

# 3

## PRIVATE CAPITAL FLOWS: FOREIGN DIRECT INVESTMENT AND PORTFOLIO INVESTMENT



*Private capital flows have become an increasingly significant source of investment in developing countries, indicating the high degree to which developing countries have become integrated into the global economy and thus how exposed they are to any financial shock.*



Photo: Eskinder Debebe/UN Haiti



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

## Introduction

Since the late 1990s, private capital flows (PCF)<sup>1</sup> have become a significant source of investment for many developing countries.<sup>2</sup> Although these flows are still largely concentrated in a few high-income and emerging economies, more PCF are moving into LICs than ever before. In countries such as Zambia, foreign private capital stocks as a percentage of GDP reached 75 percent by 2007 and, for many countries in Africa (Uganda, Cameroon, the United Republic of Tanzania and the Gambia), stocks reached 30 percent of GDP (Bhinda and Martin 2009).

However, as is well-known, PCF tend to be highly volatile — even aid is less volatile and more predictable in most countries. A financial shock can result in the sudden reversal of capital flows and also in sharp declines in inflows. Generally, it is assumed that FDI as compared to Portfolio Investment (PI) is more stable, less prone to volatility and brings significant development benefits to the country, reasons why many developing countries have designed incentive packages to attract foreign capital. “FDI triggers technology spillovers, assists human capital formation, contributes to international trade integration, helps create a more competitive business environment and enhances enterprise development. All of these contribute to higher economic growth, which is the most potent tool for poverty alleviation” (OECD 2002). However, recent evidence highlights the volatility of FDI, laying to rest the idea of FDI’s supposed stability.

The consequences of such volatility for growth are obvious, especially in countries highly reliant on such flows for investment. When investment sources are unpredictable and volatile, so is growth. This is especially the case for the smaller, lower-income countries where many FDI projects are huge in relation to the size of the host economy and because these economies tend to be much less diversified and depend on one or two large projects or sectors (Bhinda and Martin 2009).

Further, the macro-economic effects typical of such volatility also impact poor households through various channels. For instance, sudden and large inflows of private capital have been “associated with inflationary pressures, a real exchange-rate appreciation, a deterioration of the current account and a boom in bank lending” (Calvo et al. 1994). And as is well known, inflation affects poverty through its impact on real wages. Since poor households spend more of their budget, on average, on necessities than on luxuries, the rise in prices of food and essential commodities affects them more than it does non-poor households (Son and Kakwani 2006).

On the other hand, financial shocks that result in a sudden reversal of capital flows can lead to a sharp devaluation of the exchange rate. As imports become more expensive, the prices of imported goods (such as medicine and food) rise and weaken the purchasing power of poor households. Thus, a direct negative impact is on poor people’s purchasing power, caused by the sharp increase in the price of imported goods such as food and medicine.

A devaluation of the exchange rate can also increase a country’s external debt profile, which could result in the government cutting back public spending — including social expenditure — in order to meet increased debt service obligations. Reductions in expenditure on social services during crises have been shown to have both immediate and long-term impacts on poor people. Cutbacks in spending on health and education, for example, can result in a reduction in human capital, thus limiting the capacity of poor people to produce and generate income in the future (Lustig 2000). Further, poor people are often forced to liquidate physical and financial assets during a crisis in order to smooth consumption, but this often serves to limit their capacity



to continue with their livelihoods. Further, renewed employment opportunities during the initial recovery period are often less well remunerated (Fallon and Lucas 2002).

The impact of an exchange rate devaluation on the wider economy can also result in a reduction in demand for labour, with falls in real wages and increases in unemployment, and in less secure forms of employment. Devaluation harms the private sector, as banks and large companies, which have borrowed in international markets, see the value of their dollar liabilities rise. As bankruptcies in the private sector rise, this results in a decline in real wages and job losses (Honohan and Klingebiel 2000, Kimmis 2008).

As noted earlier, efforts to promote PCF have been predicated on the assumption that such investments will have significant and positive development paybacks. It is argued that FDI influences growth by raising total factor productivity and, more generally, the efficiency of resource use in the recipient economy. Further, beyond the strictly economic benefits, “FDI may help improve environmental and social conditions in the host country by, for example, transferring ‘cleaner’ technologies and leading to more socially responsible corporate policies” (OECD 2002). However, a number of studies have questioned the growth and development benefits associated with such flows. “Rates of foreign investment are very poorly correlated with job creation, poverty reduction or other development outcomes” (UNCTAD 2005, Rodrik and Subramaniam 2008, Action Aid 2009, Bhinda & Martin 2009).

To sum up, PCF have become an increasingly significant source of investment in developing countries, indicating the high degree to which developing countries have become