanation clearer, a single equation model to express the relationship between FDI – related to long-term transactions as opposed to short-term transactions – and other variables that constitute their real determinants is analysed (Jun & Singh, 1996: 73):

The **projected FDI** at time  $t$  ( $\text{PFDI}_t$ ) = **Basic situation** ( $\text{B}_0$ ) + **Political factor** of stability/instability ( $\text{P}_M$ )  $\times$  **Base** at time  $t$  ( $\text{B}_t$ ) + a set of **control variables** at time  $t$  ( $\text{CV}_t$ )  $\times$  **Base** at time  $t$  ( $\text{B}_t$ ) + random error ( $\text{E}_t$ ).

From the above postulate it emerges that:  $\text{PFDI}_t = \text{B}_0 + \text{B}_1 \text{P}_M + \text{B}_2 (\text{CV}_t) + \text{E}_t$ , so that the projected FDI is defined as a function of its determinants. The formula assumes that direct investors act rationally on full information available in international markets to minimise the cost or risk of financing their investment (assets or financial securities) while maximising their returns.

For optimal results, any analysis of the determinants of FDI should take into account the particularities of the country or region under consideration. In particular, it should be understood that (as previously noted) the determinants of international capital flows or FDI are different for developed or high FDI countries and developing or low FDI countries. For instance, socio-political instability in developing (or low-flow) countries, which is manifested in work hours lost, is a significant deterrent for international capital flows, particularly FDI, especially in a labour intensive economy. On the other hand, developed or high-flow countries are generally perceived as being macroeconomically and socio-politically stable, which has a powerful influence on attracting international capital flows. These are mainly FDI flows, based on cross-border M&As, which have been the major drivers of FDI to those countries. Such countries are therefore likely to be capital intensive, requiring more substantive and long-term commitment and accountability.

This study uses the second approach to establish the determinants of FDI. It is concerned with the advantages gained from FDI by investors, with the stable structural characteristics of the industries in which foreign investors operate and in imperfections in the industrial and technological markets. It encompasses the main characteristics on which the whole process of FDI is based: moving from intention, through preliminary studies by MNCs or foreign investors, to accomplishment in a *de facto* direct investment. This theory of industrial organisation and FDI also includes theories based upon factor endowments in imperfect national and international markets, which constitute important determinant factors for FDI.

Before foreign direct investors make their decision, however, they must choose between exporting products from their home countries or producing abroad in host countries. In this regard, Oh (1982: 21-23) refers to the generalised model of the product cycle developed by Hirsh in 1976, and his examination of the determinants of a firm's choice between exports and foreign production. Oh defines five variables in Hirsh's model as follows:

- $P_a$  is the cost of production per unit in the home country.

- **P<sub>b</sub>** is the cost of production per unit in the host country.
- **K** is firm-specific knowledge and intangible income-producing assets. (This also represents the superiority or advantage of firms in the home country over local firms in the foreign country.)
- **M** is the export marketing cost differential, which is the difference between export and domestic marketing costs. This is an export inhibitive factor because if the difference between export and domestic marketing costs is positive or high, this tends to restrict the promotion of exports.
- **C** represents the costs of control of a foreign subsidiary accompanied by direct investment, which are investment inhibitive factors.

Each of the above variables is measured in present value terms. Although there are other important determinants as well, the decision to export or to use the FDI route to capture the host country market is taken on the basis of the following conditions:

(a) A firm or an MNC will prefer to export to a foreign market if:

1.  $P_a + M < P_b + K$ , and
2.  $P_a + M < P_b + C$ .

(b) A firm or an MNC will prefer to invest in a foreign market if:

1.  $P_b + C < P_a + K$ , and
2.  $P_b + C < P_a + M$ .

According to Oh (1982: 23), these criteria for investment decision-making are investigated in the preliminary stages of the pre-investment phase. The criteria usually change once FDI has taken place in the host country. Oh asserts that in the long term, foreign investors become familiar with foreign operations or direct investments and the respective markets in host countries. As a result, both export marketing cost differentials (**M**) and costs of control of the foreign subsidiary (**C**) tend to disappear. If so, then the strategy of supply to the foreign country is only determined by the production cost differentials (**P**).

This suggests that the main determinants of FDI may be identified by considering both sides of the transaction, viz. foreign investor and host country. The process of shifting from export to foreign production, which aims at profit maximisation, should also be considered. With these considerations in mind, the main determinants of FDI to developing countries can be divided into two groups, namely endogenous and exogenous determining factors. These are briefly defined below.

1. Endogenous factors are factors internal to the host country which strongly influence an investor's decision to switch to investing abroad. They are related to domestic factors within the host country such as general macroeconomic stability, a business-friendly operating environment, good governance and general socio-political stability.
2. Exogenous factors are external to the host country, and influence an investor's decision to invest abroad. Examples of exogenous factors related to the host country are: international financial system stability, low costs of production in host countries compared to costs in home countries, high returns and increasing profits, risk diversification and strong competition in the home country of a foreign investor.

These two categories are discussed in greater detail in the following subsections.

### **2.2.1 ENDOGENOUS DETERMINANTS OF FDI**

- **Socio-political stability** is an important determining factor in attracting and assessing inward FDI. The absence of such stability inhibits investment since it makes foreign investment riskier and more costly. For instance, periodic or permanent strikes and industrial civil strife result in the loss of many work hours or days, and increase the cost of doing business.
- **Military stability** is an important component of the general socio-political situation, in which the latter may be conditioned or determined by the first, and military instability should be regarded as an investment deterrent factor.
- **High bribes** (or corruption) and **lack of transparency** also inhibit investment and increase the cost of doing business.
- **Good macroeconomic fundamentals and coherent monetary and fiscal policies.**

These imply a good government with a coherent economic programme. Moreover, a stable and developed financial system with a strong banking sector plays a major role in attracting FDI.

- **Favourable business operating conditions** result from and complement macroeconomic stability, since such conditions can generally only come into being if there is economic and political stability. Appropriate measures, which may exert a considerable positive influence on FDI, are removing restrictions on trade and on some kinds of capital inflow, providing good business operating conditions and stimulating import-substituting FDI. Another important measure is the development, under flexible legislation and rules, of a separate gathering in which trading in commodities (commodity market), securities (stock exchange), currencies (money market), etc. takes place. These markets can be developed by organising market participants according to a mixed market economy philosophy, giving them more marketing room and gradually liberalising the economic and financial framework for best market (and overall economic) performance. The development of a domestic market also reflects the level of economic development of a country.

One of the most important structural drivers of international private capital flows or FDI to developing countries is the expected rate of return on investments. The opportunity for risk diversification from portfolio investment is also an important driver (a short-term investment as opposed to long-term FDI). This aspect is essential for foreign investors since FDI is partly determined by a country's creditworthiness, i.e. its ability to access the foreign and domestic interbank system. This also makes resources available for external transactions or payments.

According to the World Bank (1997: 85-86), if the level of capital stock is relatively low, then, other things being equal, the marginal product of capital will be high. This means that if there are no constraints on the availability of productive factors (skilled labour, infrastructure, and other factors that are complements to capital in the production process), the rate of return on investments will be relatively high in deficit countries (or in countries with low levels of capital stock). To gradually improve business operating conditions the following steps should be carried out:

- the process of privatisation should be speeded up
- the direction of inward economic orientation and burdensome regulations should be reversed
- basic infrastructure should be developed
- production costs should be reduced.

The surge in FDI emerges from the clear expectation of continuing improvement in business conditions around the world thanks to greater macroeconomic stability, further liberalisation of the economies of developed and developing countries, convertibility of capital account and technological progress. The close relationship between the quality of the business environment and FDI has therefore become even stronger. At the same time, however, MNCs are becoming more demanding and selective in their preliminary studies and choice of investment locations.

- The importance of an **export oriented economy** is a natural consequence of the determinants discussed above. After all, a foreign direct investor wants to make profits in a strong foreign exchange currency by receiving a high rate of return on the investment. If the investor is able to link this desire with the need to export products to the parent firm or look for new foreign markets this will substantially increase the revenues and improve its stance internationally. This can also be achieved by diversifying investment and creating more affiliates in more host countries. A country that can attract FDI in this way would have to be an outward or export-oriented economy with a considerable domestic market. This would allow a foreign investor to control the domestic market and expand its products abroad towards new horizons.
- Favourable and adequate **tax and incentive systems**, with a comprehensive, in-depth regulatory framework for investment, are also important in attracting FDI. Such measures can encourage liberalisation of the rules governing FDI and give foreign investors a high standard of protection and effective dispute settlement procedures.

Foreign investors consider the above positive and negative aspects in deciding whether or how to invest their capital in host countries, these aspects being directly relevant to FDI

assessment. This allows them to calculate, in advance, the potential costs of the investment and of any fortuitous disruption in projected production.

### **2.2.2 EXOGENOUS DETERMINANTS OF FDI**

The exogenous factors that most frequently persuade foreign direct investors to invest abroad are described below.

- **Strong domestic/internal competition** in their home countries may force foreign investors to seek better business opportunities (to make profits) abroad.
- Foreign investors invest abroad to keep and develop foreign markets for their home firms' products by **oligopolistic or monopolistic** methods.
- The **low cost of producing** in host countries may persuade foreign investors to produce abroad.
- Foreign investors seek increasing profits. Partial **market control** abroad or domestically helps to ensure greater profit. Moreover, it leads to other benefits such as improvements in the mode of production (horizontally and/or vertically integrated firms) and diversification of products.
- Foreign investors usually have **factor endowment advantages** over industries in host countries through intangible assets. Furthermore, foreign investors may invest to exercise their oligopoly or monopoly power in a given country because of market imperfections in that country. An example of such an imperfection is the underdevelopment of the market for information technology in many developing countries, together with the lack of equilibrium between supply and demand in this market, the poor domestic leadership and insufficient general rules.



## **2.3 EFFECTS OF INTERNATIONAL CAPITAL FLOWS ON DOMESTIC FINANCIAL SYSTEMS**

Before analysing the effect of the determinants of international capital flows to developing countries on their domestic financial systems, the concept of a financial system and financial intermediation is briefly discussed.

The financial system comprises the lending and borrowing of funds by non-financial concerns and the intermediation of these activities by financial institutions. Such institutions facilitate the transfer of funds, provide additional money when required and create markets in debt instruments so that funds are efficiently priced and allocated.

The focus here is on financial intermediaries, that is, *deposit intermediaries* such as central banks, commercial or private banks and postbanks; and *non-deposit intermediaries* such as insurers, pension and provident funds, unit trusts and financial companies or corporations. Government policies, together with the activities of these intermediaries, are important factors in attracting or deterring international capital flows. In turn, the effects of international capital flows on the domestic financial system are greatly influenced by the banking sector and its links to the macroeconomic policies of the country concerned.

To cope with rapidly increasing international capital flows requires a relatively developed financial system. Because financial systems channel funds from surplus to deficit countries, the role of financial markets should also be taken into account.

Financial markets, as one element of the financial system, usually facilitate the lending of funds from saving to borrowing units that wish to undertake investments domestically and internationally. This is, in fact, their main economic and financial function. Thus borrowers sell financial assets (of money markets, such as treasury bills, bank certificates of deposit, and funds loans; and of capital markets, such as business equities, other securities, mortgages, state and corporate bonds, consumer and business loans, etc.) to savers in exchange for the funds they need. Such financial assets constitute the claims of the lenders on the future incomes of the borrowers who use those funds for investments (in international or domestic markets).

Stock exchanges are an important part of the capital market in that they provide a market for shares and loan stocks that represent the capital that has been raised. It is important to emphasise that cross-border M&A activities (or simply capital market transactions such as joint ventures) have become an increasingly important vehicle for FDI in the world economy for both industrial and developing countries. These activities normally include private-to-private transactions as well as acquisitions through privatisation of government assets, which have increased significantly in developing countries through FDI transactions. For instance, according to the World Bank (1999a: 48), these transactions on privatisation of government assets accounted for about 50% of cross-border M&A sales in the developing countries between 1991 and 1997.

M&A activities have an investment horizon of more than one year – a typical characteristic of FDI – and are usually associated with funding large capital investment projects. These transactions have large and immediate effects on capital markets, or to be more precise, on stock exchanges and the financial systems in the countries concerned. Stock exchanges are, of course, also markets for shares of ownership in businesses and in bonds issued by governments and firms. In these markets global indices can go up or down depending on the type and size of the transaction and the sentiment or expectations of investors.

Lopez-Mejia (1999: 3) stresses that international capital flows have two major effects on the domestic financial or banking system.

1. Under a pegged or fixed exchange rate regime, the budget deficit (the shortfall between public revenues and expenditures) – which includes financial transactions undertaken by central banks, and other public and financial institutions that play the same role as taxes and subsidies – increases if a sterilisation policy is followed. This happens when sterilisation is carried out by means of open market operations and the financial system is not fully developed and liberalised. In an illiquid domestic market, central banks find that open market operations can be costly and ineffective. In this environment a surge in capital inflows resulting from high interest rates would lead the monetary authorities to revalue the local currency in an attempt to remove a surplus in the balance of payments and/or the excessive accumulation of official

foreign reserves resulting from capital inflows. Since revaluation makes imports more price competitive, this would undermine the competitiveness of export industries and reduce the gross domestic product. The inflation rate would then rise as a result of a build-up of the official foreign reserves by capital inflows.

As mentioned, sterilisation gives rise to high consumer prices and leads to possibly inflationary increases in the domestic monetary base or domestic money supply without effecting a corresponding increase in production. This has a dramatic, negative effect on the budget balance since high prices increase the level of government expenditure against the unchanged level of income. The steps taken by monetary authorities would include open market sales of government bonds and other securities to mop up the increases in domestic liquidity. High-yielding domestic bonds and treasury bills are sold and foreign exchange holdings are bought by central banks earning lower interest rates. The adoption of a policy of sterilisation is an attempt to defend the domestic currency against ups and downs in the domestic economy with a view to stabilising the currency. The need for sterilisation measures is generally greater under a fixed or pegged exchange rate system, or where the monetary authorities intervene heavily to manage the exchange rate (e.g. under a managed exchange rate system).

2. The second major effect of international capital flows on the financial system is the increased financial vulnerability of domestic markets. The financial system itself might become more vulnerable because of a rise in lending, which exacerbates the maturity mismatch between bank assets and liabilities, and consequently reduces loan quality. Increases in bank credit may follow high levels of capital inflows, thereby triggering an increase in aggregate demand. The financial system may then become more volatile if there is a surge in short-term flows (hot money) into liquid assets, such as bank deposits and treasury bills, which are easily reversed. This is obviously unsustainable in any open economy and may well translate into a financial crisis.

Continuing with this point, it is clear that massive amounts of international capital flows into a developing economy, at attractive real interest rates, may precipitate a banking crisis if such funds are withdrawn suddenly or the prices of assets used as security or

collateral by the banks begin to decline for any reason. This may then trigger a generalised financial crisis if good fundamentals are not in place, such as a strong banking system, macroeconomic fundamentals (such as a low inflation rate, sound economic growth, balance of payments equilibrium and coherent monetary and fiscal policies) and efficient allocation of foreign funds, and sufficient domestic absorptive capacity of funds. Large amounts of capital flows may thus overheat an economy, with very large increases in monetary and credit growth which strain the banks' capacity to adequately assess the risks associated with this increase. Another consequence may be exchange rate volatility as a result of overheating. This eventually leads to capital outflows because of the negative changes in the expected rates of return on assets, or of unpredicted casual contagion effects from other economies.

An increase in interest rates resulting from a withdrawal of foreign capital may lead to an increase in savings and lower domestic investment; while a reduction in exports may prompt a reduction in investments and consequently a reduction in income and production or GDP. This may lead to a decrease in government expenditure. A reduction in investment necessitates a reduction in aggregate production and trade, in other words a reduction in GDP, which slows down the economy and may put the whole country into recession. This gives an indication of the relationships between international capital flows and growth. In concrete terms, it shows how a reversal of international capital flows may negatively influence the course of economic growth of a country, and vice versa.

Gruben and McLeod (1998: 298) suggest that if a government decides to use capital controls to reduce volatility by reducing short-term capital inflows, the price it may have to pay could be lower growth. As a complementary measure, capital controls may be offset by increases in savings resulting from high interest rates. These authors maintain that if a country wants to impose capital controls or introduce incentives on international capital flows, these steps should be related to their effects on FDI. Why? The answer is that FDI has had the most pronounced positive impact on the development and growth of various countries. The correlation between FDI and growth thus has clear policy implications for privatisation initiatives and foreign ownership restrictions. On the other hand, there is a positive correlation between growth and capital flows. This is despite the fact that volatile capital flows have implications for macroeconomic and exchange rate

policies that may be problematic for the domestic financial systems and financial markets.

According to the World Bank (1999a: 51-53), apart from being an important source of finance, FDI has had the following implications for the economies of developing countries:

1. By involving MNCs, FDI encourages the transfer of technology. This has translated into higher productivity and GDP growth in the host country.
2. FDI has contributed to growth in developing countries through improving the skills of the labour force. MNCs have improved these skills through on-the-job training and seminars and formal education, an important element in increasing productivity.
3. FDI contributes to the growth of developing countries by promoting the development of domestic markets. Because of their size and the value of their intangible assets, MNCs can invest in industries with large capital requirements coupled with certain trade limitations. Potential local competitors have not, in most cases, had the same technical and productive capacity to access potential markets because of their technological and financial limitations. On the other hand, FDI can improve the competitive position of domestic firms through forward and backward linkages with affiliates to MNCs. There is thus a constant relationship of transfer of technology between MNCs and their affiliates in host countries to improve efficiency, quality, productivity and competitiveness. The engagement of foreign firms in the domestic market may demonstrate the potential and profitability of new products, thereby encouraging local competitors to replicate them. Finally, the entire economy may benefit from price reductions in inputs to domestic production and the development of local distributors and buyers of the MNCs' products.
4. FDI may also help to promote growth in developing countries by increasing local exports, and consequently easing the balance of payments constraint (or improving the country's liquidity). This is possible because MNCs often account for a significant share of host country exports and possess intangible assets such as marketing skills, superior technology, branding and an established distribution network. Any excess of exports over imports creates a balance of payments' current

account surplus; this allows for greater increases in new investments, production and growth before rising imports and a balance of payments constraint reappears.

However, the most significant channel through which FDI contributes to productivity growth in developing countries is increased access to modern technology, brought about through market transactions such as joint ventures, licensing and goods trade. The spillover effects have been translated into major productivity growth in developing countries as a whole. However, the extent to which a country benefits from FDI will depend on its macroeconomic policy environment and economic openness. Economic openness, such as an open trade regime, leads to a more positive FDI to GDP ratio (FDI/GDP), and to a greater share of high technology products in exports. The higher the correlation between FDI and GDP the greater the importance of FDI related to GDP.

## **2.4 THE EFFECT OF CHANGES IN EXCHANGE RATES, INTEREST RATES AND TAXATION ON FDI**

### **2.4.1 EXCHANGE RATES AND FDI**

Foreign exchange, as a currency of an overseas country, is purchased by a given country in exchange for its own currency. The demand for foreign exchange is derived from underlying transactions in international trade and investment. Governments may regulate the foreign exchange market or may leave it unregulated, with the exchange rate (the price of a currency expressed in terms of another currency) reflecting the macroeconomic policy in place. The basic question is whether the rate should be left to the free interplay of the forces of demand and supply or whether it should be managed by the central bank.

The strength of a currency is determined by the size and performance of a given economy which therefore determines its level of appreciation/revaluation or depreciation/devaluation. A strong currency is therefore linked to sound, stable macroeconomic policies and a growing economy, which also determine the extent to which a country is able to attract international capital flows, particularly FDI. However, a strong currency is not necessarily attractive from an FDI perspective, particularly if the investment is geared to the export market.

Any change in a country's exchange rate affects the way international creditors and investors view the possibility of investing in that country. Oh (1982: 37) cites Joan Robinson's observation that the effects of a change in exchange rate would begin with the balance of trade (with appreciation/revaluation or depreciation/devaluation, which would affect aggregate demand). Then, as a result, the change would continue through alterations in national incomes and induced discrepancies between saving and investment, both at home and abroad.

Since this chapter broaches some important issues related to the international financial system and the mobility of capital in international markets, it is also important to examine some economic policies that may influence the foreign exchange rate and how its over or undervaluation may result in macroeconomic distortions, such as unemployment, which could affect FDI indirectly.

#### **2.4.2 INTEREST RATES**

When a government wants to reduce the inflation rate it may decide to reduce the growth in money supply. This contraction may cause interest rates to rise and aggregate demand to decrease, leading to an appreciation of the domestic currency. As a result, production and employment may also decrease. This may be more clearly explained by means of the example below, which examines the relationship between two countries under a flexible interest rate system.

If the central bank of country **A** decides to restrict monetary supply through increasing interest rates above the level of interest rates of a foreign country (country **B**), this implies that the high interest rates of the domestic currency of country **A** will make some portfolio investments in that country more attractive than in country **B**. Therefore, this situation constrains investments from country **A** to country **B**. Conversely, investors in country **B** will find it more attractive to invest in country **A**'s money market. However, a change in the interest rate may affect diverse types of portfolio investments (equities, bonds and treasury bills) equally since the prices of these financial instruments vary inversely vis-à-vis the interest rate, as explained by Mohr (1998: 184-188).

1. Equities or ordinary shares are shares in an issued capital of a company. The share price, which measures the market price of a unit of a company's equity capital, is

traded in the stock markets on a daily reports basis. Their holders become members of a company. Interest rates affect equities since share prices reflect the discounted value of future dividend payments, which depends on future company profits. High real interest rates may reduce economic growth and thus company profits, leading to lower demand for such equities and lower share prices. In this sense, high real interest rates may be a disincentive to FDI. As companies are always the main borrowers in the financial systems aiming at new and increasing investments, obviously the level of borrowings depends on the level of interest rates. If interest rates are high companies are less prone to borrowing and vice versa. Future financial results may therefore be affected indirectly by the current level of interest rates, which may in turn also influence the investments made today. It is not good for an economy if companies borrow less money or repay their debts faster due to higher interest rates. Companies go ahead with investment projects if the market rate of interest is below the projects' break-even rate. As interest rates fall, more projects meet this criterion, and companies' borrowings and investments increase. Increases in investments mean an increase in GDP and in economic growth, which *is* good for an economy.

On the other hand, when investors expect recession, they are less keen to buy equities and this makes share prices fall; but under economic recovery they switch into equities, pushing up the share prices.

2. In general, bonds – gilts and semi-gilts – are long-term fixed-interest-bearing financial instruments. Their prices are inversely related to interest rates: when bond market interest rates fall, the price of the bond increases because the holder is entitled to a fixed coupon rate, which remains unchanged.
3. Treasury bills (TBs) are short-term government securities, usually 91-day bills. They are short-term financial instruments, which are related to the money market; money market interest rates are, thus, short-term interest rates. The TB rate is the discount at which TBs are issued. Also, interest rates affect TBs inversely, so that the higher the price of a TB, the lower the interest rate is, and vice versa. Higher interest rates may lead to an increase in investment in the money market (or short-term money market), although this also depends on factors such as expected inflation rates. Normally the



interest rate risk is greater when the period of maturity of an investment is longer; and if the interest rate is bigger the stock value is smaller. Generally investors are risk averse and may thus prefer short-term to long-term investments. As a consequence short-term rates tend to be lower than long-term rates owing to the higher demand for short-term investments.

As high interest rates trigger capital inflows in the form of portfolio investments, foreign capital will flow into country A. This is because the demand for its domestic currency rises and its foreign exchange rate (relative to the currency of country B) appreciates under a floating exchange rate system, after which the price of foreign exchange falls. This makes imports cheaper and exports more expensive in country A's currency, thereby encouraging additional imports and curbing exports; and so this assists in removing the balance of payments surplus and the excessive accumulation of international reserves, if exports do not react inversely. Thus, appreciation of the domestic currency increases the export prices of country A while the export prices of country B drop. This triggers a rise in value and quantity in the import market of country A, and a decrease in its exports, which become dearer and are more subject to competition from country B and other countries (Samuelson & Nordhaus, 1988: 1085).

The situation outlined above exhibits what may be termed the *Hume effect*:<sup>2</sup> export flows decrease while import flows of cheap overseas products increase. As a result, domestic production and growth may falter, which may deter FDI. This may, as already explained, create recession and unemployment in the economy and slow down GNP growth. The reduction in exports therefore has an equal effect on the reduction in investments and government expenditure, which implies a reduction in GNP and employment. This is because variations in exports and (foreign direct) investments have the same expansionist or contractionist effects on domestic production and employment – as exports increase production and (domestic) income – and consequently, on aggregate demand. In general,

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<sup>2</sup> This refers to the Hume mechanism for the equilibrium of gold, developed by David Hume in 1752: “when a country, which imports a lot, loses gold. In turn this situation triggers a reduction in money supply. This decrease in money supply implies a reduction in expensive imports, and therefore production becomes cheaper and more competitive, and exports increase. Thus, exports increase while imports decrease or vice versa, resulting in an improvement of the balance of payments, and equilibrium for those who lose and win gold” (Samuelson/Nordhaus, 1988: 1079-1080).

an increase in income worsens the current account balance because domestic demand or absorption increases. (As will be seen below, if  $A = C + I + G$  and  $D = X - M$ , then  $Y = A + D$ , where A stands for absorption, C stands for consumption expenditure by households, I stands for investment, G stands for government expenditure and Y stands for real national income.) However, an increase in interest rates beyond the international level will, *ceteris paribus*, trigger capital inflows and the capital account will improve. Consequently, a balance of payments current account equilibrium may also be reached by financing from capital inflows.

It is important to stress that no official or private investment abroad can be carried out without cost considerations, one of them being the exchange rate. When taking an FDI decision, the prospects or existence of an appreciation/revaluation and/or depreciation/devaluation should be taken into account since changes in the exchange rate affect the real rate of return. Whether the effects are favourable or otherwise depends on whether the currency is over or undervalued.

For instance, a devaluation of a host country's currency would make its imports more expensive and would limit the prospects for foreign investment because devaluation would raise the local currency cost of inputs for most firms whose manufacturing expenses include a high proportion of imported input. However, a devaluation may also make the host country's exports more competitive in world markets – so if the FDI is geared to exports, devaluation would help such investments. The overall effects would thus depend on the degree to which imported inputs are used in the production of the export goods concerned. Companies that use domestic inputs would also be hit, albeit indirectly, by the change in the exchange rate. The expanding exports and imports of competing firms would require more and more local resources such as labour, materials and capital; and because devaluation affects the entire economy, would make life harder. Gilman (1981: 5) points out that international capital flows are increasingly regarded, in the literature, as a stock adjustment phenomenon resulting from changes in interest rate differentials and exchange rate expectations. This economic literature takes into account that capital market integration is unlikely to be perfectly accomplished anywhere. FDI, as a stock adjustment and a financial phenomenon of the market imperfections approach, has been successfully applied to explain direct investment, under increasing international

movements of capital. Seen from this perspective, FDI is the most substantial kind of international capital flows phenomena. Thus, capital movements always involve the use of, or substitution for, foreign exchange so that debt and equity capital, internal and external resources, and holding company and affiliate funds, can all be denominated in both home and foreign currencies.

The effect of changes in interest rates and exchange rates on the economy may also be analysed using the following national income or aggregate demand identities and equations:

Considering  $Y = C + I + G + (X - M)$ , where:

**Y**, is real national income, which is equal to aggregate demand or aggregate expenditure;

**C**, is consumption expenditure by households on final goods and services;

**I**, is investment expenditure by firms;

**G**, is government expenditure; and

**(X-M)**, is net exports, viz. exports less imports.

The term in brackets **(X - M)** refers to the difference between exports and imports, or net exports. If one subtracts **C**, **I** and **D**<sup>3</sup> from both sides of the above general equation, the result is:

$$Y - (C + I + D) = C + I + D + G - (C + I + D)$$

And taking  $Y - C = S$ , that is, income less expenditure equals savings; then

one has made use of the fact that:  $S - I - D \equiv G$ , that is, saving (**S**) less investment (**I**) less net exports (**D**) is identical to government expenditure (**G**).

In a closed economy, savings (**S**) is always equal to **I**, that is,  $S = Y - C - G$ , where savings (**S**) is defined as the portion of the national income (**Y**), which is not spent.

Then, the identity **GNP**,  $Y = C + I + G$  may be reformulated to the following:

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<sup>3</sup> As explained above,  $D = X - M$ .

$$I = Y - C - G, \text{ and finally: } S = I$$

The most significant impact on a household's saving decision is its income or salary. The higher its income, other things being unchanged, the more the household will save. Thus, aggregate household or total private sector savings nationally depends on the level of economic activity of the country. Thus there is interdependence between total private sector savings and the level of economic activity since the development of economic activity also depends on how households and firms save. In other words, economic activity also depends on the level of households' and firms' savings to bring about an increase in the level of overall domestic investments.

A thorough analysis to ascertain which factor influences aggregate demand is essential in order to be clear about what precisely determines the level of aggregate demand. Changes in interest rates and the exchange rate, as we know, affect aggregate income and demand, and foreign trade (exports and imports) differently as follows.

First, in terms of the above equation of national income or aggregate demand, interest rates may affect aggregate demand in the domain of changes in consumption and in investment, as is explained below (Mohr & Rogers 1991: 127-132):

The main interest rates in an economy are determined in the asset or money market and are related to supply of and demand for money, the intersection between their curves indicating the equilibrium interest rate. Therefore, it is important to assess what causes interest rates to increase or decline, with immediate effects on aggregate demand. For instance, an increase in income can affect asset markets by heightening money demand and thus interest rates, which in turn reduces aggregate spending or demand. Changes in interest rates normally affect aggregate demand by affecting one or more of its components (viz. consumption by households, private investment spending by businesses, consumption and investment spending by government, or foreign demand). This happens because the composition of the investment and consumption spending components of aggregate demand depends on the interest rate. Since the interest rate is the major determinant of the desired or planned rate of investment, investment spending depends on interest rates. If from the above equation it is taken into account that:

$$I = \tilde{I} - bi \quad (1)$$

where  $\bar{I}$  is the autonomous investment at  $i = 0$ , and  $b > 0$ , and if it is considered that

$$C = \check{C} + c(Y - tY) = \check{C} + c(1 - t)Y \quad (2),$$

where  $\check{C}$  is the autonomous private consumption,  $c$  is the marginal propensity to consume and  $t$  is the tax rate, then, taking the identity

$Y = C + I + G$ , (it can be understood that  $I = Y - C + G$ , or aggregate investment equals aggregate income minus aggregate consumption and government expenditure), the result is:

$$Y = \check{C} + c(1 - t)Y + \bar{I} - bi + \check{G} \quad (3),$$

where  $\check{G}$  is the government autonomous spending. Finally, simplifying equation (3) the result is

$$Y = \hat{Y} + c(1 - t)Y - bi \quad (4),$$

where  $\hat{Y} = \check{C} + \bar{I} + \check{G}$  is the level of autonomous spending or income.

**NB:** It is noted that for the purpose of this dissertation, the topic of the relationship between investment and interest rates is subsidiary to FDI flows and their main determinants.

From the equation (4) it can be concluded that an increase in interest rates reduces aggregate demand at a given level of income because an interest rate increase reduces investment spending. Moreover, it is important to observe that in the IS-LM model of aggregate demand, interest rates and income are jointly determined by equilibrium in goods and assets markets. It is not, however, advisable to use fiscal expansionary policy as a tool for demand management since this policy tends to raise consumption through the multiplier and to increase interest rates. The induced increase in interest rates reduces investment. Finally, the increase in government spending tends to crowd out or displace private investment.

On the other hand, changes in exchange rates have a significant effect on the trade balance through exports and imports, and finally on the equation of national income or aggregate demand. Looking at the above general equation of an open economy,

$$Y = C + I + G + (X - M),$$

it is obvious that any change in net exports' components  $(X - M)$  resulting from changes

in the exchange rate also affects aggregate demand. Spending on exports produced domestically should be added to the other GDP components of spending (national income or aggregate demand), but should exclude imports produced abroad. The relationship between GDP and GDE (gross domestic expenditure) is another key factor, because while GDP includes exports and excludes imports, GDE includes imports and excludes exports. The difference between them is net exports ( $X - M$ ). Foreign trade has direct implications for national income, aggregate demand and the balance of payments of a country, and accordingly the exchange rate is a component that cannot be ignored.

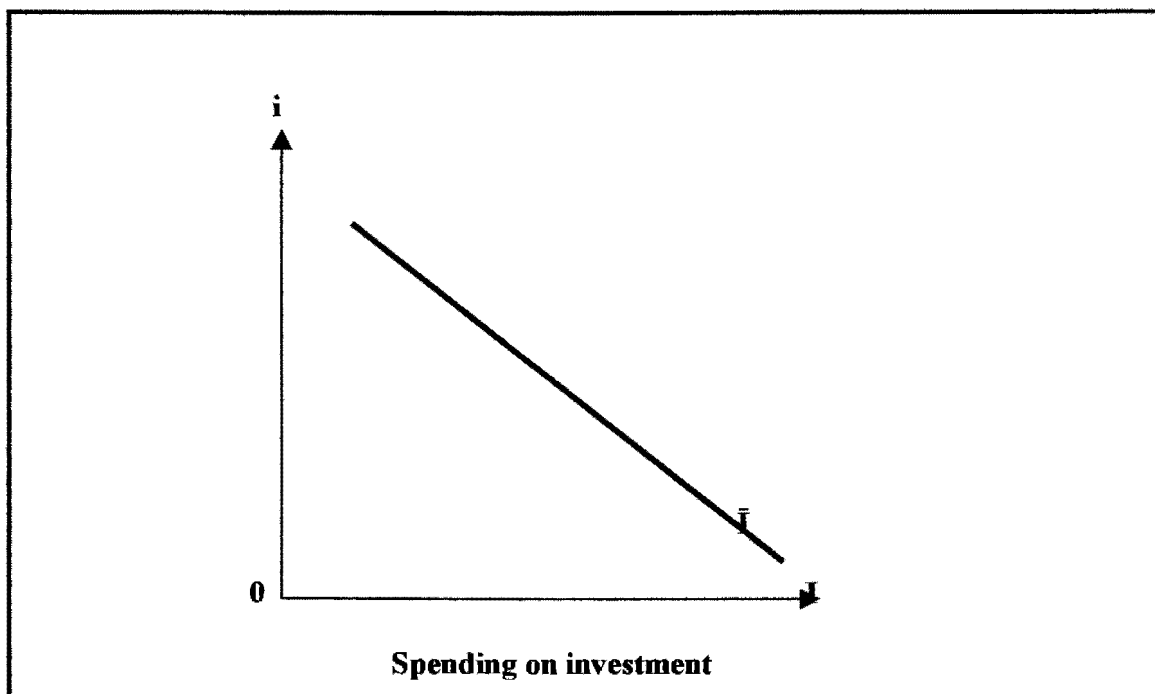
The exchange rate – which is the price of a domestic currency in terms of another currency and which may appreciate or depreciate – determines the domestic price of imported goods, services and assets and the foreign price of domestic liabilities. As these are components of consumption of households, investment and spending by the private and public sector, the exchange rate affects aggregate demand and the quantity of foreign currency demanded on the foreign exchange market.

The impact of the exchange rate on the aggregate demand can be summarised as follows (Mohr, Fourie & Associates 2000: 473):

1. If a change in the exchange rate results in depreciation/devaluation of the domestic currency against a strong foreign currency such as the US dollar, this decreases export prices in dollars and makes exports more competitive. At the same time, import prices increase, which restricts the demand for imported goods. This improves the net export position and the current account of the balance of payments. But this is accompanied by a rise in the general level of domestic prices in the economy, which creates inflationary pressure on the economy, with a negative impact on aggregate demand.
2. However, if a change in the exchange rate results in appreciation/revaluation of the domestic currency this increases export prices in dollars, making exports less competitive, and decreases import prices, thereby boosting the demand for imported goods. The position of net exports worsens and the deficit on the current account of the balance of payments starts growing. This causes a reduction in the level of national income and output, and a fall in the general level of domestic prices. This

(also known as deflation) reduces the inflation rate and therefore has a positive impact on aggregate demand. Other deflationary measures, including fiscal measures such as tax increases and monetary measures such as high interest rates, may improve the balance of payments position by reducing the demand for imported goods.

Investment is a form of spending related to additions to a country's capital stock with the ultimate aim of making profits. Companies will therefore borrow to invest in capital goods and increase aggregate output. However, Mohr and Rogers (1991: 130) warn that the higher the interest rate, the more companies have to pay out in interest each year from the earnings they receive from their investment spending. This tends to lower their profits, which makes them less willing to borrow and consequently to invest. This reasoning also works conversely. This process is illustrated in figure 2.1 below:



**Figure 2.1: The investment curve**

As may be seen from figure 2.1, a rise in the level of interest rates in the economy tends to decrease investment. High interest rates also imply high costs of capital or investment. But they also function as an incentive to higher savings and greater capitalisation, and in a high interest rate environment, people tend to refrain from substantial consumption.

Conversely, when interest rates are low people tend to save less as their savings offer inadequate remuneration. However, low rates increase the benefits of adding to capital stock (machinery, structures, etc.), which stimulates investment spending. For instance, if a company borrows money from a bank in order to make an investment and subsequently the rate rises, the higher interest rate will force the company to pay out more on interest each year than it will receive from its investment spending.

According to Dornbusch and Fischer (1991: 130), the investment curve in figure 2.1 shows how much investors are willing to invest for each level of the interest rate. If the curve slopes negatively, towards the left, this reflects a reduction in interest rates and good incentives for investments. However, the curve is intentionally and negatively sloped to assume that a reduction in the interest rate should reflect an increase in the profitability of adding to the level of overall investment spending. In this case the investment curve is determined by the level of interest rates (**i**), by the slope (**b**) (a coefficient which measures the sensitivity of investment spending to interest rates) and by the level of autonomous spending with investment (**Ī**) (that is, investment which is independent of both income and interest rate). This may be expressed as:

$$I = \bar{I} - bi \quad \text{with} \quad b > 0.$$

Thus, if investment is very sensitive to interest rates, any small decline in them may bring about a huge amount of investment. As a result the curve will be less sloped, and will be closer to a vertical position. Since higher interest rates imply a higher cost of capital (or higher cost of investment), other things remaining unchanged, this lowers the prospective profitability of an investment. The profits are lower after paying interest, and in consequence investors (either domestic or foreign) refrain from investing and the volume of investment diminishes. Thus one can conclude that aggregate investment (aggregate investment = net foreign investment + domestic investment) and interest rates function and vary inversely owing to the influence of savings on them and vice versa. However, the difference between savings and investment is positively related to interest rates if saving increases as a result of an increase in interest rates (Copeland 1995: 113).



### **2.4.3 TAXATION AND OTHER INCENTIVES**

This sub-section is included here to complement the discussion of FDI determinants as regards host and home countries. This topic does not, however, constitute a basic part of this dissertation, and is intended only to highlight the lifting or lowering of trade barriers related to FDI flows. These comments on taxation are therefore by no means exhaustive or even comprehensive, since the topic is referred to in this context only as it throws light on FDI flows and their determinants.

Thus, taxation should be taken into account with tariffs, quotas and other measures, which may restrict FDI and flows of international trade. These trade flows are the other channels through which governments may (by adequate fiscal policy) influence the level of economic activities and capital flows in contrast with measures such as devaluation and revaluation aiming at internal and external equilibrium. The decision to invest abroad also depends, to a great extent, on an attractive regulatory framework in the host country as regards the rate of return on investments, the taxation system and the protection of copyright, among other things.

Expectations, confidence, interest rates, the exchange rate system and other fiscal measures which influence the cost of investment, are also important factors. Taxation, tariffs, quotas and other restrictions may function as incentives with tools such as fiscal reductions, concessions and exemptions for (domestic or foreign) investments, as was seen in the categories of FDI discussed in chapter 1. On the other hand, they may function as disincentives to investment and foreign trade as the need to ease these contrasts with domestic policies put in place in many developing countries which rely on taxation as their main source of financing their national budgets. The net return on FDI may be affected by the tax systems of both the home and the host countries; in that case, the tax system or tax policy may also influence the decision to engage in foreign investments, as well as the way in which those investments are financed.

In the same vein, Lizondo (1991: 78) notes that the avoidance of double taxation on income earned abroad depends on the tax system: (1) the territorial approach, which is more common, and (2) the residence approach. Under the first approach, the home

country does not tax income earned abroad, while under the second approach, such income is not taxed but a tax credit (to be paid over an extended time period) on taxes paid to host governments is allowed. This means that tax payments in the home country can be deferred until the income earned abroad is repatriated to the holding enterprise.

The rise of FDI as a source of transfer of technology is in part a reaction to taxation. The after-tax return on FDI – being the most relevant tax for most investors – may be affected by the tax system of both host and home country. Apart from the avoidance of double-taxation discussed above, taxation difficulties may arise when there is no double-taxation agreement between the countries concerned, or when they do not belong to the same regional, economic or financial organisations. In such instances the two countries will have different rates of taxation on foreign trade. The host country taxes an MNC's earnings or income generated within its jurisdiction, in accordance with its taxation system. However in the absence of a double-taxation agreement the MNC's earning may also be taxed in its home country when its earnings are repatriated. This obviously discourages FDI and hampers international trade, although it should be borne in mind that through its affect on output or GDP and the volume of foreign trade of both home and host countries, FDI is likely to affect the terms of trade between them.

This study thus includes an examination of FDI incentives as these make a valuable contribution to the host country's economic growth and development. There are important instruments that may be used to encourage international capital flows and trade. The permitted use of these measures is qualified in the Uruguay Round of multilateral trade negotiations. As regards FDI these incentives may include the following measures:

- a guarantee of stability, or reducing the political and economic risk faced by foreign investors
- import tariffs to encourage local production
- tariff exemptions to encourage capital-intensive activities or to promote import-substituting investments
- direct production subsidies

- favourable tax treatment of income generated abroad that has a direct effect on the net return on FDI and which is influenced by some instruments (e.g. corporate tax, foreign tax credit and deferral of home country taxes on unrepatriated income)
- favourable tax treatment of income generated at home, which determines and affects the net profitability of domestic investments and may trigger FDI, if investment at home is not profitable
- a general and flexible (or relaxed) taxation system in order to temper the costs of FDI in the host country.

## **2.5 CONCLUDING REMARKS**

This chapter attempted to explain the importance of the main determinants attracting FDI into developing countries. Investment in general, but particularly FDI, is a key economic factor in increasing aggregate output, economic growth and development in developing countries. The chapter showed that for an increasing number of countries, FDI has also become a key factor in the globalisation of the world economy. It was argued that the explanatory approach was the most suitable approach for the purposes of this study. This approach links location theory, industrial organisation and international trade to explain FDI.

The different determinants of FDI for developed and developing countries were then briefly considered. It was concluded that there are two broad categories of FDI determinants, namely endogenous and exogenous determinants. It was argued that both endogenous and exogenous determinants are important in dealing with FDI flows. Endogenous determinants were defined as factors internal to the host country that strongly influence an investor's decision to switch to investing abroad. Exogenous determinants are factors external to the host country that strongly influence an investor's decision to invest abroad.

The role of FDI in the transfer of technology was discussed, together with the implications of this for developing countries. The effects of international capital flows on

domestic financial systems were also considered, and it was shown that they make a profound impact on shaping and consolidating the structure of the domestic economies of the developing countries that receive such flows, and on growth and development within these host countries.

In concluding the chapter, the effects of changes in exchange rates, interest rates and taxation on FDI were examined. It was argued that subsidies and (low) interest rates increase investments and income, and that exchange rates – depending on the kind of system involved – have a different effect on aggregate demand. It was also pointed out, however, that high interest rates and taxation, tariffs and quotas may also deter FDI, if they are not managed appropriately.

## **CHAPTER 3**

# **THE IMPLICATIONS OF FDI FOR THE BALANCE OF PAYMENTS**

### **3.1 INTRODUCTION**

The main objective of this chapter is to discuss the importance of FDI for the balance of payments. The balance of payments is defined as a set of official accounts that record the transactions between the residents of a single country and the rest of the world over a particular period, normally one year. The chapter considers the effects of FDI on the main balance of payment accounts: the financial account, the current account and the official reserves. The financial account is important in defining and registering the movements of international capital flows. The current account is affected by FDI inflows through income generated by MNCs (in the form of remitted profits, dividends, royalties, fees and other payments from affiliates to the parent companies, or in the form of reinvested earnings). Changes in the official foreign exchange reserves reflect the financing or accommodation of deficits or surpluses in the overall balance of payments respectively.

The close relationship between FDI, the exchange rate and the balance of payments as regards external balance is then analysed and its direct impact on the equilibrium of the domestic economy is examined. The application of various adjustment mechanisms is also analysed and discussed. The need to apply appropriate macroeconomic policies in the presence of payments imbalances to restore internal and external balance is also considered.

The discussion of the effects of FDI on the balance of payments emphasises the potential impact of large-scale capital inflows and outflows. A consideration of a country's hypothetical macroeconomic fundamentals shows that international capital flows (in the form of FDI, FPI and other investment flows) also exert a considerable influence on the balance of payments in defining the course of a country's monetary and fiscal policies, particularly with respect to the required level of official reserves and internal and external economic balance. As stated in chapter 1 (section 1.3), the main distinction between FDI

and FPI is that the purpose of FDI is to acquire an ongoing, long-term, controlling interest in the management of an enterprise operating overseas, whereas FPI is generally a short-term, financial investment in securities markets. FDI and FPI therefore differ in some respects, but they may, in other respects, have similar effects as regards the balance of payments. These similarities and differences are discussed in the course of this chapter.

The role of the monetary authorities (central banks) in sterilising capital flows in the domestic markets to stabilise their currencies and attract foreign investment is also considered. International capital inflows may be useful in solving a policy dilemma created by balance of payments constraints, either by net inflows financing the current account deficit or by a surplus in the current account financing the financial account deficit.

### **3.2 FDI AND THE BALANCE OF PAYMENTS**

Over the past few years there has been a surge in the international movement of capital from one country or region to another, with direct implications for the balance of payments of the countries and regions involved. The operations of MNCs, and thus FDI flows, are largely responsible for major changes in the balance of payments, whether as inflows or outflows of capital. This is because the role of MNCs and net FDI has become increasingly more important than the role of institutional investors or portfolio investment in developing countries. Thus if we look at the total net private capital inflows of \$160.0 billion moving to developing countries in 2001, 105.1% was related to FDI. Net portfolio investment together with bank loans and other credits (debt flows) to the same markets represented 11.6% and -16.7% respectively (World Bank, 2002: 32).

Mohr et al (2000: 460-461) remind us that the balance of payments consists of five basic accounts, namely the **current account**, the **capital transfer account**, the **financial account** (or the capital account, as it was known prior to June 1999) and **unrecorded transactions** and the **official foreign exchange reserves**. The balance of payments should be understood as the accounting system applied to external transactions that affect a country's real foreign exchange reserve position. Only the current account and the

financial account are discussed here on account of their major importance to the balance of payments.

The **current account balance** of the balance of payments includes the sum of all net international flows of goods, services, income and unilateral transfers. This account therefore measures net current payments and the difference between national savings and investment. It also identifies international payments, which must be arithmetically matched by capital flows and changes in official international reserves. Its main focus is on trends and size of international foreign trade in relation to GDP. Thus, any trade deficit on this account (which is negative net exports reflected on the current account balance of goods, services, income and unilateral transfers) can be covered by exports of services or by net inflows of rents, interest, profits, dividends and other transfers. On the other hand, a current account deficit may be financed by inward FDI, FPI, loans from overseas or depletion of official international reserves. This account does not record changes in international capital flows.

The **financial account balance** includes the sum of net international investment and loans (i.e. net FDI, net portfolio investment and net other investment) and is not directly related to the process of production and consumption. Before June 1999, it covered all transactions that involved capital transfers, and acquisitions or disposals of non-produced and non-financial assets. Non-financial assets comprise transactions associated with tangible assets used in the production of goods and services but not actually produced (such as land and subsoil assets), and transactions associated with non-produced, intangible assets (such as franchises, leases or other transferable contracts). The distinction between short-term and long-term capital flows in the old capital account before June 1999 no longer exists in the financial account balance. Net FDI, net FPI and net other investment thus fall under this account. FDI and FPI have already been defined in chapter 1, and according to Mohr et al (2000: 464), other investment is a residual category which includes all financial transactions (such as short-term trade credit which is used to finance imports and exports) not included under FDI or FPI.

The role of FDI in compensating for a fortuitous current account deficit may be explained by the contribution of FDI to job creation and to the increase in overall output and

consequently in aggregate exports. This results in a substantial increase in a country's revenues to match imports of goods and services. However, the financial account measures international capital flows, being either FDI, FPI, loans, or reimbursements and disbursements. This account is the major contributor to changes in the balance of payments and exchange rate fluctuations in the short term. Inflows into this account signify inward FDI or FPI, loans from overseas and other kinds of inflows, but outflows represent investments abroad such as acquisitions of assets, or loans to foreign countries. The financial account is therefore very important because, with the current account, it constitutes the basic balance of the balance of payments. Both yield the change in the country's whole net gold and other foreign reserves. The financial account and the current account are directly related, and they also relate to exchange rates. This matter is discussed in section 3.2.1. The focus of the financial account is basically on international capital movement and all its items are shown on a net basis, i.e., the difference between inflows (credits or liabilities) and outflows (debits or assets).

Assuming that capital formation refers to the process of adding to the net physical capital stock of a country aiming at greater aggregate output, that is, to the creation of factories, machinery, infrastructure, etc., it then becomes essential to analyse the role of MNCs in capital formation and the role of FDI in financing capital formation. Basically, MNCs contribute to capital formation by acting as "arbiters" in international markets on account of their influence over what is done or accepted in their field of activities. They do so by financing their investment in host countries with sufficient foreign exchange funds, which they bring into the country as equity capital or loans. As explained in chapter 2, MNCs also contribute to capital formation by improving the human skills and capital absorption capacity of a country, and by transferring know-how (technical progress or technical knowledge) to host countries. Affiliates of MNCs in host countries may follow a policy of low equity finance and high intra-firm borrowing because they want to circumvent foreign exchange controls. In deciding whether to borrow abroad or domestically, they choose between offshore financing costs (interest rates + fees + foreign exchange risk) and domestic financing (interest rates + fees), depending on which is the cheapest option.

Regarding the role of FDI in financing capital formation, it is important, firstly, to underline that it is a product of the MNCs. Secondly, it consists of new equities flows



(mergers and acquisitions), plus reinvested earnings, plus net loans made by the direct investors to their affiliates in the host country. There are other sources of capital formation apart from FDI, such as domestic and foreign savings deposited in domestic banks. But FDI, as a source of financing, grows in accordance with the maturity of the foreign investors: the retention of profits, or the postponement of remittances by the multinationals' affiliates to their parents in the home country, improves the current foreign exchange position of the host country. This occurs because MNCs need to create new investments or expand their existing operations, thereby enlarging the capital stock of the country. It is therefore appropriate to analyse the impact of MNCs and the FDI they generate, as a financial phenomenon, on two broad areas of the balance of payments:

1. the current account and the financial account
2. the official reserves (since the latter indicates a country's ability to pay for its imports and signals pressures on the balance of payments).

### **3.2.1 EFFECTS OF FDI ON THE BALANCE OF PAYMENTS, INCLUDING THE CURRENT ACCOUNT, AND THE FINANCIAL ACCOUNT**

Any analysis of this issue must examine the current and financial accounts simultaneously because of the interaction between them. Thus, FDI has a direct impact on both the current account (reflected in MNC-related export and import flows) and the financial account. Although FDI inflows by MNCs contribute favourably to the financial account of the balance of payments, they may also become a "drag" in the current account. The income generated by MNCs activities in host countries in the form of remitted profits, dividends, royalties, diverse fees and other payments from affiliates to the parent companies are *de facto* outflows of capital. On the other hand, reinvested earnings, which provide additional capital to the affiliates and thus increase the value of the host country's stock of foreign assets and liabilities, are recorded as both an inflow in the financial account and an outflow of the same magnitude in the current account of the balance of payments. Theoretically, these activities do not affect the overall balance of the balance of payments or the official international reserves position. In practice, however, since earnings are either remitted to parent companies or reinvested in the host country, any change in the propensity to reinvest triggered by, say, a worsening general

investment climate in the host country may result in larger remittance outflows and consequently in a deterioration of its foreign exchange position (Del Castillo 1992: 49). The effects of FDI on the current account are reflected in MNC activities in the domestic market and in the host countries' foreign trade. They buy and sell in the domestic market and this affects production, prices and the cost of factors of production. These activities also affect foreign trade and the current account (through the trade balance) by exports and imports. In the domestic market, FDI-related activities increase production and competition, and the host countries' exporting capacity through technology transfer.

The impact on the financial account is also explicable since, through the MNCs, it provides and channels the funds needed to finance greenfield investments, and M&As of affiliated firms in host countries. The financing of FDI is recorded as an inflow of capital under the financial account. It ultimately translates into an increase in the number of factories and infrastructures, improvement in employment and expanding production and exports. This in turn fuels an increase in the country's exports which then improves the trade balance and, consequently, the current account and its foreign exchange position. Finally, it should be borne in mind that total FDI flows, which are related to the financial account, minus FDI income from the current account (profits, dividends, royalties, fees and other payments owing to MNCs) equals cash flows relating to the net transfer of resources.

**TABLE 3.1 BALANCE OF PAYMENTS AND AGGREGATE NET SHORT-TERM AND LONG-TERM CAPITAL FLOWS (FPI, FDI AND DEBT FLOWS)**

ACCOUNTS	CREDITS	DEBITS
<b>Current account</b>	• Exports of goods and services	• Imports of goods and services
	• Income received, including rents, interests, profits and dividends (inflows)	• Income paid, including rents, interests, profits and dividends (outflows)
	• Current transfers, including workers' remittances and private grants (inflows)	• Current transfers, including workers' remittances and private grants (outflows)
	1. Official unrequited transfers by foreign governments (inflows) (1)	• Official unrequited transfers by national government (outflows)
<b>Financial account<sup>(a)</sup></b>	2. Official unrequited transfers by foreign governments (inflows) (1)	• Official unrequited transfers by national government (outflows)
	3. FDI by non-residents (disinvestment shown as negative) (inflows) (1)	• FDI by residents (disinvestment shown as negative) (outflows)
	• FPI by non-residents (amortisations shown as negative) (inflows) (2)	• FPI abroad by residents (amortisations shown as negative) (outflows)
	• Other long-term capital inflows or investments by non-residents (amortisations shown as negative) (inflows) (2)	• Other long-term capital outflows or investments by residents (amortisations shown as negative) (outflows)
	• Short-term capital inflow	• Short-term capital outflow
<b>Official foreign exchange reserves</b>	• Made up of gold, foreign exchange, loans and IMF SDRs, and reflecting: Net changes in reserves: Positive (-) and Negative (+)	

Source: World Bank. 2001a. *Global development finance: building coalitions for effective development finance*. Washington, DC: International Bank for Reconstruction and Development/World Bank: xiii

Note: <sup>(a)</sup> As regards FDI, FPI and other investments, liabilities represent inflows of capital and are investments made by foreigners in host countries; and assets represent outflows of capital and are investments made by domestic residents in undertakings abroad.

NB: (1) Aggregate net resource or capital flows; (2) Net resource or capital flows on long-term debt.

### **3.2.2 EFFECTS OF FDI ON THE OFFICIAL FOREIGN EXCHANGE**

#### **RESERVES**

The official foreign exchange reserves (or official international reserves) are the counterpart of the overall balance, viz. the current and financial accounts together. Any change on one of these accounts is reflected by a change in the official foreign exchange reserves. For instance, FDI inflows by MNCs affecting the current account (as regards the balance of goods and services) also affect the official foreign exchange reserves. Increased imports may represent an excessive charge on the official foreign exchange reserves while increased exports improve the international reserves position. On the other hand, if the roles of the two accounts are combined, inflows of FDI, first through the financial account and thereafter through the current account may improve the official foreign exchange reserves by increasing production and exports. The reserves may be necessary to finance any net deficit on the overall balance. In other words, as FDI directly influences both accounts, it ultimately influences official foreign exchange reserves.

### **3.2.3 SIMILARITIES AND DIFFERENCES BETWEEN FDI AND FPI ON THE BALANCE OF PAYMENTS**

Finally, the effects of FPI on the balance of payments merit brief attention. As mentioned earlier, FDI and FPI in some respects have similar effects on the financial account, and both are recorded as credit capital or inflows entries in the balance of payments. Thus their returns are recorded as debit capital or outflows in the current account. FDI and FPI differ inversely in response to interest rates. FPI has an inward move in the short-term when interest rates in the host country are high, whereas FDI, as part of aggregate investment, is positively influenced when, in the long term, interest rates are relatively low. Thus while FPI is generally reflected in the balance of payments as a short-term investment flow with an immediate effect, and as a volatile disposable fund, FDI is reflected as a long-term investment flow with a long-term effect, and as a more resilient disposable fund or capital stock of the host country.

### **3.2.4 OTHER FACTORS AFFECTING THE BALANCE OF PAYMENTS**

While analysing the consequences of FDI on the balance of payments, it is essential to include an important element which also plays a role in attracting international capital

flows in general: the exchange rate regime. Changes in the exchange rate imply the devaluation/depreciation or revaluation/appreciation of the currencies concerned. These changes make exports cheaper or more expensive and imports dearer or less expensive in foreign currency terms. This also means that no exchange rate regime is sufficient to determine inward investment and it should therefore be complemented by the appropriate macroeconomic policies (monetary and fiscal policies) and structural adjustments to produce the business-friendly environment needed to attract FDI. Such an environment is geared towards increasing exports and production, and consequently its purpose is to achieve economic growth. This issue is intricately related to the adjustment of the balance of payment mechanisms regarding international capital flows, which is dealt with next.

The connections between FDI related to capital formations and the balance of payments concern the following:

1. adjustment programmes (open macroeconomic balance of payments adjustment mechanisms, including current account adjustment)
2. international investment position and long-term capital movements
3. short-term capital movements
4. international linkages to stability and development
5. role of international organisations and arrangements, which includes:
  - international assistance programmes
  - trade and financial flows
  - IMF conditionality (the conditions imposed by the IMF on members' borrowings from the Fund).

Points 2 to 5 have already been developed in previous chapters and are not dealt with again here.

Adjustment programmes regarding FDI, or international capital flows related to the balance of payments adjustment mechanisms, are concerned with increasing aggregate output. Such programmes, coupled with macroeconomic policies, are thus also concerned

with exports. Their aim is to restore external and internal equilibrium to the balance of payments, should any disequilibrium occur.

### **3.3 BALANCE OF PAYMENTS ADJUSTMENT MECHANISMS**

It is generally accepted that balance of payments equilibrium occurs when, over the long run, a country spends and invests abroad no more than other countries spend and invest in it. The balance of payments may be regarded as a monetary phenomenon and must be treated in terms of the applicable macroeconomic policies.

As is well known, consumption is a function of income (because consumption changes as income changes), and prices affect the level of expenditure. Transactions and variations in prices and income, which may occur at any time, may trigger either a surplus or a deficit on the balance of payments. Accordingly, there are three main adjustment mechanisms for restoring the balance of payments equilibrium, namely:

- the price approach or effect
- the income approach or effect
- the monetary approach or effect.

These adjustment processes play a vital role in restoring overall equilibrium in the economy, as will be shown below.

However, Marques (1986: 232) indicates several factors which may contribute to a deterioration in the balance of payments:

- Changes in the value of the domestic currency against other currencies which may cause the domestic currency to appreciate or depreciate, should the fundamentals of macroeconomic stabilisation not be apparent
- An increase in the prices and/or volume of imports
- A decrease in export prices and /or volumes
- Crises in consumer countries that would encourage them to decrease their imports of

consumer goods and services

- Loss of foreign markets
- Excess of short-term capital inflows (“hot money”) in terms of bank deposits and treasury bills, without the requisite economic and financial background or sustainability
- Capital flight or capital outflows
- Structural changes, such as a decrease in FDI
- Poor administration of adjustment policies.

The wealth accumulation aspect of the balance of payments financial account is important in analysing the overall balance. This can be seen more clearly by recalling from section 3.2 of this chapter that the current account is equal to the difference between aggregate domestic savings and investment, or  $(X - M) = (S - I)$ . That is,  $(X - M)$  or net exports or net foreign investment express an export surplus, which also represent an accumulation of foreign assets over imports. This restates the condition for the equilibrium level of national income. Then,

$$\mathbf{CAB = S - I = NFA + OIR,} \quad (1)$$

where:

- **CAB** is the current account balance,
- **S** is the domestic savings,
- **I** is investments,
- **NFA** is the net financial account (without reserve assets),
- **OIR** is official international reserves.

According to Salvatore (2001: 597), this indicates that at the equilibrium level of national income, the nation could have a surplus in its trade balance (a net injection from abroad) equal to the excess of saving over domestic investment (a net domestic leakage). On the

other hand, a deficit in a nation's trade balance must be accompanied by an equal excess of domestic investment over saving at the equilibrium level of national income.

The identity  $I + (X - M) = S$  shows that at the equilibrium level of national income, domestic investment plus net foreign investment equals domestic saving.

Returning to equation (1), taking into account that  $(CAB) = (X - M)$  and including the government sector, then we have:  $(X - M) = (S - I) + (T - G)$ . But if one considers that **injections (I, G and X) = leakages (S, T and M)**, then a government budget deficit ( $G - T$ ), where  $G > T$ , must be financed by an excess of  $S$  over  $I$ , and/or an excess of  $X$  over  $M$ , that is  $(G - T) = (S - I) + (M - X)$ . This increase in  $(G - T)$  corresponds to an expansionary fiscal policy, which expresses an increase in  $G$  and a reduction in  $T$ , or both. Therefore, contractionary policy refers to the opposite (Salvatore 2001: 626) where:

- $T$  is tax revenue, and
- $G$  is government expenditure.

The IMF (1997: 162) indicates that where capital inflows are associated with an excess of investments over savings, this should involve a reduction in the net foreign assets of the country, which will change its net investment flows position. The key analytical issue, then, is whether the country will be able to service a change in the net foreign investment position without undertaking significant changes in macroeconomic policies (interest and exchange rates). If the foreign investment makes a substantial contribution to the productivity and growth of an economy (i.e. its profitability is partially directed towards paying the rate of return which attracts funds to finance investments) and if additional investments will enhance the debt-servicing capacity of the economy, then the foreign investment does not place a strain on the balance of payments in the future in servicing the debt. Consequently, capital inflows should be invested productively in the domestic economy, besides allowing for the external financing for a current account deficit. In this case, the capital-importing country's current account deficit should manifest an efficient allocation of foreign resources.

However, the IMF (1997: 163) observes that there are many situations in which it may not be feasible to rely on foreign and/or domestic private and official flows to finance a



balance of payments deficit. To be more precise, it may not be viable to rely purely on automatic adjustment mechanisms (viz. to finance a current account deficit on a sustained basis by external and private funds); it may also require some complementary policy measures. In analysing the balance of payments adjustment mechanisms it is, therefore, very important to consider the introduction of policy measures to achieve external equilibrium, i.e. where a deficit on the current account can be financed by the financial account (private capital inflows: private or official transfers). However, it should be noted that changes in official international reserves are a residual, accommodating, or balancing item in the balance of payments, and are not a policy option. If the basic balance of the current and financial accounts above the line records a deficit, then the official international reserves will be run down accordingly. Because the official international reserves are generally limited, if the automatic adjustment mechanisms do not restore equilibrium above the line quickly enough, then policy intervention by the monetary authorities may be necessary.

Regarding internal equilibrium, it is important to take into account the role of fiscal and monetary policies in restoring the balance of payments equilibrium. In reality, policies (see section 3.3.3) implemented to restore external balance may also have an effect on internal balance. For instance, changes in money supply affect domestic interest rates, and changes in interest rates affect the level of income and investment. Another example is that a fall in interest rates may induce an increase in the level of income and investment and imports to rise. This also induces a rise in short-term capital outflows, depending on whether monetary policy is easy or tight. This is borne out by the equation or identity,

$$X - M = S - I, \text{ or } I + X = S + M,$$

which means that net exports equal the difference between saving and investment.

Other policy measures include the following:

1. Expenditure-switching policies, which are associated with changes in the exchange rate. These refer to devaluation and revaluation of the domestic currency. Devaluation switches expenditure from foreign to domestic commodities and is also used to correct a deficit in a country's balance of payments. These policies tend to increase domestic production and income, which induces a rise in imports and cancels a part

of the initial improvement in the current account. Revaluation of the currency has inverse results.

2. Measures of direct control, which comprise tariffs, taxes, quotas and other restrictions. These measures are used by governments to make an immediate impact on external and internal equilibrium by influencing the course of international trade and capital flows.

The magnitude of an adjustment in the overall balance of payments depends on the nature of the elements of the current account balance: for instance, part of the deficit arising from trade, service and income transactions may be offset by a surplus from current transfers of the current account balance.

Considering that  $CAB = TB + SIB + CTB$ , (2)

where:

- **TB** is the trade balance,
- **SIB** is the service and income balance, and
- **CTB** is the current transfers balance,

one can conclude that, by introducing these elements into equation (1) above, the result is:

$CAB = S - I = TB + SIB + CTB = NCFT + OIR$  (3)

It should be noted, however, that large amounts of FDI inflows may imply that dividend and other income flows from the current account (**CAB**) owing to parent companies may increase over time. Unless these dividend and other income outflows are matched by corresponding inflows from outward FDI, then **CAB** will be less than it would be without such FDI.

A final point is that adjustment mechanisms concentrate mainly on the current account because it is the most important indicator of a country's economic and financial health.

### **3.3.1 DISTINCTION BETWEEN AUTOMATIC ADJUSTMENT MECHANISMS AND DISCRETE POLICY ADJUSTMENTS**

Generally, the balance of payments adjustment mechanisms are a means, used by government authorities, of correcting imbalances which stem from a fundamental or chronic disequilibrium in the balance of payments. Balance of payments deficits or surpluses may occur at any time, but provided they are small a balance of payments disequilibrium can be easily and readily accommodated. These mechanisms, particularly the automatic adjustment mechanisms, do not involve government interventions.

This section analyses the automatic price, income and monetary adjustment mechanisms for a country that faces unemployment and a deficit in its balance of payments at the equilibrium level of national income. Both the floating and the fixed exchange rate systems are taken into account in this analysis.

Under a floating exchange rate system, a balance of payments deficit will only be eliminated if a country's currency depreciates freely. But for this to happen the Marshall-Lerner condition should be met (that is, the sum of the price elasticities of the demand for imports ( $D_m$ ) and demand for exports ( $D_x$ ) in absolute terms, is greater than 1). Otherwise, devaluation/depreciation of the domestic currency will lead to a worsening trade or current account balance, rather than the expected improvement. The depreciation would imply an increase in exports and aggregate income and an increase in aggregate investment and production, which would ultimately reduce the overall deficit (as a result of increasing income and increasing imports). But the increase in exports, production and investment in the earlier stage would, in turn, lead to a favourable business operating conditions and would have a positive effect on international capital inflows (mainly FDI and FPI). The reduction in the money supply and in national income would reduce prices in the deficit country relative to prices in the surplus country, which would further improve the trade balance because the reduction in income has a deflationary effect on the whole economy (with a shortfall in total spending/aggregate demand at full employment). In addition, Salvatore (2001: 613) suggests that all of these automatic adjustment mechanisms together are likely to produce a complete balance of payments adjustment. The disadvantage is that these mechanisms sacrifice internal to external

balance. However, according to Salvatore (1995: 533), under a managed floating exchange rate system, a country's central bank does not usually allow the full depreciation needed to eliminate the deficit completely.

Under a fixed exchange rate system (such as operated from after the end of the Second World War until 1973), a currency can only be devalued within the narrow limits allowed. And yet, the automatic adjustments have to come predominantly from monetary adjustment unless a country devalues its currency.

As stated above the main automatic adjustment mechanisms are the price effect, the income effect and the monetary mechanisms. They are clearly identified and briefly explained below (Salvatore 2001: 515, 553, 589):

1. **The automatic price approach or effect.** Prices change in response to changes in demand and supply resulting in allocation of resources. This approach takes into account that a country's current account should be affected by price changes, i.e. by changes in exchange rates under floating and fixed exchange rate systems to bring about adjustment or equilibrium in the balance of payments. A country that wanted to correct a deficit or surplus in the current account of its balance of payments would normally change its exchange rate accordingly.
2. **The automatic income approach.** This approach relies on induced changes in the level of national income and expenditure of the deficit or surplus country to bring about the appropriate adjustment or equilibrium in the balance of payments. It represents the application of Keynesian economics to open economies, viz. to countries engaged in international transactions. For this reason, it is distinguished from the automatic price approach, also known as the traditional or classical adjustment mechanism.
3. **The monetary approach or effect.** The monetary approach to the balance of payments is an extension of domestic monetarism to the international economy and considers the overall balance of payments as a monetary phenomenon. Money is regarded as the core player in markets and plays a key long-term role in causing and restoring of external equilibrium (under an efficient international market of goods and services, and financial assets). Its main postulate is the nominal demand for money

balances, which is positively related to the level of nominal national income and is stable in the long term. The condition of money market equilibrium is that demand for money (**M<sub>d</sub>**) equals supply of money (**M<sub>s</sub>**). Thus, for instance, any change in the demand for money resulting from, say, an increase in the country's GDP, can be satisfied by a surplus in the balance of payments or an increase in the country's domestic monetary base, or by an inflow of official international reserves. If the country's monetary authorities do not increase the domestic monetary base, then the excess demand for money will be satisfied by an increase in the balance of payments surplus. The approach concentrates on the domestic monetary base (**M**), which is composed of official international reserves or assets (**R**) and domestic credits or assets (**D**), and on the relationships between them. Key features are sterilisation operations by central banks, an increase in savings (with cuts in consumption) aiming at current account adjustment, and an increase in official reserves and consequently in the domestic monetary base. The approach entails certain policy measures that can be placed into two broad categories, as follows (Salvatore 1995: 617-623, 639):

- *A fixed exchange rate system.* First it should be taken into account that a currency devaluation, the imposition of a tariff or quota, and multiple exchange rates increase prices and the demand for money in any country. It is believed that under this system and according to the law of one price, commodity prices and interest rates do not change and are the same throughout the world in the long term. As a result countries have no control over their money supply. This explains why, under a fixed exchange rate system, certain important measures are needed to take control of a country's aggregate money supply and its aggregate demand for money in the long-term. Therefore, if the central bank does not increase the money supply enough to match the increase in the demand for money, or if the increase in money supply falls short of the increased demand for money, there is excess demand for money in the economy. The economy might, however, grow either through international capital inflows or through reserves from abroad, and this speeds up the long-term automatic adjustment mechanism or tendency. On the other hand, this situation can cause inflation resulting from excessive monetary growth if complementary macroeconomic measures are not put in place.

- *A floating exchange rate system.* Under such a system, any balance of payments disequilibrium is immediately and automatically corrected by automatic changes in the exchange rate. This may happen without any direct influence of international capital inflows or reserves. This means that a country should retain control over its monetary policy and concomitantly over its money supply to match the demand for money in the domestic economy, otherwise a deficit in its balance of payments would set off a currency depreciation as a result of excessive monetary growth from international capital inflows or reserves.

Adjustment mechanisms become necessary as a result of changes in domestic prices associated with changes in the exchange rate. According to Salvatore (2001: 517), for instance, a deficit in the balance of payments as a result of an excess of money supply leads to an automatic depreciation of its currency. This increases prices and the demand for money, which is sufficient to absorb the excess supply of money and automatically eliminate the balance of payments deficit. Salvatore asserts that the opposite is also true for a country running a surplus in its balance of payments under a floating exchange rate system.

When all the automatic price, income and monetary adjustments are allowed to operate, the adjustment to any balance of payment disequilibrium is likely to be more or less complete even under a fixed exchange rate system. The problem is that automatic adjustment may have serious disadvantages, which countries may then try to avoid by using adjustment policies.

### **3.3.2 DISADVANTAGES OF AUTOMATIC ADJUSTMENTS**

Salvatore (2001: 608, 611-612) identifies the following main disadvantages of automatic adjustments:

- Erratic fluctuations in exchange rates, accompanied by major interference in international trade and a costly adjustment process, are possibly the greatest disadvantage of automatic adjustments under a freely floating exchange rate regime. Such fluctuations can, however, be avoided by using a managed floating exchange rate system.

- Under a fixed exchange rate system with automatic adjustments, a devaluation can destabilise international capital flows. A fixed exchange rate system forces a country to rely primarily on monetary adjustment to eliminate its current account deficit and unemployment in the long term, because a change in the money supply affects the balance of payments through interest rates (domestic investment, income, imports and the current account balance) and domestic prices. For example, reductions in the money supply and in income reduce prices in the deficit country relative to the surplus country, further improving the current account of the deficit country.
- A country facing an increase in its imports at the expense of domestic production would have to allow its national income (or Gross National Income) to fall in order to reduce its trade deficit.
- A country facing an increase in exports from a position of full employment would have to accept domestic inflation to eliminate the trade surplus.
- For automatic monetary adjustment to operate, a country must passively allow its money supply to change as a result of balance of payment disequilibria and thus give up its use of monetary policy to achieve its most important objective of domestic full employment without inflation.

### **3.3.3 MAIN METHODS OF ACHIEVING FULL EMPLOYMENT AND RESTORING THE BALANCE OF PAYMENTS EQUILIBRIUM**

As an alternative to the automatic adjustment mechanisms, there are three policy options for achieving full employment with price stability and for restoring balance of payments equilibrium under both floating and fixed exchange rate systems. These policies are complementary rather than competing, and are needed to counteract unwanted side effects of the automatic adjustment mechanisms. The three policies are discussed below.

1. **External price adjustment mechanisms (or expenditure switching policy in prices).** This adjustment means altering the exchange rate against world prices for a country's imports and/or exports. It therefore involves the devaluation/depreciation and/or revaluation/appreciation of the currencies concerned, in order to make exports

less expensive/dearer and imports more expensive/cheaper in foreign currency terms. It is assumed that the prices of tradables will go up or down as result of a pure switching policy in prices, viz. altering the exchange rate to stabilise domestic prices and restore the balance of payments equilibrium. For instance, a devaluation of a domestic currency would aim at switching expenditure from foreign to domestic goods and services, and would simultaneously correct or have a positive effect on the deficit of a country's balance of payments, and vice versa. The application of this policy would increase aggregate production and income, which would induce a rise in imports. The implication for the current account would be that part of its initial improvement resulting from the effects of the devaluation would be neutralised, and vice versa.

- 2. Internal price and income adjustment mechanism (or absorption or demand reducing policy).** These policies are used to change the level of domestic income and spending, which includes expenditure on imports. This approach uses deflationary and reflationary monetary and fiscal policies to alter the prices of domestically produced goods and services vis-à-vis the prices of products imported from overseas. Its objective is to make exports less expensive/dearer and imports more expensive/cheaper in foreign currency terms. In effect, the absorption approach includes the automatic price and income adjustment mechanisms. In this sense, a depreciation or devaluation stimulates domestic production for exports and import substitutes and increases the level of GDP and GNI. This may lead to an increase in the level of imports, which reverses part of the improvement in contrast with the relative improvement of the balance of payments. This may occur if a country is at full employment level, when production can stabilise, and a decrease in the value of the domestic currency tends instead to increase domestic prices. This increase in domestic prices would leave the trade balance unchanged, unless real domestic absorption is somehow reduced.

It is broadly accepted that the income adjustment mechanism is associated with macroeconomic policies applied by a specific country in order to reduce excess demand for non-tradables. Reduced absorption (or aggregate demand) reduces or completely eliminates the current account deficit. The fact that income and price



adjustments are complementary means that better adjustment results are achieved by combining expenditure switching and demand reducing policies. In addition, a restrictive absorption policy on its own is not sufficient because it creates an excess supply of non-tradables. Likewise, an expenditure switching policy on its own could fail because of the increase in demand for non-tradables, which would cause the prices of these goods to rise. This could jeopardise the entire purpose of the depreciation (Corden 1994:15-16).

3. **Trade and foreign exchange restrictions or direct controls.** This involves the use of tariffs, taxes, quotas, foreign exchange controls and so on to affect the price and availability of goods and services, and of the currency with which to purchase these products. These controls may also be regarded as expenditure-switching policies as opposed to altering external prices or exchange rates (devaluation/appreciation or revaluation/appreciation). These instruments are applied in specific instances where other policies have failed, taking into account particular items of the balance of payments (external balance) to stem inflation and other domestic imbalances (internal balance).

Under a fixed exchange rate system there are two methods that are generally used to correct disequilibria in the balance of:

- Minor balance of payments disequilibria are corrected by means of the appropriate adjustment policies explained above.
- Fundamental or chronic disequilibria require, in addition, a devaluation or revaluation of the domestic currency. The success of this approach depends on favourable business conditions.

The floating exchange rate system theoretically provides an automatic mechanism for removing balance of payments disequilibria at an early stage, before they become fundamental or chronic. Therefore, a deficit results in an immediate depreciation of the exchange rate, and a surplus results in an immediate appreciation of the exchange rate under favourable business conditions.

The next section examines the effects of FDI on aggregate output and exports (internal and external balances), which are related to the income adjustment mechanism or absorption reducing policy. This does not, however, imply that other important adjustment mechanisms are not worth considering.

### **3.4 EFFECTS OF INTERNATIONAL CAPITAL FLOWS ON ADJUSTMENT MECHANISMS**

The effects of FDI on the balance of payments are analysed by considering two basic economic cases, viz. internal and external equilibrium.

Internal equilibrium refers to a particular level of demand for domestic factors of production, capital and labour, which secure full employment. This equilibrium is obtained by fiscal and monetary policies. External equilibrium refers to a balance of payments equilibrium, particularly to the overall balance. This is affected by changes in foreign exchange rates, use of reserves and limited use of restrictions on some trade transactions. However, where necessary, the imposition of (mainly short-term) controls on capital movements or restrictions may be considered.

The basic aim of economic policy is the achievement of both internal equilibrium (or full employment) and external equilibrium (or balance of payments equilibrium). This requires employing some means of control over (1) both aggregate expenditure and demand, for example, macroeconomic policies, and (2) international trade and payments (exports, imports and debt servicing), for example, the exchange rate or exchange and trade restrictions.

In general, countries give priority to internal rather than external balance, but they are sometimes forced to change priorities when faced with a large and persistent disequilibrium. Running down foreign exchange reserves can temporarily finance a deficit on the current account, but the government or its central bank may also borrow internationally to finance the deficit, particularly when foreign exchange reserves are low. When the current account deficit matches net capital inflows, foreign reserves remain unchanged and there is no balance of payments disequilibrium in the short term.

Nevertheless, the current account deficit increases when domestic absorption is greater than the national income, or when there is excess demand and imports are greater than exports. In this case, a current account deficit may continue indefinitely without matching net capital inflows if there is no adjustment. The income adjustment mechanism should be seen as a measure specifically aimed at preventing money incomes from rising excessively in relation to growth in real aggregate output. This is so as to encourage stabilisation and mitigate tendencies toward cost inflation under full employment, contributing, therefore, to the adjustment process of the balance of payments. To illustrate this statement, the central equation for the open economy with full equilibrium between aggregate demand and aggregate supply is considered again.

$$\text{Consider } Y = C + I + G + X - M, \quad (4)$$

where:

- $Y$  is aggregate output or income,
- $C$  is consumption expenditure by households,
- $I$  is domestic investment or spending by firms,
- $G$  is government spending, and
- $X-M$  is net foreign investments or the trade balance, that is income from exports ( $X$ ) minus expenditure on imports ( $M$ ).

If  $A$  is considered as an absorption which is the total expenditure by households, firms and the government, in other words, the sum of consumption, investment and government expenditure; from the above central equation, one should have that  $A = C + I + G$ , or hypothetically one may have Absorption ( $A$ ) = Income ( $Y$ ) + Net Lending by Foreigners ( $NLF$ ), when domestic agents are able to spend more than their income by borrowing the difference ( $NLF$ ) abroad, or:

$$A = Y + (M - X). \quad (5)$$

$$\text{And, therefore one should conclude that } Y = A - M + X. \quad (6)$$

Here, the effect of international lending on the foreign exchange market is stressed: with international lending, foreign investors need foreign exchange (say, dollars or pounds) in

order to buy domestic securities in host countries. This demand for domestic securities is added to the demand that originates with buyers of host countries' exports. Equation (6) can be explained as follows: a country's exports have to be added to the components of spending on aggregate income ( $Y$ ) or GDP, and its imports have to be subtracted from aggregate absorption, to obtain domestic expenditure.

On the other hand, if  $S = I$  is taken to equal  $X = M$ , then the trade balance will also be in equilibrium. In other words,  $X - M = S - I$ . From this the following equation may be derived:

$$I + (X - M) = S,$$

where the expression  $(X - M)$  refers to net foreign investment (which plays the same role as NLF in equation 5), because an export surplus represents an accumulation of foreign assets to cover export surpluses. Therefore, this last equation indicates that at the equilibrium level of income, domestic investment plus net foreign investment equals domestic saving. If net foreign investment is negative, this means that domestic investment exceeds domestic saving by the amount of net foreign investment, i.e. the difference between the amounts foreigners are investing in the country and domestic investors are investing abroad (Salvatore 2001: 597).

Salvatore (1995: 531) suggests that depreciation or devaluation should be complemented by reducing real domestic absorption to eliminate or reduce the balance of payments deficit. The purpose would be to prevent depreciation or devaluation from leading to an increase in domestic prices, which reduces a country's competitiveness and increases the fiscal deficit.

If Absorption ( $A$ ) is greater than Income ( $Y$ ),  $A > Y$ , there is **excess demand**,  $Y - A < 0$ , which implies  $X - M < 0$ . If an economy *spends* more than it *produces*, this results in a **deficit in the current account**, which should be corrected by reducing aggregate demand through deflationary monetary and fiscal policies. This will reduce the level of national income and increase aggregate output, which is usually accompanied by a fall in the general price level (disinflation). Deflationary measures are deliberately employed by the authorities in order to reduce inflation and improve the balance of payments position by reducing import demand. Instruments of deflationary policy include fiscal measures such

as tax increases, and monetary measures such as high interest rates to attract funds from abroad. Recourse to deflationary policy may also mean reductions or a cessation of (domestic and/or foreign) investments, with a direct negative effect on aggregate output, exports and income of the host country.

Conversely, when Absorption (**A**) is smaller than Income (**Y**),  $A < Y$ , there is **excess supply over demand**, in other words, over expenditure or absorption, and  $Y - A > 0$ , which implies that  $X - M > 0$ . Therefore, domestic output exceeds domestic absorption, resulting in a **current account surplus**. Resuming the above reasoning, an increase in inflows of capital through FDI or FPI results in the creation of foreign assets or affiliates of MNCs in a host country. The production and exports of these assets or affiliates contribute to an increase in aggregate output or GDP, and to economic growth. Ultimately this improves the balance of payments through the current account balance.

Analysing the above question in a different way, let us start with the close relationship that exists between the balance of payments and the domestic economy. This relationship is apparent in the links between the balance of payments current account and aggregate domestic savings and aggregate investment, so that the current account is equal to the difference between aggregate domestic savings and investment. In other words, recalling equation (2):

$$\text{CAB} = \text{TB} + \text{SIB} + \text{CTB} = \text{S} - \text{I} \quad (7)$$

Therefore changes in the current account balance, stemming from any of its elements, may reflect changes in savings and investment. This is because, for instance, a change in investment relating to aggregate domestic savings has the same impact on the current account balance in the short term. As the balance should always be in equilibrium, a larger or smaller surplus or deficit must necessarily be matched by an increase in aggregate domestic savings. This combination refers as well to aggregate investment of the same magnitude, since financial flows associated with the excess of savings over investments involve an increase in the net foreign asset position. This then leads to alterations in the net investment income flow of the country, and vice versa.

From the above and from the equation  $I + (X - M) = S$ , it is clear that both saving and investment have a domestic and a foreign component. In an open economy exports, like

aggregate investment, are an injection into the country's economy, while imports, like aggregate saving, are a leakage out of the country's economy. Therefore, exports as well as investments boost domestic production, while imports and saving represent income earned, but not spent on domestic production. Access to foreign saving and FDI inflows may be the best way to overcome a deficit in external financing and ease a country's balance of payments constraint.

On the other hand, if a rise in productivity of capital in domestic investment is not matched by a corresponding rise in aggregate domestic savings, then interest rates will tend to rise, and the excess of investment over aggregate domestic savings will be reflected in a current account deficit. This deficit may be financed either by official international reserves or by a net financial inflow, induced by the higher domestic interest rates compared with interest rates abroad (or the world interest rate). This is because high domestic interest rates affect FPI positively and affect FDI negatively. In summary, if a current account deficit is financed by the combination of an increase in liabilities to non-residents and a reduction in claims on non-residents; and if the net result is a decline in net foreign assets, then this may lead to a reduction in net investment income and may increase the current account deficit, unless rates of return on investment are adjusted to offset the increased deficit.

The above exposition highlights the importance of applying certain policy measures, such as changes in tariffs, quotas and exchange rates. These measures are designed to adjust a current account disequilibrium in order to restore balance of payments equilibrium. Central banks play a decisive role in the sterilisation of the foreign exchange market by intervening when necessary, and in monitoring the banking system and applying foreign exchange policies. These policies are usually designed to stabilise financial markets so as to attract more international capital flows in the form of FDI, FPI and loans – basic elements for correcting disequilibria. But as pointed out above, this depends on the policy selected and on the level of domestic interest rates.

In analysing the relationship between the balance of payments and the domestic economy one should also take into account the following: the difference between gross national disposable income or national income (**GNDY or Y**) and aggregate expenditure on goods

and services by domestic residents: in other words, domestic absorption (**A**), as was done above. Therefore, the central equation may be rewritten as follows:

$$\mathbf{GNDY = C + I + G + CAB} \quad (8)$$

and then, knowing that  $\mathbf{A = C + I + G}$ , the result is:

$$\mathbf{CAB = GNDY - A} \quad (9)$$

As stated above, the income adjustment mechanism aims at restricting a rise in money income in relation to growth in real GDP. It also aims at stabilising prices and curtailing the inflation rate in a situation of full employment. The implication of the above relationship is that any improvement in a country's current account balance (**CAB**) requires that some resources must be foregone through a fall in domestic absorption (**A**). In other words, it requires that a reduction in expenditure relative to income should be observed. This differs from the earlier analysis in that it takes into account three important components: current account, national income and absorption. This also means that any change in absorption or gross national disposable income will immediately affect the current account balance because, as equation (9) shows, expenditure is a function of income. But balance of payments equilibrium may be achieved by means of an increase in national income (achieved, for example, by structural measures that reduce distortions and increase the efficiency of the economy).

In addition, one can defend the argument that there are indirect connections between FDI and official international reserves (**OIR**) in a country's balance of payments. These connections exist through the financial and current accounts. If it is accepted that a deficit in the overall balance may be financed either by the financial account through inflows of capital (FDI, FPI or foreign loans) or by withdrawing from official international reserves; then, conversely, it should also be true that FDI can contribute to the improvement of the interaction between financial and current accounts. This occurs through equity flows, export flows, short and long-term loans from parents to affiliates, income earnings and reinvested earnings by affiliates in host countries. If this leads to a balance of payments surplus, it will influence the official international reserves since a surplus increases the reserves. The following identity may be derived from the above hypothesis:

**Balance of Payments Surplus = Current Account Balance (CAB) + Net Financial Account (NFA), (without reserve assets) = Increase in Net Gold and other Foreign Exchange Reserves.**

Then, in summary, we may say that:

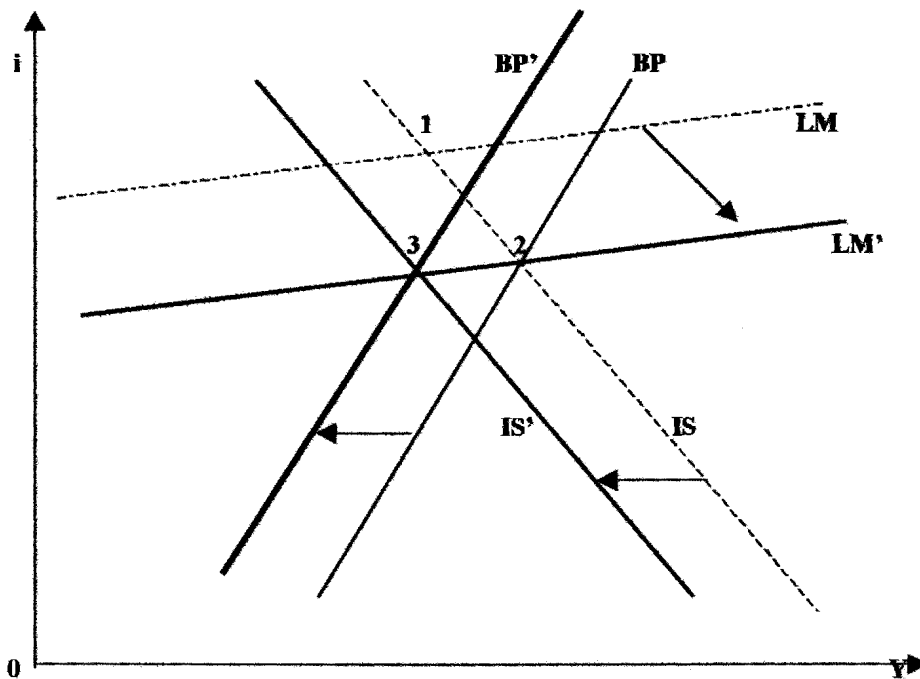
**Balance of Payments Surplus = Increase in Net Gold and other Foreign Exchange Reserves,**

if (and only if) the combination of both the **CAB** (as a function of net exports, income and current transfers) and the **NFA** (as a function of domestic [**i**] and international [**i\***] interest rates [with  $i > i^*$ ]) as regards FDI and foreign savings, triggers the supposed surplus. This is a necessary basic condition and occurs whether the CAB and NFA are both positive or whether one of them is negative. In the latter case, one of them should be covered by the other in order to obtain the combined surplus, otherwise one has a balance of payments deficit.

In the current account, the trade balance is a function of income and net exports. Thus an increase in income may worsen the trade balance since this may lead to an increase in imports. However, as regards the financial account, a rise in domestic interest rates will stimulate capital inflows in the form of FPI, which will improve the country's financial account position. If income increases and there is simultaneously an increase in domestic interest rates, this may result in a balance of payments equilibrium.

The situation depicted above is likely to occur in small and low-risk surplus countries heavily dependent on mono-products such as oil and tourism, with a high level of FDI. However, in these surplus countries industries are often intensively exploited by MNCs where foreign and domestic incomes significantly exceed foreign and domestic expenditures.





Source: Fourie (1999: 144)

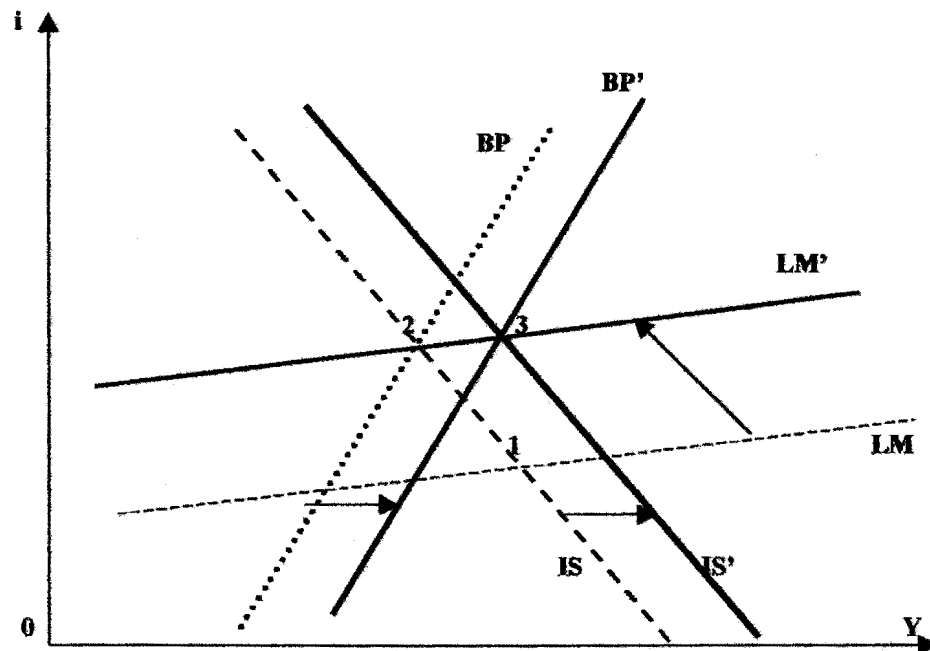
**Figure 3.1: The balance of payments adjustment mechanism starting from an internal equilibrium with a balance of payments surplus (as a result of an increase in FDI and/or exports) under a floating exchange rate system**

**NB:** The IS and LM curves belong to the IS-LM model of aggregate demand related to an open economy, which deals with fiscal policy (aggregate expenditure or demand) and monetary policy. Thus, it is a theoretical construct that integrates the real sector, IS (investment-saving), and the monetary sector, LM (liquidity-money). It is related to demand for and supply of money towards equilibrium taking into account national income and interest rates.

In terms of figures 3.1 and 3.2, the analysis of the impact of international capital flows (particularly FDI, or changes in exports revenues) on the balance of payments should focus on two sets of conditions, namely a surplus and a deficit:

1. The balance of payments starts from an internal initial position of equilibrium, with income and interest rates in equilibrium as well. At this equilibrium point 1, the balance of payments starts its adjustment in surplus since the intersection of the IS and LM curves is above the BP curve.

**A balance of payments surplus** (see figure 3.1). *Under a fixed exchange rate system* the LM curve is shifted to the right in the first balance of payments adjustment phase, reflecting a decline in interest rates and increase in international capital inflows (increase in income) in the form of FDI or revenues from exports, in the first balance of payments adjustment process. This moves the equilibrium level from point 1 to point 2 in the diagram. *Under a floating exchange rate system* both IS and BP curves shift to the left owing to currency appreciation in the final balance of payments adjustment process. This makes exports less competitive, moves the equilibrium level from point 2 to point 3 in the diagram, and reduces the aggregate income level.



Source: Fourie (1999: 144)

**Figure 3.2: The balance of payments adjustment mechanism starting from an internal equilibrium with a balance of payments deficit under a fixed exchange rate system**

2. The balance of payments adjustment mechanism starts its adjustment in deficit at point 1, since the intersection of the IS and LM curves is below the BP curve, and at point 3 there is final internal and external equilibrium.

**A balance of payments deficit** (see figure 3.2). *Under a fixed exchange rate system* the LM curve is shifted to the left, which reflects an increase in interest rates, a reduction in income and international capital inflows, and increase in outflows in the

form of international payments or funds or a reduction in FDI, in the first balance of payments adjustment process. This moves the equilibrium level from point 1 to point 2 in figure 3.2. *Under a floating exchange rate system* both IS and BP are shifted to the right owing to currency depreciation in the final balance of payments adjustment process. This makes exports more competitive, moves the equilibrium level from point 2 to point 3, and increases the level of aggregate income.

As already explained, international capital inflows translated into FDI – say a plant manufacturing exportable products – represent an increase in the capital stock or formation of the host country. Obviously, this increase will be positively reflected in an increase in the country's aggregate output and consequently in its aggregate exports. This will improve the current account of the balance of payments since aggregate income also increases. As discussed above, increasing exports leads to a surge in aggregate income, which increases aggregate expenditure. This may, in turn, precipitate a balance of payments disequilibrium, i.e. a current account surplus. However, the increase in aggregate income will also lead to an increase in imports, induced by the increasing marginal propensity to import resulting from high national income. But if marginal propensity to import is less than one, then the current account should still improve.

An initial surplus in the current account may be eliminated by an increase in aggregate imports. Therefore, it is the increase in national income which causes imports to rise and thereafter reduce the surplus. This makes the domestic currency appreciate, with a negative effect on exports, which now become dearer. This reduces aggregate exports and income and, consequently, the country's liquidity, and may be conducive to a current account deficit. Another possible negative impact is a decrease in aggregate capital flows owing to a reduction in the level of interest rates when FPI is involved.

Broadly speaking, the basic issue is as follows: An increase in income normally worsens the current account balance because domestic demand increases. However, an increase in interest rates above the international level will, *ceteris paribus*, trigger capital inflows, and the financial account will improve. This would help to finance a current account deficit. In the event of perfect capital mobility, the rising interest rate will attract foreign capital, which will stimulate domestic economic growth. Thus, a surplus on the balance

of payments occurs when there is excess demand for domestic money, a situation that stimulates capital inflows through a higher interest rate. But when income increases, even the smallest increase in interest rates is enough to keep the required balance of payments in complete equilibrium, since the current account deficit would be financed by capital inflows.

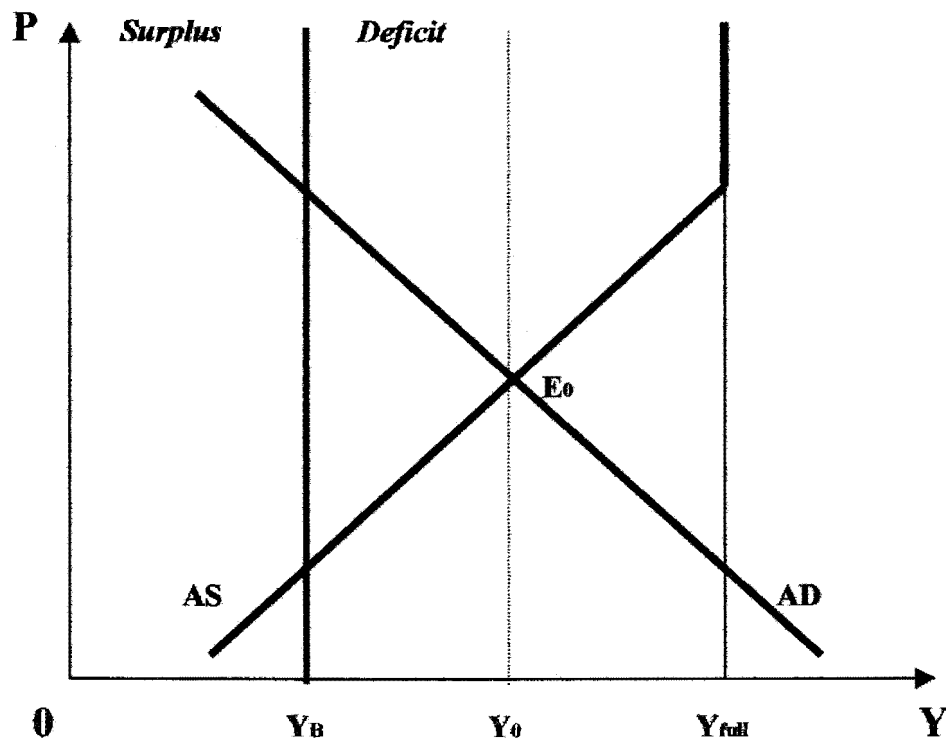
Finally, it is important to bear in mind the following: the presence of capital flows in the form of FDI and FPI suggests that a country can, in fact, impose and apply an expansive domestic economic policy under certain conditions. This is without necessarily experiencing balance of payments problems, with FDI playing a significant role in expanding economic activities and global productivity, and in increasing economic growth in host countries.

#### **3.4.1 THE BALANCE OF PAYMENTS CONSTRAINT AND THE NEED FOR INTERNATIONAL CAPITAL FLOWS**

It is generally assumed that any country's monetary authorities want to run the balance of payments with a current account surplus in order to finance foreign transactions/expenditures and domestic economic activities. To generate a balance of payments surplus a country should either increase its exports or decrease its imports, other things being equal or unchanged. But in developing countries this necessity collides with other factors involved in achieving full employment in the economy because for most developing countries imports of capital goods are crucial for maintaining and improving the level of domestic economic activities and accelerating economic expansion and growth.

The dilemma begins with the need to stimulate economic activities and income, on the one hand, so as to reduce unemployment and generate a surplus. On the other hand, in order to reduce the current account deficit, the authorities may increase international capital flows (as will be seen later) but in some instances the authorities may be virtually forced to decelerate economic expansion (by applying restrictive or contractionary policies) and to reduce the level of national income so as to reduce aggregate imports, although they would like to reverse this situation. These policies in turn lead to and increase unemployment. Restrictive or contractionary policy aims to reduce government

expenditures and/or increase taxes, both of which reduce domestic production and income and induce a decrease in imports. Tight monetary policy aims to reduce a country's monetary supply and cause a rise in interest rates. This discourages aggregate investment, aggregate income and aggregate imports, and leads to capital inflows (in the form of FPI) in the short term or to reduced capital outflows.



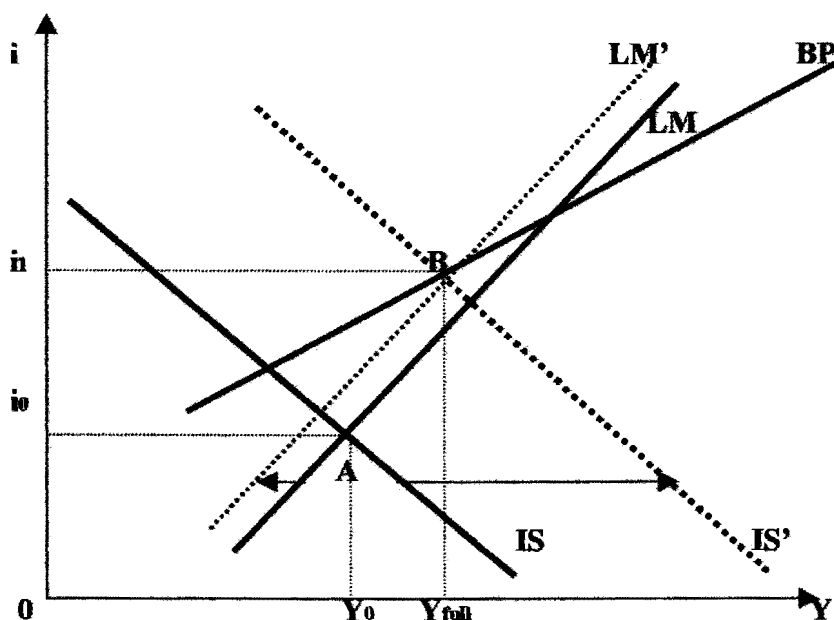
Source: Mohr et al (2000: 577)

**Figure 3.3: The policy dilemma created by balance of payments constraints**

**NB:**

- **P** is the level of prices,
- **Y** is total production or income,
- **AD** and **AS** are aggregate demand and aggregate supply respectively,
- **Y<sub>B</sub>** is the level of production or income at which  $(X - M)$  or net exports are zero or there is equilibrium on the trade balance,
- **Y<sub>0</sub>** is the equilibrium level of production or income determined by **AD** and **AS**,
- **Y<sub>full</sub>** indicates the full employment level of production or income, and
- **E<sub>0</sub>** indicates the equilibrium point at **Y<sub>0</sub>**.

According to figure 3.3, at  $Y_0$  there is unemployment and a deficit in the current account of the balance of payments. As explained above, the policy dilemma begins when the authorities need to apply measures to reduce the deficit in the current account, which may cause unemployment, whereas measures to reduce unemployment may increase the current account deficit.



Sources: Lindert & Pugel (1996: 484-485)

**Figure 3.4: The combination of the effect of monetary and fiscal policies on internal and external disequilibria**

Taking this analysis from the angle of internal and external disequilibria, choosing which policy to pursue has been a difficult issue for many countries where low aggregate demand has resulted in high unemployment, but with a deficit in the balance of payments. Inversely, high aggregate demand may result in low unemployment with a surplus in the balance of payments. Figure 3.4 illustrates the importance of mixing monetary and fiscal policies (IS-LM-BP or the Mundell and Fleming model) to solve this policy dilemma and achieve internal balance with full employment, and external balance with balance of payments equilibrium (by neutralising an unnecessary surplus or deficit). To deal with high unemployment and a balance of payments surplus, policymakers usually expand

aggregate demand with expansionary policy. However, to deal with inflation and a balance of payments deficit, policymakers normally decrease aggregate demand with contractionary policy. Figure 3.4 refers to a disequilibrium in an economy with inflation and a balance of payments deficit. Therefore, at the starting point A, national income  $Y_0$  is below the full employment level,  $Y_{full}$ , and the balance of payments is in deficit. To reach full employment and balance of payments equilibrium at point B, the right amounts of tight monetary policy and easy fiscal policy should be combined. Since the measures to reduce deficit in the current account may increase unemployment and vice versa, as was pointed above, the application of monetary and fiscal policies could be the basis for a creative solution to the dilemma.

Mohr et al (2000: 577-578) explain how to resolve this by allowing the current account deficit to be financed by net international capital flows, i.e. by a surplus in the financial account of the balance of payments. Alternatively a deficit in the financial account could be financed by a surplus in the current account, which means that spending, production and income should be maintained at a low enough level to force and keep imports down. And as already explained above, this implies the introduction of conventional monetary and fiscal policies, namely restrictive or contractionary policies to reduce aggregate demand and to encourage international capital flows. But some countries are not able to rely on such inflows owing to foreign exchange liquidity problems and are forced to maintain some equilibrium on the trade balance, i.e. between exports and imports.

### **3.5 CONCLUDING REMARKS**

This chapter stresses the importance of FDI and its implications for the balance of payments of a country. The effects of FDI on the balance of payments were emphasised, as well as its positive contribution to increasing aggregate output, welfare and overall equilibrium (internal and external) in developing economies. Furthermore, the need to apply adjustment mechanisms and other policy measures with the aim of restoring balance of payments equilibrium (in the presence of a deficit or a surplus) were discussed. The chapter also focused on the need for international capital flows in the face of the policy dilemma created by balance of payments constraints.

The main conclusions of this chapter can thus be summarised as follows:

1. To attract FDI flows countries need a well-organised economy, a business-friendly environment and a well-disciplined national accounts system, including a national statistics system. The effects of FDI on GDP, economic growth and the balance of payments are considered. This chapter clearly emphasises the main similarities and differences regarding the effects of FDI and FPI on the balance of payments. Other factors influencing the balance of payments are changes in domestic money market equilibrium, national income and exchange rates (which affect foreign trade flows).
2. Under a well-organised national accounts system and developed banking system, the balance of payments can be monitored appropriately in terms of the accounting system (in accordance with the IMF recommendations), and corrective adjustment mechanisms can be applied. This aims to correct balance of payments imbalances and restore equilibrium. Thus, particular emphasis should be given to the effects of international capital inflows on income adjustment mechanisms of the balance of payments. This is because there is a direct effect of FDI on GDP and exports, and on imports determined by the level of income, which are intrinsically related to both internal equilibrium (or full employment) and external equilibrium (or balance of payments equilibrium).
3. Sometimes there is a need to consider international capital flows in various categories (FDI, FPI and other investments or loans) simultaneously with domestic objectives to avoid overheating of the economy or deficits in external financing. The combination of international capital inflows with domestic objectives may also assist in solving the policy dilemma created by the balance of payments constraints, with the aim of restoring domestic and external equilibrium.

Finally, it is important to take into account that the implications of FDI for the balance of payments should be closely analysed and linked with the level of organisation and development of the financial markets of the countries concerned. As is seen in chapter 4, financial markets either domestically or internationally intermediate capital flows between surplus and deficit economic units with a direct impact on the current and financial accounts of the balance of payments. When liberalisation of the financial



markets is under consideration, these international capital flows become more important and attractive.

## **CHAPTER 4**

# **FDI INFLOWS, THE LIBERALISATION OF FINANCIAL MARKETS AND THE FINANCIAL ACCOUNT OF THE BALANCE OF PAYMENTS IN DEVELOPING COUNTRIES**

## **4.1 INTRODUCTION**

The main objectives of chapter 4 are to analyse the relationship between FDI, the liberalisation of financial markets and the financial account of the balance of payments. The chapter also examines the interrelations between financial markets and FDI and shows that FDI has been increasingly important in providing mechanisms for development, growth and helping developing countries in the global economy. The financial markets and the need for structural reforms as regards international capital inflows are discussed, and the chapter looks at the main factors that affect developing countries in managing the financial sector, international capital flows and public funds. These factors may influence international investor sentiment significantly, particularly as regards FDI. The roles of FDI and FPI in financial markets are clearly distinguished.

The importance of FDI as regards the liberalisation of financial markets and the financial account of the balance of payments in developing countries is analysed in detail. However, such liberalisation is aimed at attracting higher levels of FDI flows and the chapter also warns about the dangers of liberalisation when appropriate policy measures or careful sequencing of policies are not put in place.

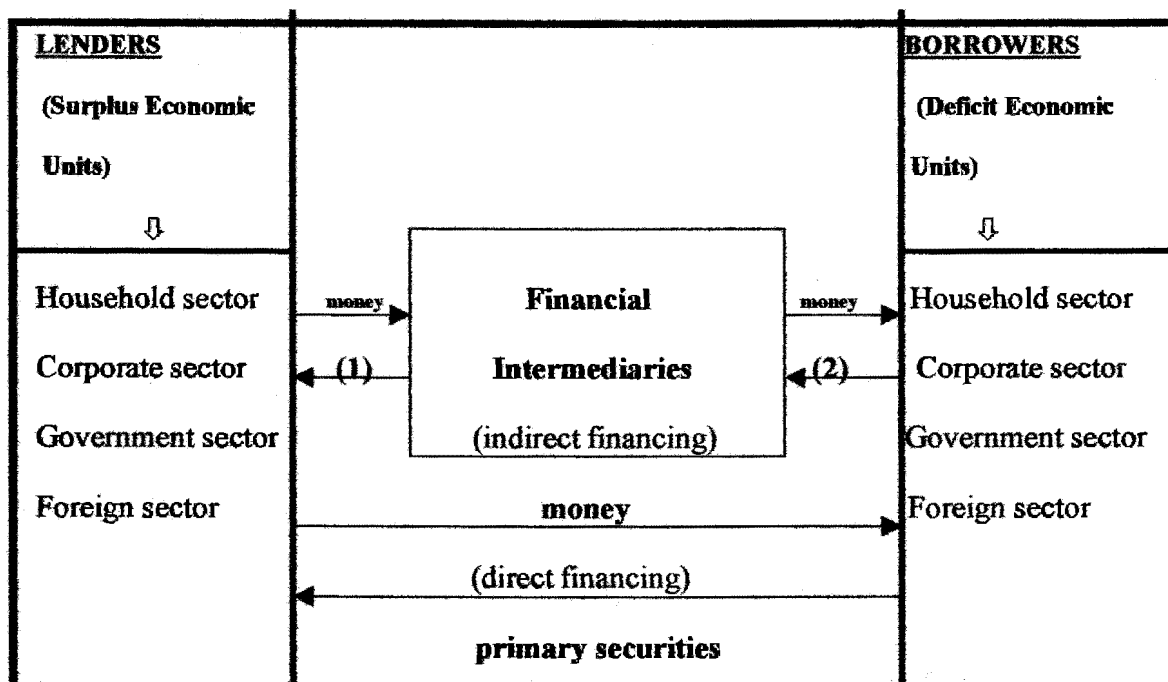
The chapter ends with a discussion of some important measures for liberalising financial markets that have been used in developing countries and measures related to the financial account of the balance of payments. The discussion stresses the desirability of greater economic openness in conjunction with a more stable political and macroeconomic environment. Examples of such measures are:

1. the creation and broadening of financial markets, including the money and capital markets, and the stock or equity markets, which encourages increased international capital flows generally, in the form of FDI and FPI inflows

2. liberalisation of the financial markets and the banking system to allow fair competition both domestically and internationally
3. liberalisation of the financial account of the balance of payments and FDI
4. relaxing/liberalising exchange controls to strengthen the domestic currency
5. other measures including the removal of prohibitions and restrictions on the entry of foreign banks into the domestic market, lifting of credit ceilings, etc.

## 4.2 THE FINANCIAL MARKETS AND FDI

In chapter 2 it was shown that the financial system facilitates borrowing and lending between deficit and surplus units in an economy. As with the financial system, the economic function of financial markets (Falkena, Fourie & Kok 1995: 15-18) is also to provide channels for transferring excess funds from surplus to deficit units. To illustrate this, figure 4.1 shows the financial market as an integrated and interrelated system to permit a clearer look at its functioning:



Notes: (1) Indirect securities issued by financial intermediaries, and (2) primary securities issued by ultimate borrowers.

Source: Falkena, Fourie & Kok (1995: 8)

**Figure 4.1: The financial system/market (or the financial intermediation)**

Financial markets constitute the mechanism that links different economic units or market participants (by providing the means for surplus units to finance deficit units) either directly or indirectly through financial intermediaries. In this case, market participants in the financial markets are: borrowers (issuers of securities); lenders (buyers of securities); financial intermediaries (buyers and issuers of securities and other debt obligations); and brokers. The price set for claims or funds invested, lent out or borrowed for various periods of time is the interest rate.

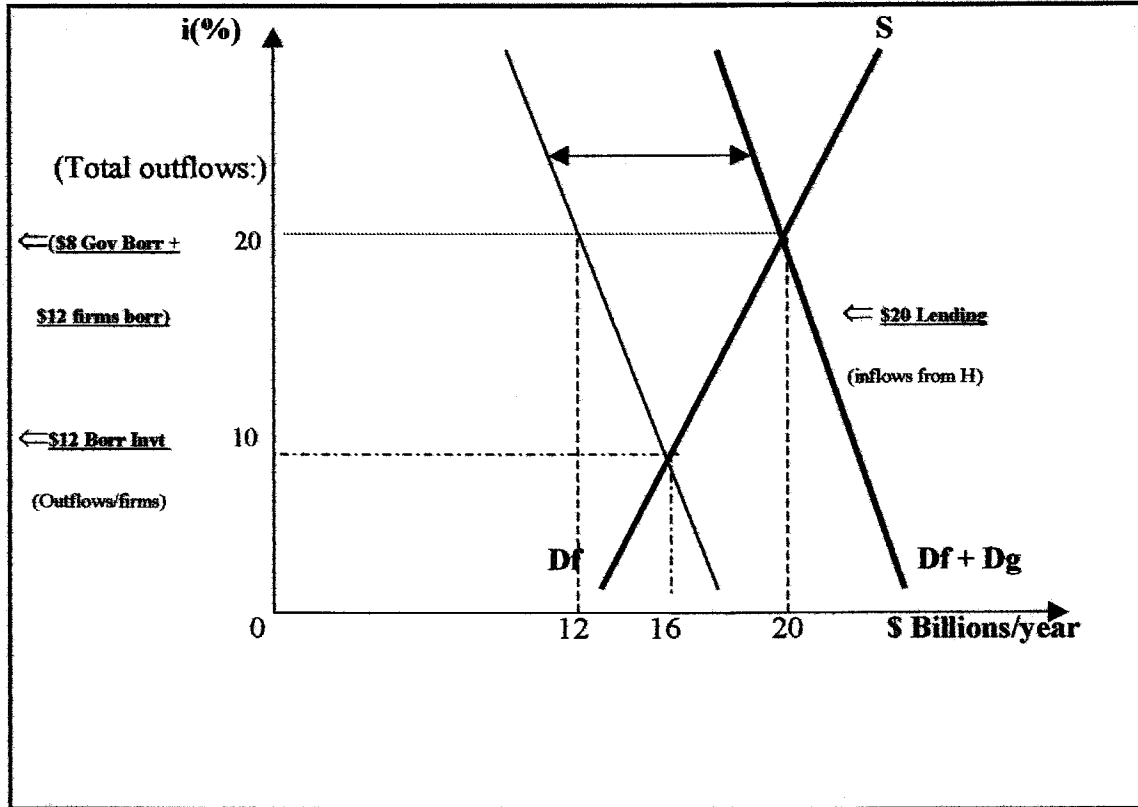
Developed financial markets foster trade and financial flows both domestically and internationally. The role of a financial market, then, is to match the savings of households with the dissaving of firms, or more generally, to match up borrowing and lending. All financial markets and other related markets are linked to international capital flows generally, in the form of FDI and FPI. The financial markets include the money and capital markets, which may be split into the primary market (for new issues/securities) and the secondary market (in which previously issued financial claims are traded). In other words, a financial market is any market where financial assets and liabilities are traded. This includes the stock exchange or stock market, the bond market and the foreign exchange market. The equity market is usually formalised in the form of stock exchanges and although it is not involved in borrowing and lending, it is nevertheless a financial market for securities. A stock exchange market is also part of the capital market and is an example of a secondary financial market where already issued shares may be exchanged many times over. New share issues (initial public offerings or ipo's) and rights issues are examples of a primary market where domestic companies and FDI-related companies can raise capital. The equity or stock exchange market as financial market should not be confused with the loanable fund or money market. Generally, the presence and sophistication of capital markets is one of the major elements that distinguish industrial from developing countries.

As regards the foreign exchange market, it is important to note that foreign borrowing and lending does not take place in such a market but in the money and capital markets concerned. Such transactions, recorded in the financial account of the balance of payments, create a derived demand for and supply of currencies in the foreign exchange market. In other words, currencies are traded in the foreign exchange market. Therefore,

the foreign exchange market may be thought of as the market that links the domestic goods, money and capital markets, and international capital flows to their foreign counterparts. The key role of the foreign exchange market for dealing with FDI should not, however, be ignored.

It should be pointed out that there is a reciprocal and positive relationship between financial markets, FDI and growth. On the one hand, FDI develops and strengthens the host country's economy by increasing its productive and export capacities, which encourages growth and employment. It therefore improves and enhances a country's formation of capital stock and GDP. Indirectly, FDI forces governments to improve their macroeconomic environment and to reform their financial markets to attract FDI. On the other hand, a good/stable or bad/unstable financial market may be a lure for or deterrent of FDI. Generally, FDI only works in countries where sound macroeconomic policies are evident, and where financial markets are developed and stable and their structures interlink coherently.

Figure 4.2 shows that the supply of loanable funds is the net lending of the household sector, and the demand for loanable funds is the net borrowing of the firms sector. Consequently, the **household sector's net lending** equals **household savings** minus **household borrowing**. Similarly, firms' net borrowing equals firms' borrowing minus firms' saving. One can thus conclude that in the loanable funds market, if government's and firms' demand for loanable funds increases, then the total demand for loanable funds curve is shifted to the right. This represents an increase in the aggregate demand for loanable funds. As a result there is a rise in the interest rates and in the quantity of loanable funds borrowed and lent. In contrast, at higher interest rates, the number of firms borrowing for investment is lower and greater international portfolio capital flows are attracted into the country (as seen in chapter 2). In other words, at the new equilibrium interest rate of 20%, households are willing to lend somewhat more and firms are willing to borrow less. The difference between the amount households are willing to lend (\$20b) at that rate (20%) and the amount firms want to borrow (\$12b) just equals the amount government needs to borrow (\$8b) to balance its budget.



**Figure 4.2: The money or loanable funds market (without the foreign sector)**

Source: Khon (1991: 27)

Notes: Demand for loanable funds (D):

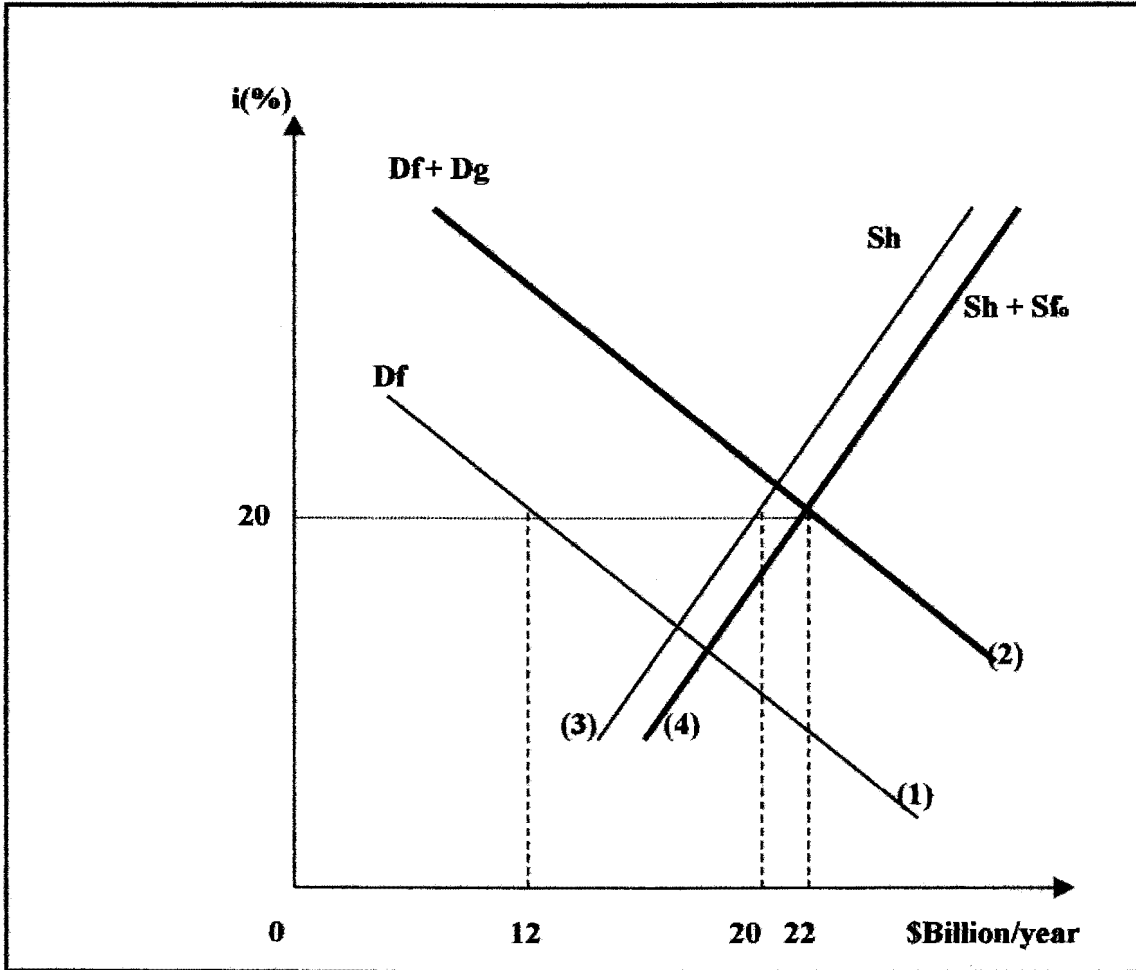
- $D_f$  for demand of firms, and  $D_g$  for demand of the government

Supply of loanable funds (S):

- Government borrowing (Gov Borr) for government borrowing, Firms borrowing for investment; (Borr Inv) for borrowing for investments.

The main emphasis of financial markets lies on the money and capital markets in intermediating short-term and long-term securities respectively (or purely financial or portfolio investment). As mentioned above, in the financial markets (which are also called the loanable funds market) the price is the interest rate. It should be noted, however, that the loanable funds market is not an equivalent term for financial markets in general. Whether these transactions take place domestically or internationally affects the level of domestic and foreign investments significantly through interest rates. The aim here is to explore the best way to manage the financial markets and their gradual liberalisation, to minimise the risks and maximise the benefits from greater foreign investments. By introducing the foreign sector into the financial market, it is possible to

analyse the effects of international capital flows (in this case, international lending) on the loanable funds market (see figure 4.3).



**Figure 4.3: The loanable funds market (including the foreign sector)**

Source: Kohn (1991: 637)

Notes: Supply of loanable funds includes:

- $S_h$  for supply of loanable funds by households; and  $S_{fo}$  for supply of loanable funds by foreigners

Demand for loanable funds includes:

- $D_f$  for demand for loanable funds by firms; and  $D_f + D_g$  for the total demand for loanable funds by firms and government

In an open economy the total supply of loanable funds is the supply from households plus the net supply from foreigners. The aggregate demand is the demand by firms to finance FDI and domestic investments plus the demand by government to finance its balance of payments or budget deficits. According to figure 4.2, one has the following: at the equilibrium interest rate of 20%, firms borrow \$12 billion a year, government borrows \$10 billion, households lend \$20 billion and foreigners lend \$2 billion a year. The figure

stresses the importance of international capital flows for deficit countries which thus have to have recourse to the international financial market to compensate for their insufficiencies.

The openness or liberalisation of a financial market may be very costly and could be associated with serious financial crises if macroeconomic stability does not exist. The openness of such a system may, in fact, be dangerous if liberalisation of the financial account of the balance of payments occurs before the host country's financial market has been duly structured and strengthened. Besides this, a healthy macroeconomic environment and economic growth are crucial to the development of a viable financial market (and, particularly, a sound banking system). From this it is evident that financial markets connect different market participants, by channelling domestic and foreign savings from surplus to deficit units. Furthermore, in the financial market banks are the core players who finance economic activities, intermediate transactions and operate clearing and payment systems in the money and foreign exchange markets. Banks also borrow by assuring savers that their deposits are liquid and secure, since through the savers' deposits banks can make credits or funds available to finance borrowers' or investors' productive projects (mainly FDI and domestic investments).

On the other hand, the banking system is the main vehicle for transmitting monetary policy measures and intermediating financial resources in the financial market where a central bank's mission is, among other things, to protect the value of the domestic currency and to combat inflation. These measures include the level of market interest rates, the stock of liquidity, inflation targeting policy and other measures related to overall economic activity and prices. This makes the banking system the single most essential element of a sound financial market. Clearly, therefore, a healthy, well-structured financial market is a strong advantage in coping with the recent explosive growth of international capital flows. It is, in fact, considered that nowadays FDI has a larger specific weight than other kinds of capital flows in the context of international capital flows and an increasing importance for the development of developing countries. This highlights the need for sound macroeconomic policies in developing countries and for liberalisation of domestic and international financial markets, as is shown later. To liberalise these markets, significant liberal reforms should be introduced and transactions



should be freed from strict restrictions (thereby liberalising the financial account), allowing greater international capital mobility. This makes sense since deficit countries with limited savings strive for and should be allowed to attract international financing and FDI; this should, however, be channelled to higher productive domestic investment projects to encourage faster growth and higher living standards in those countries.

FDI has been the largest component of international capital flows into developing countries and is therefore an important factor in growth and development for developing countries, particularly deficit countries. Virtually all financial flows in the financial markets are intermediated by financial intermediaries. These flows are either domestic from domestic savers, or international capital flows from foreign savers. Therefore, international capital inflows and outflows have a substantial impact on the financial market since they represent financial resources into and/or out of a country.

As noted in chapter 3, the first effects of FDI on an economy are seen in the financial market through the balance of payments (including financial and current accounts, and official reserves). Therefore, fluctuations in international capital flows may be either beneficial or problematic for a country, depending on how its financial/banking system is structured and whether or not it is sound enough to respond to them. However, the main point of this section is that international capital flows, particularly FDI inflows, must be matched by a stable macroeconomic environment, which determines and conditions the mobility of flows into a country. However, the same holds true for international capital outflows, such as FDI outflows or investments abroad or capital flights: the stronger the macroeconomic environment, the more likely it is that a country will cope with the effects. Finally, it should be emphasised that there is a positive link between financial markets, FDI and economic growth. When countries record high growth with low rates of inflation and current account surpluses is good, this high growth in the economy is primarily due to the high growth rate of real (private) fixed investment resulting from FDI under an inward-looking import substitution strategy. Any real appreciation of the currency as a result of this strategy could help to finance imports of raw materials and intermediate goods for domestic industry but without damaging or stagnating exports. On the other hand, the positive impact of financial reforms on the investment climate enables

countries to reduce the problems related to financial markets imperfections and make it more attractive to foreign investments.

### **4.3 THE FINANCIAL MARKETS AND THE NEED FOR STRUCTURAL REFORMS IN DEVELOPING COUNTRIES**

Financial reforms and development are lengthy processes which involve the development of trust and policy credibility, complex institutions and complicated governance procedures (World Bank 2000: 165). A well-functioning financial market is essential for economic development. As pointed out in the previous section, this is because it intermediates between savers and borrowers and is therefore better able to mobilise domestic and foreign funds and channel them into the domestic economy. In so doing, the financial market facilitates competition between domestic and foreign market participants, better allocation of resources, market integration and, eventually, poverty reduction. A repressed or distorted financial system or market normally fails to mobilise capital adequately and cannot steer domestic or foreign investments to areas of prospective growth. Because of the great distortions existing in developing countries' economies, their financial markets need to be reformed so that these economies can be adjusted by government authorities. However, the World Bank (2000: 162) suggests that the scope and pace of reforms may differ across countries worldwide, and reforms should essentially be based on two main pillars: liberalisation and balance sheet restructuring. Thus the main structural measures or reforms to be introduced in financial markets in order to attract more international capital flows include the following:

#### **4.3.1 LIBERALISATION OF FINANCIAL MARKETS**

The liberalisation of a financial market is expected to promote and encourage financial deepening with an immediate and positive effect on savings and credit allocation. This section features points that are discussed in subsequent sections (see, in particular, section 4.5). However, in view of the importance of liberalisation, it is developed here by suggesting wider aspects of structural adjustment and reforms. These reforms include:

1. A liberalised, revised and updated Central Bank Act, including a bill related to the

functioning of the entire banking system (banks, merchant banks, securities firms and insurance companies). These instruments should also envisage allowing licences to be granted to new, capable, private banks – including foreign banks and brokerage houses – and non-bank financial institutions. On this basis, efforts should be made to continually improve and update regulations and supervisions.

2. Simultaneously, borrowing and lending activities overseas should be closely monitored to ensure that practitioners are solvent and sound so as to prevent negative consequences in the country's foreign indebtedness. Deposits with overseas branches by domestic banks should, for example, be carefully scrutinised and allowed only if they do not represent a capital flight or disturbances in official reserves or, indeed, a danger to the whole economy.
3. The management of the central bank's official reserves should be strictly controlled and if necessary reviewed with the intention of meeting the IMF's international standards and practices.
4. The financial market should be created and enlarged, the money and credit markets (including interest rates) should be liberalised and ceilings and other controls on credit allocation removed.
5. Corporate financial statements should be prepared in accordance with the law on a consolidated basis and certified by well-known international auditors in order to impose transparency in enterprise management. Accounting standards and disclosure rules should therefore be strengthened to meet acceptable international practices.
6. Any troubled or insolvent financial institution should be closed, or if it has any viability it should be restructured and recapitalised. A privatisation programme to measure M&As by domestic or foreign institutions should also be envisaged since these steps do not endanger the economy by challenging the sovereignty of the country.
7. Legislation should be introduced regarding support, other than protectionism, to financial institutions, based on pre-established rules and transparent records. Legislation should also encourage these institutions to improve their risk assessment and pricing procedures, and encompass loans recovery and deposit insurance schemes according to prudential standards.

### **4.3.2 BALANCE SHEET RESTRUCTURING**

The balance sheet is an accounting statement and lists the assets, which the banks own, and sets these against the balancing liabilities (obligations or claims) of the creditors who provided the funds to acquire the assets. Balance sheet restructuring and the privatisation and recapitalisation of state banks are often among the first steps in financial reforms. This is because of the highly visible presence of state banks in developing countries, many of which are flawed by various imperfections and by a pervasive lack of transparency. This is mainly the case in countries that were formerly socialist in orientation or whose economies were centrally planned, and that were characterised by state monopoly of the economy and the banking system. Under their new orientation, these countries should endeavour to increase private participation in banks to improve the quality of products and services offered and ensure transparency in their management, with the aim of increasing the level of aggregate investment in the sector concerned. Privatisation of financial institutions usually begins with governments seeking strategic partners to assume majority or partial ownership of large commercial banks to facilitate capital flows into the domestic economy (World Bank 2000: 162).

Other restructuring or structural measures directed at the financial market include the introduction and improvement of stock markets, and the entry of non-governmental organisations (NGOs) and other agents to the semiformal or micro-finance sectors. To summarise, the main financial reforms that ensure stability in developing countries and capture the benefits of integration into world capital markets comprise four key components, as follows (World Bank 1999b: 69-70):

1. Developing countries need to strengthen banking regulations and, where possible, build complementary, well-regulated stock or securities markets.
2. While banking regulations are being strengthened, policies should be directed towards reducing the demand for – and volatility of – short-term foreign borrowing.
3. Greater international cooperation in setting and implementing fiscal, monetary, and exchange rate policies should be considered.

4. Long-term foreign investment or FDI should be attracted by cultivating a growth-oriented economic environment – including investing in human capital, allowing domestic markets to work without unnecessary distortion, and committing to a strong regime of investors’ rights and obligation – and not by offering excessive subsidies or other inducements.

These reforms are very closely linked with the issue of international capital flows, mainly in the form of FDI, which provide developing countries with benefits such as public sector infrastructure projects while the need for government and domestic savers to serve as the sole sources of financing of the domestic economy falls away. In the private sphere the benefits of long-term foreign investment or FDI begin with the expansion of the host country’s capital stock and production.

Other benefits from financial reforms are related to the activities of MNCs, which enhance competition and impel the crowding in of domestic investors of the host countries. As many economists have pointed out, FDI has a more profound impact on growth in developing countries which pursue export promoting policies than in countries that follow import substitution policies.

However, many economists still dispute the hoped for benefits of FDI and point to the potential disadvantages thereof. Such economists also argue against the use of macroeconomic policies simply to satisfy the demands of foreign investors, and say that policy should be devised primarily with domestic considerations such as growth and employment in mind. But others argue that FDI brings about more benefits than harm to developing countries that have undertaken specific reforms in their financial markets and in financial account liberalisation.

While on the topic of financial market reforms, it is important to distinguish between the various requirements of FDI. First, reforms in the financial markets allow for greater FDI in developing countries enabling them to reach higher levels of aggregate output, development and growth in an attractive and healthy macroeconomic environment, including a balanced balance of payments and attractively low interest rates. Also, reforms in the financial market, including stock market reforms, allow foreign investments to flow into countries provided that good economic fundamentals are in

place, the market for stocks is stable and the interest rate is relatively high to attract purely financial or portfolio flows. However, high interest rates may attract greater investment in interest yielding assets such as treasury bills and bonds, but may discourage FPI in domestic equities.

Countries can also attract FDI by developing stock markets. This means that developing countries should strengthen their banking systems and regulations and build complementary, well-regulated stock markets. This would help them benefit from domestic financial liberalisation, and it is justified because many policies for reducing volatility in the banking system can also help reduce volatility in domestic bourses. Examples of some strong developing and emerging countries in this area are Hong Kong, South Korea, Indonesia, Malaysia, South Africa and Brazil.

#### **4.3.3 THE DISTINCTION BETWEEN FDI AND FPI IN FINANCIAL MARKETS**

As pointed out above, the development of stock markets may provide an alternative funding source for investments. Although FPI is very volatile and does not offer the same opportunities for technology transfer and increased competition as FDI, it can also be very useful to developing countries, despite its potential disadvantages. FPI can be encouraged by opening stock markets to foreign participation, which increases capital inflows (as FDI and FPI) and market liquidity by deepening the pool of buyers and sellers, making the market a more attractive source of equity financing.

As a stock market develops and strengthens, it benefits other parts of the financial market as well as the wider economy through FDI involvement in the economy and by accompanying stock market purchases (World Bank 2000: 84). The liberalisation of the financial account of the balance of payments therefore tends to benefit FDI and FPI inflows. The latter are experienced in the domain of the stock market and when interest rates are very attractive. This is because FPI is mediated through financial markets and is highly sensitive to changes in interest rates and in the investment environment, which may come from factors that may be internal or external to the recipient countries. FPI is more liquid than FDI and can be easily withdrawn through financial markets.

On the other hand, FDI can also be attracted into developing economies by well-developed, strengthened capital or stock markets linked to developed banking systems.

FDI is made in recipient countries through the establishment of production lines, which are difficult to dissolve in a short time. Therefore, in the case of FDI, disinvestment or reversibility is much more difficult than in the case of FPI. It would, for instance, be difficult for an MNC to disinvest and sell its foreign affiliate, especially if it were intertwined in its international production network.

Healthy, developed financial markets have a strong positive relationship with international capital inflows. This in turn brings about more market liquidity which, together with market stability, is one of the most important preconditions for FDI and FPI inflows and, therefore, for economic growth. Global interest rates are not very significant in explaining FDI flows, which have been the largest component of private flows to developing countries, but are much more important as regards FPI flows. FPI is quite susceptible to cyclical or temporary factors (at the international level versus structural factors or country-specific factors at the country level), including changes in interest rates.

FPI flows are also very responsive to stable financial markets (money and capital markets, and foreign exchange and stock or equity markets) and to variables such as interest rates, the price set for claims or funds invested, lent out or borrowed for some time. As with FDI flows, FPI flows can be assumed to be inflows *or* outflows of capital. Under a liberalised financial market or financial account liberalisation, FDI and FPI inflows and outflows represent investments in direct enterprises and portfolio equities in a host country and abroad respectively. As was shown, FPI is related to the financial sector. It makes a considerable macroeconomic impact on the economy as it helps strengthen the financial infrastructure or sector, and is a source of financing expansion in economic activities. Countries with strong economic fundamentals, such as a high investment-to-GDP ratio, low inflation, growth, low real exchange rate variability and a developed financial market – factors that affect the long-term rates of return to investors – have received the largest FDI and FPI as a proportion of domestic GDP. At the other end of the spectrum are the countries with very weak fundamentals that have not attracted international private capital flows at all (World Bank 1997: 85). A further point is that financial markets develop best in the presence of legal codes of conduct that stress the rights of shareholders and a regulatory framework that encourages the disclosure of

corporate information. Accurate information from independent sources makes an emerging market more attractive to foreign equity investors and increases the stability of the capital market, which reduces volatility in the financial markets for portfolio equity flows (World Bank 1999b: 84).

Therefore, to avoid volatility or financial crises and their negative impact on the domestic currency, countervailing measures that may be taken include the reduction of non-performing assets and a restriction of widespread free movements of short-term funds (mainly of FPI) in response to interest rate differentials. On the other hand, massive capital inflows (or cash in foreign exchange) may be problematic and should therefore be carefully monitored to restrain speculative activities. All this stresses the need for more regulations on the use of funds by the banking system and other market participants for real estate and other speculative purposes.

#### **4.4 MAIN IMPEDIMENTS TO MANAGEMENT OF FINANCIAL MARKETS, INTERNATIONAL CAPITAL FLOWS AND PUBLIC FUNDS IN DEVELOPING COUNTRIES**

The main impediments to sound management of financial markets, international capital inflows and public funds in developing countries have come under a great deal of discussion. Their removal or alleviation has been due to the role of international institutions like the IMF, World Bank and WTO, which have pressurised developing countries to combat corruption, and to improve and increase good governance and transparency. These impediments are both exogenous or objective on the one hand, and endogenous or subjective, on the other hand. Exogenous, objective factors relate to external factors originating from outside the country concerned, such as inducements to make commitments that may endanger the management of foreign and public funds. Endogenous, subjective factors relate to malpractices in the management of financial markets and public funds that are seen to stem from the leaders' behaviour rather from the lack of a precise or coherent government programme. According to the World Bank (2000: 164-165), the main factors that have contributed to the failure of economic and financial reforms are the following.



#### **4.4.1 INCORRECT SEQUENCING**

Financial reforms have often preceded macroeconomic reforms and stabilisation. Often interest rates were liberalised before fiscal deficits were brought under control. If it is assumed that fiscal deficit is a macroeconomic indicator that depends on other variables such as interest rates, the level of aggregate output and aggregate demand, etc., then it should be understood that these measures should be put in place first. Otherwise, higher interest rates can increase government debt, crowd out private credits or investments and contribute to further macroeconomic imbalances as well as reduce banks' incentives for new clients. For example, since the late 1990s and early 2000s Zimbabwe's domestic public debt has been high and political and economic conditions in the country have become progressively unstable. This has led to the collapse of the financial system necessitating gradual policy reversals that have undermined its credibility.

#### **4.4.2 INCOMPLETE REFORMS**

Lack of progress on certain reforms exists because the governments of some developing countries have not been sufficiently coherent with their reform programmes and recapitalisation of companies and banks are not sufficient. For example, many countries' financial markets are used to finance public activities and insolvent corporations. This is the case with the least developing countries such as Angola and Mozambique, whose financial systems have not undergone substantial reform and are not developed. These governments may, for instance, maintain insolvent industries and public corporations for "social" purposes such as satisfying employment or populist policies, although the impact on public finances is ultimately negatively. This may then culminate in a chronic budget deficit which the government finances by means of public funds or borrowings from central banks, which further aggravates the overall economic situation.

#### **4.4.3 WEAK INSTITUTIONS**

Developing countries are, almost by definition, underdeveloped and weak economically and financially. Therefore, their financial institutions are also very weak and require support from international multilateral institutions.

#### **4.4.4 FOCUS ON NATIONALISM**

Some monetary zones base their reforms on small national systems, which turn out not to be sufficiently consistent. As their markets are very small, this makes diversification of transactions difficult, along with higher costs of supervision and other overheads that raise the cost of capital.

#### **4.4.5 MACROECONOMIC RISKS**

These reflect poor coordination between fiscal and monetary policies. This means, for example, that if tight monetary policy is maintained in the face of loose fiscal policy, interest rates are likely to rise to unhealthy levels. Therefore, banks will retreat from developing new business in favour of holding public debt. Thus, for example, high perceived macroeconomic risks can be inferred from the short-term maturities at which most African governments borrow.

#### **4.4.6 MARKET RISKS**

Market risks normally arise from capital market insufficiency, which has been the main feature of the capital markets of developing countries (with the exception of the emerging markets of the “Asian tigers”, Russia, South Africa, Brazil, Argentina, Mexico, Chile and Venezuela). Most developing countries lack a secondary market for (already) issued shares, which restricts liquidity and increases the risks and costs of borrowing;

#### **4.4.7 MICROECONOMIC RISKS**

These are due to government policy and have a profound impact on capital costs for private sector companies. The accuracy and reliability of financial information, including company accounts, may have a positive effect on the cost of capital, particularly in equity markets. This includes the legal system that enforces financial contracts. If the legal system or framework does not exist or is weak, this may increase the cost of capital and limit access to finance.

#### **4.4.8 FLAWS IN THE PAYMENT SYSTEM**

A payment system that does not allow rapid and reliable transfer of funds for settlement of financial transactions also increases the cost of capital. Therefore, a system for title transfer that is slow or insecure increases the cost of capital raised through debt securities

by reducing transactional liquidity in the secondary market or by causing a risk premium to be built into secondary market rates.

#### **4.4.9 OTHER FACTORS**

Apart from the above considerations, other factors that have contributed to the poor performance or failure of the economies or financial markets of developing countries as regards international capital flows are:

- Lack of definition in structural adjustment programmes and the absence of institutional structures to assure the accomplishment of the reforms
- Mismanagement of the economy and a dearth of human capital in the financial sectors
- Considerable government and political interference in the execution of the economic and financial programmes, and a weak regulatory framework
- Shaky banking system and thin financial markets
- Weak leadership and lack of political willingness and strategy to bring about crucial changes
- Unstable and a multiplicity of foreign exchange rates, flaws in the regulatory framework, undisciplined market-participants with their negative impact on the economy, mainly in speculative practices
- General political instability and (in some developing countries) the permanent war factor
- Low pace of privatisation and the absence of transparency in the treatment of public finances and trade transactions, translating into bribery and the absence of open competition
- High level of financial fraud and corruption in the state's administration and in state corporations, which diverts large amounts of money away from the official or state circuit.

#### **4.5 FDI INFLOWS AND THE LIBERALISATION OF FINANCIAL MARKETS AND THE FINANCIAL ACCOUNT OF THE BALANCE OF PAYMENTS**

The explosive growth of international financial transactions and international capital flows is one of the most profound and far-reaching economic developments of the late 20th and 21st centuries. These developments have several origins, as follows (IMF 1998: 1):

- The removal or relaxation of statutory restrictions on financial account transactions
- Macroeconomic stabilisation and policy reforms in developing countries, which created a sufficiently attractive economic environment for foreign capital flows
- Privatisation of companies in host countries
- Multilateralisation of trade, which encouraged FDI and international financial transactions designed to hedge exposure to currency and commercial risks
- Growth of derivative instruments, which has permitted international investors to assume some risks while limiting their exposure to others
- Innovation and advances in technology, particularly information and communications technologies, which facilitated financial services worldwide with far-reaching positive results.

All this reflects the main steps taken towards liberalising financial markets and the financial account of the balance of payments, which has triggered increasing international capital mobility. Restrictions on international financial transactions have been relaxed or removed, resulting in the explosive growth of international capital flows, mainly FDI. Additionally, regulations constraining the operation of domestic financial markets have also been relaxed or removed as countries have moved away from repressive financial policies.

As explained in heading 4.2, liberalisation of the financial markets and the financial account of the balance of payments should be carried out carefully due to the risks

involved. One of these is that liberalisation may produce vulnerability or volatility in the economy and consequently in the financial markets. Therefore, good economic fundamentals are needed to sustain the whole process, since international capital flows are very volatile, particularly short-term FPI flows. Nowadays, due to globalisation, domestic and international financial liberalisation is an imperative to facilitate and improve capital mobility. It is carried out by intensifying competition in the financial sector and removing protection of intermediaries from the consequences of bad loans and bad management practices. Robust, prudent supervision and regulation in an appropriately stable macroeconomic environment should support this liberalisation.

Liberalisation of the financial markets means freedom of competition between financial institutions and the removal of protectionism and discrimination. However, financial account liberalisation also means the freeing of transactions from rigid restrictions that can make it difficult for capital flows to move freely into or out of a country. Lee (1997: 3) states that a surge in international capital inflows should coincide with the following:

1. Faster trade and financial liberalisation, particularly with a shift to allowing foreigners to acquire domestic stocks and bonds
2. Lower taxes on investment in order to stimulate a surge of FDI (by non-residents)
3. Higher interest rates to stimulate capital inflows in the form of FPI leading to a wide differential in favour of the domestic market
4. Expectations of foreign exchange appreciation or a stable foreign exchange pattern. (Appreciation of the host country's currency is, however, a two-edged sword. Thus repatriated profits will be higher when translated into the source country's currency, but if FDI is geared towards exports from the host country, the appreciation will, at least temporarily, reduce the competitiveness thereof.)

Many economists agree that the soundness and credibility of a financial market can be supported by assurances that the domestic government debt portfolio is being managed prudently and efficiently, and that there is a regulatory framework to protect investors' rights. Hence, liberalising the financial market and concomitantly the financial account of the balance of payments is a good step in the direction of attracting more foreign

investment, mainly FDI. According to Singh (1999: 184-185), additional structural measures a country could apply in aiming at liberalising and attracting capital flows (particularly FDI) are:

1. Trade liberalisation, based on the elimination of trade-related subsidies, restrictive import licensing and centralised state import programmes. It should be noted that in the past, MNCs would sometimes establish operations in a host country to avoid high tariffs and other barriers to their exports to the host country's domestic market. However, if the purpose of the FDI is for export rather than supplying the domestic market, then lower trade barriers would help. There are two main reasons why FDI affects development through trade:
  - a) Trade has traditionally been the principal vehicle linking countries and consequently national economies worldwide.
  - b) Due to the close and growing interrelationship between investment and trade, one of these cannot be addressed without the other. Thus, the process of trade liberalisation should take into account its impact on FDI and vice versa.
2. Liberalisation of the financial account of the balance of payments (the old capital account) is based on the following important steps:
  - a) Because restrictions in developing countries have been extensive, in many instances tantamount to a specified level of protectionism, liberalisation could be effected by reducing restrictions on FDI in the equity market by increasing the ceiling on aggregate ownership (say, for instance to 49% or 51%). It could also be achieved by the establishment of individual ownership (say, for instance between 10% and 20%). On the other hand, foreign investors normally purchase securities or domestic money market instruments, which include treasury bills, negotiable certificates of deposits, government stocks and bankers' acceptances in the domestic money and corporate bond market, under the control of the central banks.
  - b) Permitting foreign banks to purchase equities in domestic banks at a defined percentage limit so as to avoid dominant positions. These operations should be carried out under harmonised legislation and supervision, provided that these

purchases contribute to the efficiency and soundness of the financial and banking system. This would mean a better image and improved creditworthiness, and would prompt an increase in capital inflows into the country.

c) Borrowings by domestic corporations either domestically or internationally should also be liberalised with the proviso that these transactions be supervised by a central bank. Credits into the economy should be carefully planned and injected, and should be regulated by the monetary authorities in accordance with monetary policy owing to their impact on inflation and foreign and public debt supervision by the central bank of domestic commercial banks should be permanent and, on some occasions, reinforced. Credits into the economy are usually needed to expand the economy, but these operations should not represent any danger to the domestic economy or its financial market regarding its foreign debt providing that there is liquidity. Thus, liberalising the domestic banking system or opening it fully to capital inflows and outflows should take place only after the entire system, or important parts of it, are stable and solvent. The removal of excessive prohibitions or restrictions on the entry of foreign financial institutions should also be considered.

d) The procedures and assessment of FDI and other investments should be simplified by reducing restrictions on investments. This may be done by easing laws and creating incentives. Specific examples of laws or restrictions that have or can be eased may be drawn from Mexico in Latin America and Malaysia in Asia. In these emerging markets there is freedom of entry and no investment ceiling as regards FDI, and the repatriation of income and principal is free from restrictions on foreign exchange movements. However, some registration procedures are required to ensure repatriation rights on freedom of entry, while registration or authorisation is required on restrictions on foreign exchange movements related to capital outflow (Singh 1999: 187).

The liberalisation of the financial market should be carried out both domestically and externally. But it must be pointed out again that liberalising the financial account requires a stable, well-developed financial system to avoid serious economic distortions and financial problems. The domestic financial market should thus be developed and

strengthened, and international financial stability should be promoted by institutions such as the World Bank and IMF. South Africa is a good example of a strengthened domestic financial market. Its financial system is one of the deepest and the most sophisticated outside the OECD countries (World Bank 2000: 161) and as a result South Africa weathered the contagion from the emerging market crises of the 1990s without being harmed by it. This resulted in a substantial increase in foreign investment, particularly FDI.

The liberalisation of the financial account should therefore be conducted in an orderly, well-sequenced way and accompanied by appropriate, sound macroeconomic policies (including monetary, fiscal and exchange rate policies). Normally, foreign investors assess a country's investment climate not only in terms of FDI policies *per se*, but also in terms of macroeconomic and macro-organisational policies. Greater transparency and disclosure of timely financial and economic information data will influence this assessment positively.

This chapter also suggests that the financial market should perform functions such as adequate mobilisation of domestic and international savings into the country and efficient intermediation of financial flows particularly with regard to the allocation of resources to productive uses from surplus units to deficit units, i.e. from savers to borrowers (or investors). It should be assumed that other basic premises for liberalising the financial market are the following:

- The independence of central banks and their accountability, and the legal framework of the banking system, should be strengthened, aiming at better supervision. Additionally, state-owned commercial banks should be able to set their own interest rates and should be encouraged to mobilise deposits from the public and foreign sectors. This should be at the levels at which banks think these operations are feasible for particular projects, aiming at attracting capital flows from the public and abroad.
- The banking system should be liberalised by removing most restrictions on the entry of foreign banks into the domestic banking system, thereby encouraging more foreign funds into the country; and by the establishment of branches of domestic



banks either in the domestic market or abroad where this is possible.

- Credit ceilings as a means of monetary control should be abolished or eased, since this eliminates restrictions on capital inflows as necessary resources needed to finance diverse projects in the economy. But sometimes there is a need for the introduction of indirect capital control measures (indirect monetary instruments). These measures may include variable deposit requirements to discourage excessive capital inflows/outflows, and interest equalisation taxes so as to reduce distortions and regulate and level inflows and outflows of capital (Lee 1997: 9-13).
- In deepening, broadening and establishing a well-developed financial market, the central bank should control (reduce/increase) the injections of liquidity into the market through its liquidity credit system.
- Institutions responsible for the general regulation and supervision of the banking system should be established and existing institutions strengthened.
- The rehabilitation of commercial banks and loans recovery should be improved and banks and non-bank financial institutions should be allowed to raise equity capital in the stock markets. Although most banks in emerging markets already do this and are listed on stock exchanges, in the majority of developing countries this question still remains very worrying for governments, because they are still struggling to create and develop stock markets and strengthen their financial markets.
- The banking system should be opened to fair competition both domestically and internationally, and the process of privatising state commercial banks in some developing countries should be promoted. This would, increase FDI inflows in the form, for example, of M&As. This should be carried out according to the best international practices in bank management. It should also be emphasised, however, that in most emerging markets commercial banks are private.

#### **4.5.1 THE CONSEQUENCES OF EASING EXCHANGE CONTROLS**

It is important to recall that the 1990s were characterised by a generalised floating exchange rate system with a general single foreign exchange rate and the liberalisation of

financial account transactions. The liberalisation of financial account transactions involves substantial changes towards different types of private capital inflows, such as FDI, FPI (foreign bond and equity investment) and loans (short and long-term borrowing from abroad as regards individuals, corporates, banks, and investors) in the financial markets. Examples of liberalisation specific to FDI are:

- Greater freedom in selecting international locations, reaching decisions, choosing the mode for serving each market and meeting functional needs
- The increasing ability of MNCs, through FDI, to fine-tune and differentiate their combinations of international modes (trade, joint-ventures, non-equity alliance, licensing, etc.) to suit each activity and location
- As a result of privatisation, greater scope for worldwide expansion of international production and finance.

Additionally, between 1991 and 2000 FDI liberalisation continued to increase and 1 185 regulatory changes were introduced in national FDI regimes, of which 1 121 were directed towards creating a more favourable environment for FDI. During 2000 alone, 150 regulatory changes were made by 69 countries, 147 (98%) of which were more favourable to FDI (UNCTAD 2001a: 6). Examples of liberalisation specific to FPI include:

- changes (openness) in the stock markets
- free entry for foreign investors
- liberal tax concessions
- benefits such as high return on their investments
- privatisation of public sector companies (an important component of structural adjustment programmes).

As pointed out previously, developing countries differ substantially in the nature of their legal institutions, corporate governance practices, banking regulations, capital market

development and sustainability of their macroeconomic environments. This rules out the possibility of a unique recipe or formula of financial account liberalisation for them.

Thus, as mentioned above, the liberalisation of the financial account of the balance of payments is defined as freedom from prohibitions on transactions in its financial account. This generally refers to the issue of exchange control regulations and whether the relaxation of such controls is beneficial to a specific country. Falkena et al (1995: 422-423) define exchange controls as officially regulating matters such as the purposes for which foreign exchange may be acquired by residents; the terms and conditions on which it may be acquired; the terms and conditions on which foreign exchange or foreign currency assets may be held by residents; and the terms and conditions on which non-residents' holdings of domestic currency and the proceeds of sales of domestic currency assets may be transferred out of the country.

On the other hand, current account convertibility is defined under Article VIII of the IMF's Articles of Agreement as freedom from restrictions on the making of payments and transfers for current or capital international transactions. This Article does not proscribe the imposition of restrictions, such as import tariffs and taxes, on the underlying transactions. Financial account convertibility is taken here to mean the removal of exchange and other controls but not necessarily all tax-like instruments imposed on the underlying transaction, which market participants retain the option of undertaking (IMF 1998: 2-3).

As a direct control measure, exchange control regulations such as those mentioned above obviously serve the purpose of disciplining or limiting the demand for foreign exchange or increasing the supply, mostly with a view to protecting the official foreign reserves and the exchange rate. This is done by direct and indirect controls. Direct controls affect the undertaking of forward cover. For instance, if general expectations point to a depreciation of the domestic currency, this may result in exporters not covering forward as the domestic currency will be expected to depreciate by more than the forward foreign exchange (let us call it the US dollar) premium. This will lead to a shortage of forward dollars as importers will have been covering forward, i.e. demanding forward dollars, and there will have been few forward dollars supplied by exporters covering forward.

Because of this, central banks in developing countries often make it compulsory for exporters to forward cover their foreign exchange receipts. Direct controls may keep a certain amount of previous capital inflows in the country, but they discourage the injection of future international capital inflows into the country (Correia, Flynn, Uliana & Wormald 1996: 778). In some countries, such regulations are also meant to help maintain a fixed or pegged exchange rate, or to support a floating exchange rate when other instruments of monetary and fiscal policies (related to the management of domestic monetary supply and demand) fail.

Sometimes, however, exchange controls should be relaxed. They are, in fact, a valuable instrument of monetary policy in regulating foreign trade and other transactions on the current and financial accounts. For instance, if there were no restrictions on foreign trade and other transactions, it would be very easy for a firm to hide its capital movements, which would reflect negatively on the balance of payments. In this respect Correia et al (1996: 777) suggest that if there were no restrictions on the current account and on financial account transactions it would be very difficult for the exchange control authorities to control activities such as:

- over-pricing imports and under-pricing exports
- MNCs' charging expenses to domestic branches
- foreign-controlled companies/affiliates declaring very large dividends (to facilitate repatriation of earnings of capital on repayment of capital).

Depending on the situation in each country, restrictions on capital outflows may be eased as regards FDI and other investments abroad after they are duly approved by the exchange control authorities. The relaxation of exchange controls in many countries has opened the door for individuals to invest in offshore accounts and companies to finance approved investments abroad. Individuals and companies are now also allowed to hold foreign currency accounts at domestic banks. It is assumed that exchange controls should work in two directions, i.e. as regards both inflows and outflows of capital to balance the balance of payments.

It is important to emphasise that exchange controls, as one of the liberalising monetary policy instruments, have been seen as a clear and flagrant violation of the basic rules of market-oriented philosophies (in terms of which all decisions are made by market participants – individuals, households and firms – with no government intervention), or of the mixed market economy (where financial and economic decisions are made partly through the market and partly by government, the degree of development varying from country to country). Although nowadays exchange controls are still widespread, it is also important to stress that exchange control systems were mainly the regular and common characteristic of economies in wartime conditions, such as food rationing systems, price controls, physical import controls, export controls, etc.

#### **4.6 IS LIBERALISATION OF EXCHANGE CONTROLS BENEFICIAL TO THE COUNTRIES CONCERNED?**

Generally, increasing financial ties between countries, especially between industrial and developing countries, have been associated with liberalisation of both international and domestic financial markets, and these with the rapid growth of international capital flows, production and trade. Thus the remarkable growth of cross-border FDI, such as M&As and greenfield investment, has been due, in part, to fewer impediments to capital movements and to the general trends in internationalisation of production and finance. However, in a significant number of cases, financial market liberalisation seems to have been associated with poor macroeconomic stability and an inadequate regulatory framework, and with costly financial crises such as those in the emerging markets between 1997 and 1999. These crises occurred in the less as well as the more liberalised financial markets. Nevertheless, there have also been many cases in which the liberalisation of the financial markets and the financial account has played a positive and meaningful role in crises. According to the IMF (1998: 1), this raises a serious question about whether and under what conditions this liberalisation is beneficial or harmful to the countries concerned. Liberalisation is undoubtedly inevitable for all countries wishing to participate in and benefit from international trade, unless a country attempts to suppress a

“danger” of some kind by applying draconian financial repression, which in fact makes the situation worse.

The best remedy in certain adverse economic and financial situations is to combine healthy macroeconomic policies to contain aggregate financial imbalances with sound, prudent policies to ensure adequate private incentives for risk management. This combination should be backed up by adequate supervision and regulation of the financial sector. With this premise in mind, liberalisation of financial markets and of the financial account of the balance of payments is not only inevitable but also beneficial for the countries concerned and helps increase net inflows of foreign capital. One important finding is that, under liberalisation, capital controls have a significant impact on macroeconomic policies and results. But a potential negative macroeconomic effect of removing capital controls lies in the danger of liberalising the financial account before the domestic financial market has been suitably strengthened, which can provoke volatility in the financial market and in capital flows. Such a situation may lead to the development of a serious economic and financial crisis. On the other hand, capital controls are usually imposed to support stability and, at least temporarily, policies that would be unsustainable under free capital mobility. However, the relaxation of exchange controls does not appear to have led to noticeable improvement in FDI or portfolio equity inflows in some countries where these were not combined with other adequate macroeconomic policies, such as appropriate monetary and fiscal policies (including attractive interest rates and other incentives), market stability, etc.

On the other hand, because of the remarkable progress in information technology and by reducing transactions costs, international capital flows have been encouraged into developing countries. International capital flows have been attracted differently by the individual circumstances of the economies of the developing countries concerned. An important development is the combination of the liberalisation of financial markets with the explosive growth of international capital flows, particularly FDI, translated into cross-border M&As (or borrowing and lending). According to the explanations in chapter 1 and in the above sections, FDI has been the most pronounced capital flow and has been attracted into developing countries under a stable macroeconomic environment, where foreign investment laws are liberalised and investors' rights are protected and respected.

The liberalisation of the financial account is also associated with higher domestic investment supported by FDI operations related to MNCs because there are relatively strong positive links between liberalisation of the economy and private investment. Liberalisation when well sequenced helps to deepen domestic financial markets, particularly for portfolio flows.

In a liberalised economy, FDI flows are very sensitive and responsive to business-friendly and macroeconomic stability conditions. Under the liberalisation of the financial markets and the liberalisation of the financial account, FDI flows can be either capital inflows or capital outflows. FDI flows are capital inflows or liabilities if the direct investment is from abroad and made by foreigners, and capital outflows or assets if the direct investment is made overseas from residents of a specific country. FDI is also more responsive to low interest rates since foreign investors can also borrow from local or domestic financial markets. In these markets, FDI has a significant impact at the microeconomic level and helps increase the aggregate output or GDP and growth of the host country, since FDI basically addresses productive sector needs. It also plays a significant role in market access and transfer of technology to host countries. Thus, capital account liberalisation is beneficial and can have a positive impact on the economies of host countries through the transfer of technology spillovers. These spillovers are more pronounced in the case of FDI through MNCs' incorporating new technologies in their affiliates. Since new technologies are generally conceived, developed and adapted by MNCs in industrial countries, FDI is the most efficient vehicle through which developing countries can gain access to them. However, FDI spillovers have been greater in rich countries than in poor countries where technologies are often less attuned to the needs of the economy. Therefore, open and liberalised financial markets or economies have investment ratios (to GDP) higher than those of relatively closed economies.

#### **4.7 CONCLUDING REMARKS**

This chapter has stressed the close and positive relationship between FDI and the importance of liberalising financial markets and the financial account of the balance of

payments. The increasing importance of FDI as a mechanism for development, a channel for the transfer of technology, a vehicle for growth, and a means of helping developing countries into the global economy were discussed.

The key role of financial markets as regards international capital flows (particularly FDI) was emphasised, and the need for foreign and domestic funds, and the increasing participation of the private sector in the economy were revealed in the course of this argument.

Disregarding some criticisms of liberalisation of economies, financial markets and the financial account, and of the shift towards globalisation, it was argued that this process is beneficial for developing countries because through FDI it promotes domestic investment, technology transfer spillovers and financial development. It was noted that some studies focusing on large emerging market economies have indicated that stock exchange markets become larger and more liquid after the financial account is liberalised. Liberalisation also promotes competence and the quality of goods and services, and reduces capital costs (due to progress in information technology). In addition, it triggers greater mobility of capital worldwide, mainly cross-border M&As activities, and the needed international capital inflows into developing economies for the required production expansion. It was therefore shown that the merits of liberalisation are also related to freedom of trading and competing, freedom of cooperation and integration of groups regionally and worldwide towards a single marketplace.

The chapter argued that one of the greatest merits of the liberalisation of financial markets is to provide opportunities for greater access to foreign saving. This is associated with opening the financial account of the balance of payments, which generally leads to greater international capital inflows which, if managed appropriately, trigger more investments, such as greenfield FDI, and economic growth of the countries concerned. This observation is more valid for developing countries, since the nature and impact of investment in industrial countries is likely to be much more muted because of their continuous access to financial markets and because most FDI flows involve mergers and acquisitions while in developing countries most FDI inflows involve greenfield investments.



The IMF (2001b: 170) suggests that the challenge for developing countries, therefore, is to maximise the net benefits from liberalisation of financial markets and financial accounts in the following two ways:

1. For those countries that already have significant involvement in global financial markets, the key requirement is to create institutions and a legal framework that strengthen the positive aspects of financial integration and benefits from foreign investments. This should be combined with macroeconomic policies and a sound financial system, which enable these countries to protect themselves against swings in investor sentiment.
2. For those countries which are not involved in global financial markets, financial account liberalisation should be sequenced and should remain the ultimate goal. However, the pace at which this liberalisation can be achieved varies significantly from country to country.

The chapter has shown, as well, that liberalisation of financial markets and financial account of the balance of payments has its costs. The main problems are generally associated with excessive international capital inflows and outflows, and the volatility of net capital flows. It was therefore concluded that successful financial account liberalisation requires careful sequencing of policies that may help to avoid or reduce the likelihood of external or financial system instability.

Finally, the chapter emphasised that an improvement in financial development, especially if associated with a strong financial system and adequate macroeconomic policies, can help cushion the negative impact of liberalisation.

## **CHAPTER 5**

# **COMPARATIVE ANALYSIS OF FOREIGN DIRECT INVESTMENT FLOWS TO SOUTH AFRICA AND ANGOLA**

## **5.1 INTRODUCTION**

This chapter examines, first, recent developments in Africa and whether African countries are ready to intensify the process of global integration. It questions their readiness to integrate more fully into the global environment, where international capital flows are very large and potentially disruptive to their economies. The main constraints on international capital inflows to sub-Saharan Africa are considered, and the short and long-term prospects of development in this region are discussed. Other aspects, such as how Africa has pursued economic recovery, are also discussed.

The second part of the chapter seeks to clarify some crucial issues such as the positions of South Africa and Angola in the present African economic and financial environment. For example, does Angola have adequate institutions and policies to cope with the requirements for development and regional integration? What benefits can South Africa and Angola bring to initiatives for regional economic financial integration, such as the Southern African Development Community (SADC) and programmes such as the New Partnership for Africa's Development (NEPAD)? What are the major existing and potential sectors attracting FDI to each of them? What are the basic economic differences between the macroeconomic policies, privatisation programmes, tariff and tax policies, incentives (tariff and tax), etc. of these two countries? The chapter takes into account that South Africa is undoubtedly the biggest, most developed and diversified economy on the African continent and that Angola, until recently, was ravaged by war for more than 25 years and is a highly risky country. It is concluded that Angola, unlike South Africa, is at present likely to lose more than it would gain from regional integration owing to the state of its underdeveloped economy after almost three decades of civil war.

Finally, particular attention is paid to the changing financial environment that now characterises the African continent, with special emphasis on FDI to South Africa and Angola. The major factors driving FDI to South Africa are analysed and compared with the performance and potential of Angola. The economic performance of both countries is analysed, their ability to attract FDI is considered and the direct impact of their activities on the Southern African region is assessed.

## **5.2 PERFORMANCE AND POTENTIAL OF THE AFRICAN CONTINENT**

The economic environment on the African continent is portrayed negatively by many commentators. For many people around the world, the mention of Africa evokes images of civil unrest, war, poverty, disease, maladministration, corruption and mounting socio-economic problems. There is a common perception that these factors have constrained and negatively affected international capital flows into the region as whole. But this is not the whole picture. Despite the fact that there are still large areas of instability in some parts of the continent, there are many focal points, which offset these handicaps with positive performances. However, many questions have been raised about whether the continent is ready for the challenges of the 21st century – whether it will be able to transform its negative image. Whatever one's perspective, however, the greatest emphasis should be placed on efforts to promote peace, socio-economic stability, prosperity (by reducing poverty) and sustainable development in the whole continent. Once sufficient progress has been made in this direction, the ultimate aim should be to intensify the process of regional integration and globalisation. Only by following this path will African countries be able to develop and play their full role in the regional and global economies.

Before analysing the comparatively recent developments highlighted by data on FDI to South Africa and Angola, it is necessary to examine generally the most recent economic developments in the region. According to the African Development Bank's 2001 report (see table 5.1), after slowing to 2.7% in 1999 the African economy, as regards its real GDP growth, recovered modestly to an estimated 3.2% in 2000.

This recovery was due to rebounds in the region's major economies, such as South Africa, Egypt, Morocco and Nigeria. It was particularly marked in the oil exporting countries, owing to the recovery in oil prices in 2000. Another factor was the continued strength of some of the smaller economies, such as Uganda and Mozambique. Other factors that drove the recovery in 2000 included substantial progress in macroeconomic

**TABLE 5.1 MACROECONOMIC INDICATORS FOR 1996 TO 2001 IN AFRICA**

INDICATORS	1996	1997	1998	1999	2000 <sup>(a)</sup>	2001 <sup>(b)</sup>
1. Real GDP Growth	5.3	3.2	3.2	2.7	3.2	4.1
2. Real per Capita GDP Growth Rate	2.8	0.7	0.8	0.4	0.9	1.8
3. Inflation (%)	27.0	14.1	11.2	12.0	12.7	10.2
4. Investment Ratio (% of GDP)	18.1	18.2	20.2	20.4	19.9	20.3
5. Fiscal Balance (% of GDP)	-2.6	-2.7	-3.6	-3.4	-1.0	-1.3
6. Growth of Money Supply (%)	18.7	17.5	14.2	17.9	13.4	10.9
7. Export Growth, Volume (%)	4.7	3.6	0.0	0.6	7.3	5.3
8. Import Growth, Volume (%)	2.5	6.8	4.7	2.6	4.8	5.1
9. Terms of Trade (% change)	4.8	0.6	-11.3	8.6	15.7	-5.8
10. Trade Balance (US\$ billions)	4.8	2.2	-17.5	-10.4	11.4	2.9
11. Current Account (US\$ billions)	-5.3	-6.4	-24.6	-18.5	-2.0	-8.6
12. Current Account (% of GDP)	-1.0	-1.2	-4.5	-3.4	-0.3	-1.4
13. Debt Service (% of exports)	22.9	19.2	20.4	19.3	16.2	20.6

Notes: (a) Preliminary (b) Estimate

Source: African Development Bank, ADB. 2001. *African development report 2001: a summary*. Abidjan: Oxford University Press: 5.

stability, structural reforms and adjustments, and good and transparent governance. The growth trend in the continent now appears to be firmly established at 3.2%. In sub-Saharan Africa growth stood at 3% in the same year, a good performance compared to the whole region with its historically poor performance (World Bank 2001a: 202). This growth is even more positive when the sub-Saharan population growth rate (2.4%) is taken into consideration. According to the World Bank (2001c: 46), the average annual population growth rate for the region was 2.8% for the period 1980 to 1999 and the forecast for 1999-2015 is that the rate will decline to 1.9% mainly due to natural disasters, catastrophes and diseases around the sub-continent. The investment ratio in

Sub-Saharan Africa (at about 19.9% of GDP), which is the main ratio as regards capital formation, development and growth, has shown some stability but is below the level needed to support adequate employment growth. This figure is insufficient compared with other developing regions. For instance, in East Asia and Latin America this figure has been at about 22% of GDP (World Bank 2000: 19).

According to the table 5.1 and ADB (2001: 5-7), marked improvements in the continent as a whole were seen in 2000 in the following macroeconomic indicators or areas:

1. The fiscal position of African countries improved, with budget deficits of 1% of GDP compared to an average of 3.5% in previous years. This reflected the higher oil revenues, which also contributed to significant improvements in domestic and external balances. The improved fiscal discipline of countries undertaking stabilisation and structural adjustment programmes was also a contributory factor.
2. The inflation rate stabilised at about 12%.
3. After registering a slight decrease, from 0.8% in 1998 to 0.4% in 1999, real per capita GDP growth rate increased to 0.9% in 2000.
4. The growth in the volume of exports in the region increased more rapidly than imports, from 0.6% in 1999 to 7.3% in 2000; while the growth in the volume of imports only increased from 2.6% to 4.8% in the same period. As remarked above, this reflects the increase in oil export volumes and revenues, which significantly improved the trade balance and led to a turnaround in the terms of trade, which improved by 8.6% in 1999 and 15.7% in 2000. All this had a substantial, positive impact on the overall balance of payments, decreasing the deficit in the current account from \$18.5 billion in 1999 to \$2.0 billion in 2000, that is from 3.4% to 0.3% as a percentage of GDP. In the same period, the trade balance appears to have increased to record a surplus of \$11.4 billion in 2000 compared to a deficit of \$10.4 billion in 1999, which markedly improved the current account.
5. Debt service as a percentage of exports, which indicates the capacity, in foreign exchange, for repayment of debt service, has improved since 1996. This figure was registered at 16.2% in 2000, down from 22.9% in 1996, which means that in spite of

great adversities in the region, something has been done to reduce this burden.

Growth in the industrial and services sectors was the main contributor to output and revenue expansion in the whole region in 2000. Growth in the agricultural sector has, however, been timid with a tendency to decrease, and it is important to reverse this trend to increase Africa's share in the global economy. This is only achievable by diversifying production for domestic and export markets, improving production conditions and increasing quality to counteract the declining tendency in agricultural commodity prices and adverse weather conditions.

### **5.3 LONG-TERM PROSPECTS FOR THE REGION**

Assessments of the global economy in 2001 were mostly pessimistic, given the forecasts made by multilateral institutions since early 2001. In addition there were the economic and financial repercussions of the events of September 11 in the US, which will, not doubt, have a dramatic effect on the whole African continent. The outlook for the region should be seen and based on long-term prospects.

#### **5.3.1 GENERAL CONSIDERATIONS**

The slowdown in the US, European Union and Japan during most of 2001, coupled with a sluggish recovery in early 2002 in the global economy, will depress most developing countries' economies. This is likely mainly due to weak demand from industrial countries, which will depress some export prices (excluding oil, gold and platinum prices, which have remained at high levels) and volumes; thus, gains in trade are conditional on recovery in the OECD countries. According to the World Bank (2001b: 205), exports from the sub-Saharan African countries were expected to grow by 2002, but terms of trade were also expected to deteriorate because of higher import prices and reduced export prices. Only exploration and the development of new activities (such as offshore discoveries, which raise production and exports) may help to offset terms of trade losses. But the forecast for the region is that by 2003 export volume growth will accelerate strongly pushing GDP growth to more than 3%. The performance of the sub-Saharan African countries (excluding South Africa) is subject to the inelastic export demand for

primary commodities by the industrialised nations and a lack of diversification, which will affect their penetration of the developed markets. Thus, for some sub-Saharan countries, export diversification and favourable price trends could sustain their performance well above the regional average.

However, the African countries' export prospects may improve and may benefit from a number of specific trade initiatives to facilitate their access to the industrial countries' markets. Such initiatives include the US's Africa Growth and Opportunities Act (AGOA), the EU's "Anything but Arms" initiative, and the EU-South Africa Free Trade Agreement. Other initiatives aimed at improving the economic performance and outlook of the continent include the recently conceived NEPAD.

### **5.3.2 LONG-TERM OUTLOOK**

The expectations over the long term are for a continuation of the medium-term trends towards further liberalisation and better economic policies (including structural reforms), good governance and a broadly favourable domestic and external environment. A baseline scenario computed by the World Bank (2001b: 205), which assumes the continuation of current productivity trends, estimates that output growth will average 3.7% from 2004 to 2010. According to the same report, with population growth falling to 2.2%, real per capita income growth will average 1.5%, reaching \$640 (1995 US dollars) in real terms by 2010. The decade could, therefore, see the region's best-sustained performance since the 1960s, and sub-Saharan Africa, or some of its countries, could reduce their lag behind other developing regions. If this is achieved, it will then be necessary to improve the rate of domestic savings in combination with modest foreign capital inflows, in order to increase investment rates (at least to 19% of GDP) and aggregate output. Investment in human capital should also be increased and progress on building the economic infrastructure should be accelerated so as to increase productivity and growth. If some of the adverse conditions (such as wars, civil strife, disease, poor governance, low savings and investment rates, falling terms of trade, etc.) change in the medium or long-term, then signs of real improvement will be seen around the region. This should be coupled with political and economic reforms, and increased regional and private sector integration to meet international standards in governance and cooperation.

At the same time, continued efforts should be made to move towards greater openness by liberalising economic policies, encouraging foreign investment and increasing the availability of resources; and for debt relief to relax balance of payments constraints and thus positively affect domestic economies. Finally, efforts should also be made to reverse the devastating effects of HIV/AIDS, in order for the region to increase welfare, rehabilitate productive capacity, and notch up a higher economic growth rate.

#### **5.4 THE NEED FOR REGIONAL ECONOMIC INTEGRATION AND FDI FLOWS**

Economic integration refers to the commercial system of discriminately reducing or eliminating trade barriers among adjoining countries by means of preferential trade arrangements to free trade areas, customs unions, common markets or economic unions. This is done to promote foreign investment, particularly FDI, growth and development among countries of the same region or bloc.

In Africa, the process of economic integration (predominantly regional integration) can be traced back to December 1 1967 when the Treaty of East African Co-operation came into force, and the East African Economic Community (EAEC) became the first African regional economic community (Gomez 1979: 232). The EAEC comprises Kenya, Uganda and Tanzania. Since then the number of regional economic communities has multiplied. According to the 2002 annual report on integration in Africa (ARIA) of the United Nations Economic Commission for Africa (2002: 4-5), the continent so far has 14 regional communities of varying designs, scope, treaties and objectives. Some of them, such as SADC, AMU, COMESA, ECCAS, IGAD, ECOWAS and CEN-SAD<sup>4</sup>, are quite large, and there is no single model for these kinds of communities. Some are

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<sup>4</sup> AMU or UMA: The Arab Maghreb Union

ECCAS: The Economic Community of Central African States

ECOWAS: The Economic Community of West African States

IGAD: The Inter-Governmental Authority on Development (of Eastern Africa)

COMESA: The Common Market for Eastern and Southern Africa

CEN-SAD: The Community of Sahel-Saharan States (of Northern, Western and Central Africa)

SADC: The Southern African Development Community



complementary while others overlap and duplicate activities. Thus among 53 African countries there are 14 regional communities, which together have 122 member countries. Of the total number of African countries, 7 belong to 1 community, 27 are members of 2, 18 are members of 3 and 1 (the DR Congo) is a member of 4 communities. It is obvious that the continent's structures of regional integration need to be rationalised under a common platform and work programmes to attract FDI flows and achieve better results as regards international economic integration, or globalisation.

Economic integration in Africa mainly reflects closer relationships among countries belonging to the same community in the domain of trade and factors of production via FDI, and in a few cases this also includes financial markets. Given the weakness of some of the economies, regional integration via trade and FDI offers a solution to slow economic development in individual countries and has the potential to develop the whole region by attracting foreign investments and promoting economic development spillovers from some countries or regions to others. The integration and liberalisation of financial markets may, however, involve risks because of the volatility of most of the capital flows, in the form of portfolio investments, that these markets manage.

The major potential benefits of financial integration can be summarised as follows (World Bank 1997: 22-28):

1. Financial integration can boost growth through FDI and spillover of technological knowledge, by raising the level of investment (i.e. by tapping the link between local savings and investment), by improving the returns on investments, and through market efficiency effects.
2. It allows individual countries to insure themselves against adverse developments in their home economies by diversifying their assets and tapping global markets to smooth temporary declines in their incomes.

On the other hand, the major risks of financial integration are mainly based on poor economic fundamentals of countries with weak macroeconomic policies, badly managed or overprotected banking systems, and highly distorted domestic markets, which increase their vulnerability and the cost of financial integration. Volatility of international capital flows and potential vulnerability to reversals remain serious concerns in the presence of:

- large surges in international capital inflows in the early stages of integration
- susceptibility to large reversals as a result of financial crises
- more generally, the increase in volatility as a country becomes integrated and more exposed to international economy and shocks.

Thus, efforts at integration should first be directed at regional integration to improve individual countries' economic performance, paving the way for further steps at the global economic level. In line with this, the African Union (AU) – the natural successor of the Organisation of African Unity (OAU) – pledges itself to the following objectives (AU Act 2000: 3):

- acceleration of the political and socio-economic integration of the continent
- encouragement of international cooperation, taking due account of the Charter of the United Nations and the Universal Declaration of Human rights
- establishment of the conditions that will enable the continent to play its rightful role in the global economy and in international negotiations
- promotion of sustainable economic, social and cultural development as well as the integration of African economies;
- promotion of cooperation in all fields of human activity to raise the living standards of African peoples
- coordination and harmonization of policies between existing and future Regional Economic Communities
- advancement of the continent's development by promoting research in all fields, particularly science and technology.

With these objectives in mind, the New Partnership for Africa's Development (NEPAD) was approved, despite certain criticisms, in October 2001. NEPAD is a bold and clear-sighted vision of Africa's development which pledges to improve democracy, sound economic management and poverty reduction, and promotes peace, security and people-

oriented development around the continent. This initiative was presented to and welcomed by the heads of state of eight major industrialised countries at Kananaskis, Canada in June 11 2002 (Group of Eight 2002: 1-2). At regional level, the major role has been played by SADC with its pledges to enhance economic coordination and cooperation, to harmonise individual and regional development programmes, and to encourage integration within the Southern African region. SADC accordingly promotes FDI inflows into the region and supports infrastructural projects of and in member states. Under total regional stability, the execution of these development programmes should be seen as the major regional factors of economic development, particularly regional infrastructures linking different countries. In addition, the SADC should pursue its goals to achieve the total integration, liberalisation and development of the economies of the region.

As a result of the increased regional integration in the continent – notwithstanding the need for gradual rationalisation – FDI inflows grew at an annual average of about 1.2% between 1994 and 1999 (UNECA 2001:11). FDI represented about 2.8% of ECOWAS's GDP, 2.0% of COMESA's, 1.9% of UEMOA's<sup>5</sup>, 1.9% of CEN-SAD's, 1.8% of SADC's, 1.4% of IGAD's, 1.0% of ECCAS's, and 0.9% of UMA's. For Africa as a whole FDI constituted about 1.5% of GDP. During the same period SADC and CEN-SAD drew about 21% of total FDI inflows each, followed by COMESA (16.4%), ECOWAS (11.9%), UMA (5.4%), UEMOA (3.1%), IGAD (2.7%), and ECCAS (1.9%). SADC and CEN-SAD have, clearly, been the main attractors of FDI inflows into the continent owing to the role played by countries such as South Africa and Angola from SADC, and Morocco, Egypt, Nigeria and Tunisia from CEN-SAD. On the other hand, the positive trends in capital market development across the continent are expected to increase cross-border investments and catalyse the inflows of FDI by establishing partnerships with foreign investors in order to increase global-continental integration. Additionally, it should be stressed that stock exchanges, although not a significant number, exist in all African regional economic communities. All these regional integration efforts are

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<sup>5</sup> UEMOA: The Western African Economic and Monetary Union

essential to attract foreign investments (particularly FDI), develop, reduce poverty and face the challenges of globalisation.

## **5.5 FDI INFLOWS INTO SOUTH AFRICA AND ANGOLA**

### **5.5.1 PAST AND PRESENT RELATIONS BETWEEN SOUTH AFRICA AND ANGOLA**

The South African economy is the biggest, strongest, most developed, and most diversified in the continent. To analyse the African economy it is essential to analyse the South African economy's main features and performance. This is carried out in this section, and is followed by a similar analysis of the Angolan economy, where after FDI flows to the two countries can be compared. A brief examination of the relationship between South Africa and Angola forms a prelude to this discussion.

Relations between South Africa and Angola have never developed sufficiently for each country to utilise its natural potential and geographical advantages. Nevertheless, economic relationships between South Africa and Angola can be traced back to 1880 when the Boers were invited to invest in Angola and founded a settlement in Saint Januario in Humpata (in the south of Angola), where they stayed until 1928 (Sao Vicente 1994: 141). At this settlement, consisting of 277 Boers, 50 black Africans and 300 "*bastaards*", each family received 200 hectares. The Boers introduced horses, new kinds of grassveld and bushveld, longhorn cattle and a variety of maize strains. During their stay they supported the Portuguese settlers in military expeditions against the traditional rulers of the south of Angola, and exploited gold in Caconda. However, after Angola received its independence from Portugal in 1975, South Africa was at the forefront of the attempt to destabilise and block the country's communist/socialist government by supporting the UNITA opposition guerrilla movement.

Better relations have recently been established, and conditions are now more favourable for developing positive, responsible and intelligent partnerships in all domains between the two countries – mainly under the SADC agreements. However, the two countries are

at different stages of development and their economies differ in size; there are therefore vast differences in their economic performance.

### **5.5.2 THE SOUTH AFRICAN ECONOMY**

South Africa is an upper-middle-income developing country, with income per capita established at \$3 160 in 1999 (World Bank 2001d: 275). Since its reintegration into international markets in 1994, South Africa has emerged as a sophisticated economy and a promising investment destination. The country shares many features with more advanced economies, but combines a highly developed first world economic infrastructure with a big emerging market economy. As De Lange (2001: 102) makes clear, South Africa shares features of both developed and developing countries. On the one hand, South Africa has the following first-world features: a well-developed physical infrastructure; an advanced banking and financial system; and a diversified manufacturing sector that can produce varied and sophisticated products. On the other hand, South Africa has an under-educated, under-skilled population relative to the requirements of an advanced economy; large-scale unemployment which is negatively affected by economic globalisation patterns; and local communities lacking modern economic, social and infrastructural facilities. The South African economy is nevertheless superior to other major economies of the continent such as Egypt, Morocco and Nigeria and to some of the surrounding emerging markets such as Argentina, Thailand and Singapore. It is industrially developed and is one of the most important and favoured emerging markets. It offers foreign investors a sophisticated financial infrastructure and exceptional investment opportunities, and is well positioned to maximise the benefits of globalisation because it has fared better than other emerging economies. Decline in output and depreciation of its currency in the immediate aftermath of global crises have been considerably lower in South Africa than in other emerging markets. Indeed, it is one of the few emerging market economies that has not required an IMF programme or the use of Fund resources during periods of global crisis. South Africa's substantial economic progress has taken place mainly in the following areas (*South Africa Business Guide Book 2001/2002: 14-15*):

1. South Africa has followed prudent macroeconomic policies (including fiscal deficit

reduction), has undertaken trade and foreign investment liberalisation, has a sound, well-regulated banking system and adheres to a flexible exchange rate system. It has an advanced and liquid capital market, is restructuring state assets and has been promoting skills development processes. Since its reintegration into the international economy and the adoption of the Growth, Employment and Redistribution (GEAR) strategy in 1996, South Africa has been an attractive and viable destination for FDI. It also has a stable and democratic political system, a noteworthy commitment to eliminating corruption, an advanced infrastructure and telecommunications system and a sophisticated industrial base.

2. South Africa has made appreciable progress in trade liberalisation and in capital account liberalisation (by changing its policy to encourage different types of capital flows and lifting exchange controls in an orderly, well-sequenced manner). Policies to promote transparency and competition have been implemented, codes of good fiscal practice have been established and financial system regulations have been strengthened. These measures all took the best international standards as guidelines.
3. As domestic and foreign investments are key factors for economic development and growth, South Africa has, unlike most African countries, been implementing important initiatives aimed at promoting such investment. These include incentives such as a tariff reform programme, investment incentives and the creation of preferential poles of development. These poles include a commitment to creating economic infrastructural zones such as Spatial Development Initiatives (SDIs) and Industrial Development Zones (IDZs). The first is a joint initiative of the Departments of Transport, and Trade and Industry, which aims to unlock the inherent economic potential in specific spatial locations. Examples of SDIs are duty free zones, international airports and ports, and transport corridors that encourage the creation and improvement of existing infrastructure. Public resources are used to leverage private sector investment and these initiatives are aimed at boosting domestic and foreign investment, kick-starting development and job creation, and generating long-term growth. The IDZs are integrated into SDI programmes, conceived in accordance with international standards or practices. Thus, investments in IDZs benefit mainly from the following advantages: world-class

infrastructure, local and cost advantages, fiscal incentives, linkages with local and regional markets, expedited customs procedures, innovative use of human resources and labour relations partnerships. Examples of IDZs are the building of leading edge industrial development zones (also duty free zones) closely integrated with the local productive sector and linked to airports or ports. The intention is to maximise investment potential by identifying high-growth sectors and industries which offer a significant global competitive and comparative advantage. To satisfy the need for an attractive set of investment incentives, South Africa has introduced programmes to encourage and develop new and existing ventures such as the following:

- **Strategic Investment Programme:** an investment allowance against qualifying assets for large investments (R50 million and above).
- **Small and Medium Enterprise Development Programme:** a 10% establishment grant payable over two years on qualifying assets, with an additional year if the labour usage criterion is met.
- **Motor Industry Development Programme:** encourages economies of scale and rationalisation of motor manufacturing models and gives exporters offsetting import credits.
- **Critical Infrastructure Fund:** the Department of Trade and Industry underwrites up to 30% of the cost of the infrastructure necessary to secure a particular investment, with the local authority being responsible for the balance.
- **Skills Support Programme:** offers a cash grant of 50% of training costs to prepare a company's workforce for a new investment towards expansion.
- Various incentives to stimulate research and development programmes.

Finally, it is important to recognise that South Africa was one of the best performers among developing countries during the emerging markets crises of 1997-1999, and that it serves as a lure to draw foreign investment into the region. This may spill capital flows over into neighbouring countries if the latter have the necessary economic fundamentals in place. Consequently, South Africa's economic performance and its general

environment of relative stability have provided a practical example for many African countries on how to overcome adversities. This could encourage other African countries to consolidate regional integration as a valuable part of their global marketplace integration. Regional integration cannot therefore be seen as an end in itself, but as a vehicle for or a precursor of greater global integration. It seems obvious that South Africa will play a major role in influencing countries in the region to progress towards better integration and sustainable development. Angola, being geographically close to South Africa, could benefit substantially from this influence.

As was shown in sub-section 5.4, the main aims of SADC, as a regional community, dovetail with the broader objectives of the AU of achieving regional sustainable development and greater global integration. These two institutions should continue to work closely, by phasing in the process of attracting FDI and global integration of other relevant regional communities and institutions to make Africa economically a strong and competitive continent in the global marketplace.

### **5.5.3 THE ANGOLAN ECONOMY**

Angola is a low-income developing country with income per capita estimated at \$220 in 1999 (World Bank 2001d: 274). It is a markedly underdeveloped and needy country. About 90% of consumer goods are imported and most industrial and agricultural activities have collapsed or stagnated. To make things worse, Angola has, until early 2002, been in the throes of a continuing, destructive war since its independence in 1975. This has defined its relations with the global environment. Industrial production has been replaced by a rent-seeking economy, where income relies on leasing mining or drilling rights to foreign capital. Oil and diamonds have been the commodities at the heart of the Angolan economy and have countered the decline in the industrial and agricultural sectors, allowing Angola to attract international capital flows despite high costs and risks. To cite only one example, oil exports have contributed about 90% of export revenue, 80% of national revenue, and 58% of GDP. The country's crude oil production is over 780 000 barrels per day in 1999/2000 – worth more than US\$4 billion per year – and most of the production is offshore and therefore largely unaffected by war-induced disruption.



For years, Sonangol, the state oil company, has used future production as collateral for short-term loans. The country relies on these loans and on secret bonuses to finance the economy and fill its budget gap. These oil-backed loans involve fairly onerous interest rates, typically two or more percentage points above the benchmark London inter-bank offered rate (LIBOR). Sonangol is, none the less, very well received in some financial and banking circles because of its ability to meet its repayment obligations, as it has never defaulted on a loan repayment. Payments in advance to the Angolan government for oil production have reached billions of US dollars, over and above the one-off payments on the awarding of oil concessions. Lack of transparency on the “oil account” has, however, been the main cause of conflict in the negotiations between Angola’s government, the IMF and the World Bank.

Given its distorted macroeconomic environment and political instability, it has proven difficult for Angola to meet even minimal international economic standards. These are the true deterrents to attracting international capital flows to areas other than the oil and mining sectors and are more fully described below.

- **Civil strife:** Angola was devastated by almost three decades of civil conflict, which has brought international capital flows to non-oil sectors to a standstill.
- **Macroeconomic instability:** erratic fiscal, monetary and exchange rate policies and a large structural fiscal deficit with weaknesses in the domestic financial system characterise the economy. This has contributed to large macroeconomic disequilibria, high and variable inflation, instability in interest rates and considerable volatility in real exchange rates. These factors have all worsened the general investment climate.
- **Slow economic growth and a small domestic market:** although FDI flows to Angola, particularly in its primary sectors (notably the oil and mining sectors), have, on average, earned high rates of return, there has been poor growth in the country due to the very limited production in other sectors and the small size of the domestic markets, which has deterred broader-based investment.
- **Delayed outward orientation and burdensome regulations:** Angola has been slow to accommodate foreign investment outside the oil and mining sectors. Accordingly it

has remained relatively backward compared with other countries in sub-Saharan Africa, with FDI often subject to excessive bureaucratic difficulties and discriminatory regulations.

- **Slow progress in privatisation:** privatising state-owned companies to boost foreign investment has been slow or almost non-existent in Angola, far more so than in other developing countries in Africa, Asia and Central and Eastern Europe, many of which have followed aggressive and intensive privatisation programmes. To make its economy more responsive to external signals from investors, Angola should correct this and increase private sector activities and the level of investment.
- **Poor infrastructure:** Angola has an inadequate physical, financial, human and institutional infrastructure, and this is reflected in the country's poor capacity for economic growth and progress. This also affects its ability to attract foreign investments (mainly FDI).
- **High wage and production costs:** the factors listed above are combined with poor labour market policies and microeconomic regulation, and an excessive workforce in government departments and public corporations/enterprises. This was in consequence of the government's so-called providence policy, applied until 1988, in terms of which the government guaranteed employment and took responsibility for paying the salaries of the excessive workforce despite lack of qualifications and sporadic periods of inactivity. Wage costs in Angola therefore tend to be high relative to productivity levels.

To change these circumstances and attract more capital flows in the form of FDI, Angola needs to consolidate its newly-won peace and democracy, and to apply a coherent programme of macroeconomic stability and structural adjustment, along with agreements negotiated with the IMF and the World Bank. The death of Jonas Savimbi in February 22 2002 created the basic conditions for the long-needed cease-fire and lasting peace, which was negotiated and signed by the government and UNITA in April 4 2002. This may give the country a window of opportunity to overcome its economic backwardness and head towards development by fully implementing democracy. Prior to these events, however, the institutions of Bretton Woods played a significant role in leading Angola towards

democracy and development. It would be appropriate to reverse the factors discussed above by applying policies aiming at stability and recovery under programmes monitored by the IMF and the World Bank. Such programmes would involve deep transformations in the financial system, by strengthening and consolidating the banking system (including the creation of an efficient stock market) and the commitment to privatisation.

Indeed, after various negotiations with the IMF, in April 2000 Angola agreed to the implementation of a Memorandum of Economic and Financial Policies (IMF 2001a: 1-12). Under this programme Angola committed itself to the following measures, among other things:

1. Disciplined monetary and fiscal policies to lower inflation rates and reduce the fiscal deficit so as to establish domestic equilibrium, and undertaking a programme of poverty reduction
2. Good governance and transparency, with practical measures that include a diagnostic study of the oil sector and the signing of a contract with KPMG (the consultants who won the international tender) to impose greater transparency in managing its major financial resources; and an independent audit by Ernst and Young of the Angolan Central Bank (BNA) and the diamond sector companies associated with the Angolan diamond company ENDIAMA
3. Implementation of a privatisation programme of state-owned enterprises, which would begin with the state-owned BCI bank
4. Trade and tax reforms and private sector development, with incentives according to SADC policies and international standards.

These measures are necessary to respond to the international community's efforts and expectations, and to prevent available funds from being held back due to insufficient progress in economic reform. They are intended to restore international credibility and facilitate access to the international financial markets for new and cheaper loans. Obviously the measures also aim at rescheduling the Angolan foreign debt under the HIPC initiative, to make the economic environment more attractive to foreign investors.

The fact that Angola has topped FDI inflows to the continent along with Nigeria, Egypt, South Africa and Morocco is due to discoveries of substantial new oil fields in deep offshore waters not affected by the war. There is thus the prospect that Angola holds one of the world's major oil reserves after Iran and Saudi Arabia (African Development Bank 2001: 14). The great paradox is that Angola is blessed with huge wealth, yet is currently rated as one of the world's least developed countries and is on the brink of a major humanitarian tragedy (refugees) and generalised poverty.

#### 5.5.4 COMPARISON OF THE TWO ECONOMIES

The totally different economic performances and environments of South Africa and Angola make a comparative analysis of their principal indicators very interesting. Table 5.2 compares their positions using data on macroeconomic indicators and FDI in the context of the African region. The table highlights some economic indicators to compare the positions of the South African and Angolan economies in the continent. From Table 5.2 it is clear that these two economies are quite different from those of the African continent as a whole.

**TABLE 5.2 SOME COMPARATIVE ECONOMIC INDICATORS RELATED TO SOUTH AFRICA, ANGOLA AND THE AFRICAN CONTINENT**

Countries	GDP 1999 US\$ million	GDP growth 1990/99	GDI as % GDP 1999	GDS as % GDP 1999	External Debt as % of GDP/1999	FDI in 2000 <sup>(c)</sup>	
						Inflows US\$ billions	Outflows US\$ billions
South Africa <sup>(a)</sup>	131,127	1.9	16	18	19	0.9	0.6
Angola <sup>(a)</sup>	5,861	0.8	23	48	207	1.8	-
Sub-Saharan Africa <sup>(a)</sup>	332,744	2.4	17	14	70.0	-	-
Africa <sup>(b)</sup>	-	2.3	-	-	67.1	9.1	1.3
Developing countries <sup>(b)</sup>	-	3.8	-	-	43.5	240.2	99.5

Source: World Bank. 1999a. *Global development finance*. Washington, DC: International Bank for Reconstruction and Development: 170 and 230-270. <sup>(b)</sup> World Bank, 2001d. *World development report 2000/2001: attacking poverty*. Washington, DC: International Bank for Reconstruction and Development: 294-5, 296-7, 298-9 and 314-5. <sup>(b)</sup> International Monetary Fund. 2001b. *World economic outlook*. Washington, DC: IMF Publications: 170-222 and 254. <sup>(c)</sup> United Nations Conference on Trade and Development. 2001e. *World investment report 2001: promoting linkages*. Geneva: United Nations Publications: 291 – 296.

To start this comparative analysis, it is important to point out that the two economies have different sizes or dimensions. This is illustrated by the great difference between their populations, GDP and GNP. The GDP and GNP of South Africa – number 28 in the world ranking – was estimated at \$131 billion and \$133 billion respectively in 1999 (with a population of 42 million inhabitants); while the GDP and GNP of Angola – number 136 in the world ranking – were estimated at \$5.8 billion and \$2.7 billion respectively (with a population of 12 million inhabitants) in 1999. The big difference between Angola's GDP and GNP is due to the difference between factor receipts (positive) and factor payments (negative) (since  $GNP = GDP - \text{net factor payments}$ ). Angola has more negative net factor payments (return on FDI in the oil and mining sectors) than South Africa in all the sectors subject to FDI. On the other hand, Angola cannot have factor receipts since, unlike South Africa, it has no FDI abroad. GNP per capita is also different in the two countries: \$3 160 in South Africa compared to \$220 in Angola in 1999, their respective ranks being 86 and 194 (World Bank 2001d: 274-275). Angola's rank dropped dramatically from 121 in 1998 to 194 in 1999 (a difference of 73 points). South Africa also declined from 32 in 1998 to 86 in 1999. Economic growth has been well below the sub-Saharan Africa and developing countries' averages in both countries, although South Africa has performed better than Angola, with 1.9% in the period 1990 to 1999, compared to Angola's 0.8%. One possible explanation is that the South African economy is very developed and diversified, which tends to encourage greater consistency, stability and growth. In 1998 South African exports and imports were estimated at \$34 526 million and \$32 687 million respectively, while Angola registered only \$3 879 million for its exports and \$4 546 million for its imports. While South Africa is a trade surplus country (despite the fact that South Africa has run current account deficits since 1995), Angola is a deficit country, with all the attendant economic consequences. In addition, while South Africa had gross international reserves valued at \$6 353 million in 1999, Angola had only \$496 million in that year (World Bank 2001d: 302/303).

GDP (the basis for calculating economic growth) is the basic measure of the level of economic activity in a country and of the potential for job creation for its residents (Mohr 1998: 34). By this indicator, it can be seen that the Angolan economy is in serious difficulty and must make every effort to overcome this grave situation and provide its

people with a better quality of life. Angola's GNP annual growth rate was, in fact, 35.5% from 1998 to 1999, while South Africa had a rate of 0.8% in the same period. Angola's GDP annual growth rate of 0,8% from 1990 to 1999 was one of the worst in the Southern African region for this period, and its growth in private consumption per capita of -9.5% during 1980 to 1998 is also the worst for the period. As improvements in private consumption per capita are generally associated with quality of life and, more concretely, with a reduction in poverty, these figures demonstrate that living standards in Angola are extremely low. In the same period, the average annual growth of private consumption per capita in South Africa was -0.1% (World Bank 2001d: 276-7).

However, in analysing Gross Domestic Investment (GDI) and the Gross Domestic Saving (GDS) of both countries, the following observations can be made. By 1999, Angola (with 23% GDI and 48% GDS as a percentage of GDP) was still able to attract greater capital inflows than South Africa (with 16% GDI and 18% GDS of GDP). This was mainly owing to investments in new oil and mining resources. Accordingly, the Angolan rates of investment and savings were higher than those of South Africa and well above the sub-Saharan Africa average. Saving has been so much greater than investment in Angola because the war inhibited aggregate consumption and the lack of goods consumption forced increasing saving and decreased the level of domestic investment.

Largely because of their different economic dimensions, the two countries also owe different amounts. But an interesting issue arises from this analysis when these figures are related to GDP. South African foreign debt is estimated at \$24 712 billion, representing only 19% of its GDP, while Angolan foreign debt is estimated at \$12 173 billion, representing the awesome figure of 207% of its GDP in 1999. According to the World Bank criterion (2001b: 252), it is obvious that South Africa is a less indebted country, while Angola is a severely indebted country. Debt relief, in the form of cancellation, reduction or rescheduling, would thus have a much greater positive impact on the Angolan economy than on that of South Africa. For this to happen, however, the Angolan government would have to overcome its stand-off with the institutions of Bretton Woods by improving its economic and financial performance and transparency on public accounts.

Because Angola is the major oil producer and exporter in Southern Africa, with an output of 780 000 barrels per day (in 2000/1), it has attracted a disproportionate share of FDI relative to the small size of its economy. This has placed Angola in the front line of the continent as regards FDI inflows. Since 1998, Angola has topped the list of FDI recipients in Africa, with \$1.1 billion in 1998, \$1.8 billion in 1999 and \$1.8 billion in 2000 (see table 1.5 in chapter 1). These figures represented 14%, 17% and 20% of aggregate FDI inflows into the region in those years respectively. However in the same years, South Africa, the giant of the continent, received the modest percentages of 7%, 13% and 10% respectively. FDI inflows to South Africa have been attracted into sectors such as mining, manufacturing, communications (Telkom and Transnet) and finance (such as brokerage, an example being the acquisition of a 45% stake in brokerage AMB-DLJ by Credit Suisse First Boston) (SA Business Guidebook 2001/2002: 16). The decline in FDI in 2000 reflects the decrease in the rate of privatisation. On the other hand, Angola's temporary advantages in attracting FDI inflows should spill development over into other social and economic sectors and into neighbouring countries. To lessen poverty, Angola should implement sensible macroeconomic policies along with structural reforms and an adjustment programme with good governance, as suggested above. This would enable Angola to reduce the fiscal deficit, inflation rate and unemployment at regional levels in the short and medium terms. This would eventually result in establishing better living standards for the people. According to the World Bank (2001d: 302) Angola's current account has showed successive deficits: \$236 million in 1990 and \$ 1 776 million in 1998. This has been aggravated by greater imports than exports and negative net incomes. Efforts should be made to reduce these deficits, as this is essential to restore external equilibrium. This would be a strong signal for foreign investors to come in.

According to UNCTAD (2001e) FDI outflows from South Africa were estimated at \$600 million in 2000. This produced a positive balance (or net FDI inflows) of \$300 million, compared with FDI inflows. FDI outflows were the lowest since 1997, and reflected the new vision of South Africa as regards creating or acquiring assets overseas. Angola has not registered capital outflows in the form of foreign investments, nor M&As because it does not have enough capacity and resources to invest abroad; and, on the other hand,

FDI inflows have reflected investments in areas not affected by war, such as in the oil fields.

As a result, the number of foreign affiliates located in Angola is insignificant and is estimated at 21 companies in 2000. M&As require a well-developed and mature capital market (or stock exchange) where both portfolio and direct investments may be transacted. The figures of M&As in South Africa have been enormous compared with other countries in the continent and other emerging markets, as it is one of the major emerging markets worldwide. About 941 subsidiaries of parent corporations from the industrialised countries and 2 044 foreign affiliates were located in South Africa in 2000, recording \$1 171 million in sales and \$6 393 million for purchase operations. These figures represented 36.6% for sales and 96% for purchases as regards the whole African continent, and should be seen in the context of the privatisation programme undertaken by the South African government. This demonstrates that the observations made early in this section regarding the openness and dimensions of the South African economy are undoubtedly accurate. Moreover, despite the decline in 2000 due to the deceleration in privatisations, M&As in South Africa jumped from 640 sales of companies and 593 purchases of companies in 1995 to 1 902 sales and 5 715 purchases in 1999. The highest sales were registered in 1997 with \$2 664 million and the highest purchases were registered in 2000 with \$6 393 million (UNCTAD 2001e).

#### **5.5.5 ENDOGENOUS AND EXOGENOUS VARIABLES AFFECTING FDI TO BOTH COUNTRIES**

Finally, as regards the hypotheses set in chapter 2, it is important to emphasise that the basic endogenous and exogenous variables for FDI flows are related to the performance of a specific domestic economy and the international financial environment. In this regard, the endogenous variables that affect FDI flows into South Africa are as follows:

- the country's developed economy and socio-political and military stability
- the low level of petty corruption and adequate transparency
- good macroeconomic fundamentals and coherent monetary and fiscal policies
- the Strategic Investment Programme



- favourable business operating conditions with trade liberalisation
- export-orientated economy and development programmes such as Special Development Initiatives (SDIs) and Industrial Development Zones (IDZs)
- favourable and adequate tax and incentive systems.

The major exogenous variables that are external and affect FDI flows to South Africa are:

- that under easing exchange controls compared with other stringent economies, foreign investors are encouraged to invest abroad due to domestic competition in home countries
- the oligopolistic or monopolistic interests
- the low cost of production in host countries

As regards South African companies, they have factor endowment advantages through their intangible assets over some industries on the continent and some developed economies, mainly in the regional host countries.

With regard to Angola, the endogenous variables that would affect FDI flows into the country are as follows:

- Most of Angola's oil production is in offshore sites that have been largely unaffected by war-induced disruption. Despite the country's lack of macroeconomic stability, foreign investors have continued to risk their money because of the prospect of making profits in the oil, mining and fishing sectors.

There is nothing substantial to mention as regards exogenous variables. The Angolan economy and companies are underdeveloped, and restructuring (under a privatisation programme) in order to compete in the world economy and attract international investors' has only just started. Angola needs to improve its endogenous variables in order to transform the unfavourable business environment if it is to attract good investments and achieve economic development.

## **5.6 CONCLUDING REMARKS**

The African continent clearly has to continue striving to change its general image. Regionally, South Africa and Angola have still to cooperate fully and will gain a great deal from their many links, in accordance with their economic potentials. As regards FDI flows in the form of greenfield investments, it is clear that Angola stands to gain more than South Africa from such links, given South Africa's already high level of development and its greater propensity for mergers and acquisitions than for greenfield FDI. However, the links of the two countries both, regionally and globally through trade and investments, will help create environments for both to grow more rapidly over a sustained period and to achieve greater reductions in poverty. Thus, developing, diversifying and intensifying trade bilaterally and multilaterally under SADC policies and programmes such as NEPAD are likely to be one of the vital engines for sustained development and poverty-reduction growth in individual countries and in the region.

## **CHAPTER 6**

### **CONCLUSIONS**

In this final chapter an attempt is made to draw together the content dealt with in the preceding chapters of this work. It also discusses the most promising avenues for future research.

#### **6.1 MAIN FINDINGS AND RECOMMENDATIONS**

**Chapter 1** provided strong evidence of how FDI flows into developing countries have been increasing compared to other categories of international capital flows, despite some ups and downs in the second half of the 1990s and the early 2000s. Translated into numbers, global FDI inflows worldwide reached a record \$1,3 trillion in 2000, a real increase of 50 percent over the previous year. But, globally, gross FDI flows fell massively in 2001 to \$760 billion from their peak in the previous year.

Among the four main developing regions, the Asian and Pacific regions were at the forefront, with FDI rising to \$143 billion in 2000, followed by the Latin American region with \$86 billion, the Central and Eastern European regions with \$27 billion, and the African region with \$9,1 billion. The latter figure reduced the continent's share in global FDI inflows to 1 percent. At the national level, China, as one of the most prosperous newly industrialised economies, was the best performer with \$41 billion in 2000.

By the third quarter of 2000, prospects for FDI flows to developing countries as a whole and economic development in general still seemed encouraging. But, in 2001, the negative change in FDI flows to developing countries was driven by changes in the global economy, namely by slow growth or recession associated with a decline in FDI outflows from major industrial countries and by a decline in M&As estimated at 45% (World Bank 2002: 38). However, despite the global downturn in FDI and a reduction in their share of global FDI flows, developing countries have been less affected owing to

considerable stability in these flows to them. Thus the prospects for continued FDI flows to developing countries seem good, and may improve further over the next few years, while growth in developing countries will accelerate as a result of these inflows.

Finally, it should be borne in mind that any prolongation of the world economic crisis may well result in depression and a fall in international capital flows – including FDI flows – into the developing countries. The global economic slowdown in 2001 was translated into reduced international private capital flows to developing countries. As a result, net long-term international capital flows fell to an estimated \$196.5 billion in 2001 – \$65 billion below the 2000 level and \$145 billion below the peak reached in 1997, which was estimated at \$341.4 billion (World Bank 2002: 32). However, estimates from the World Bank show that despite the downturn from 1999 to 2000, FDI continues to be the most resilient kind of capital flow and should remain high over the next few years. FDI flows are therefore likely to remain the largest source of external finance for developing countries.

**Chapter 2** attempted to explain theoretically the importance of the main determinants attracting FDI flows into developing countries. It was argued that the explanatory approach was the most suitable approach for the purposes of this study. This approach links location theory, industrial organisation and international trade to explain FDI. Investment in general, but particularly FDI, was viewed as a key economic factor in increasing aggregate output, economic growth and development in developing countries. The chapter showed that for an increasing number of countries, FDI influenced by exogenous factors has also become a key factor in the internationalisation of production and finance, that is, the globalisation of the world economy.

The different determinants of FDI for developed and developing countries, home and host countries were then briefly considered and two broad categories of FDI determinants were distinguished, namely endogenous and exogenous determinants. It was concluded that the determinants for developed and developing countries are distinct. The effects of international capital flows on domestic financial systems were also considered, and it was shown that they have a profound impact on the structure of the domestic economies of the developing countries that receive such flows, and on their growth and development. It

was argued that a good financial system attracts FDI flows. The role of FDI in the transfer of technology, together with the implications of this for developing countries, was emphasised.

Finally, the chapter discussed the effects of changes in exchange rates, interest rates and taxation on FDI. It was argued that subsidies and (low) interest rates increase investments and income through their effects on aggregate output, and that the choice of exchange rate system also affects FDI. It was also pointed out, however, that increases in interest rates and taxation, tariffs and quotas may deter FDI if they are not managed appropriately.

In **chapter 3** the significance of FDI for the balance of payments and capital formation of a country was stressed. The effects of FDI on the balance of payments were emphasised, as well as its contribution to increasing the availability of external funds, aggregate output and the overall equilibrium (internal and external balance) in an economy. The need for the application of adjustment mechanisms and other policy measures was discussed. The chapter also examined the need for international capital flows in the face of the policy dilemma created by the balance of payments constraints. The main findings of this chapter can be summarised as follows:

1. To attract FDI flows countries need a good supporting infrastructure, a business-friendly environment and an adequate national accounts system, including a national statistics system.
2. Where there is a satisfactory national accounts system in place and a developed banking system, the balance of payments can be monitored in terms of the accounting system (in accordance with the IMF recommendations), and corrective adjustment mechanisms can be identified and applied.
3. Sometimes there is a need to consider international capital flows in various categories (FDI, FPI and other investments or loans) simultaneously with domestic objectives to avoid overheating of the economy or deficits in external financing. International capital inflows may help to resolve the policy dilemma created by the balance of payments constraints, with the aim of restoring internal and external

equilibrium.

A further relevant finding is that the implications of FDI for the balance of payments should be closely analysed and linked with the level of organisation and development of the financial markets of the countries concerned.

**Chapter 4** highlighted the close relationship between FDI and the liberalisation of financial markets and the financial account of the balance of payments. FDI as a vehicle for development and growth, a channel for the transfer of technology, and a means of inserting developing countries into the global economy was discussed. The key role of financial markets was emphasised.

It was also argued that liberalisation of regulated markets and the furthering of efforts at globalisation were beneficial for developing countries because, through FDI, they promote domestic investment, technology transfer spillovers and financial development.

The chapter argued that one of the greatest merits of the liberalisation of financial markets is to provide opportunities for greater access to foreign saving. This is associated with opening the financial account of the balance of payments, which generally leads to greater international capital inflows and these, if managed appropriately, stimulate further investment and economic growth. This is particularly valid for developing countries.

The chapter suggests that the challenge for developing countries is to maximise the net benefits from the liberalisation of financial markets and financial accounts in the following two ways:

1. For countries that already have significant involvement in global financial markets, the key requirement is to create institutions and a legal framework that strengthen the positive aspects of financial integration and benefits from foreign investments. This should be combined with good macroeconomic policies and a sound financial system to protect themselves against swings in investor sentiment.
2. For countries that are not involved in global financial markets, financial account liberalisation should be sequenced but this should remain the ultimate goal.

The chapter also showed that liberalisation has its costs. The main problems are generally associated with excessive international capital inflows and outflows, and the volatility of

net capital flows. It was therefore concluded that successful financial account liberalisation requires careful sequencing of policies that may help to avoid or reduce the likelihood of external or financial system instability.

Finally, the chapter emphasised that an improvement in financial development, especially if associated with a strong financial system and disciplined macroeconomic policies, can help cushion the negative impact of liberalisation.

In **chapter 5** it was argued that African countries should continue striving to improve their image and should intensify the process of global integration, while taking into account that international capital flows tend to be very large and therefore potentially disruptive to their economic development. The short and long-term prospects of Sub-Saharan Africa were then discussed. It was concluded that while a slowdown in the major economies would naturally affect all developing countries, exports from Africa could benefit from external initiatives such as the US African Growth and Opportunities Act (AGOA) and internal developments such as NEPAD (New Partnership for Africa's Development).

Regionally, South Africa and Angola – as the biggest FDI recipients – have still to cooperate fully. Once they do so they will gain a great deal from their many links. While Angola stands to gain more than South Africa from such cooperation, the two countries would both grow more rapidly over a sustained period and achieve greater reductions in poverty. Thus, developing, diversifying and intensifying trade bilaterally and multilaterally under SADC programmes such as the NEPAD programme are likely to power sustained development and poverty-reduction growth in individual countries and in the region.

## **6.2 SUGGESTIONS FOR FURTHER RESEARCH**

Turning to the question of areas for further research, the increasing influence of FDI on the internationalisation of production and finance worldwide could be further examined. In particular, attention should be paid to the growing importance and influence of FDI on

developing countries in the global economic process and their relationship with the major developed countries in this regard.



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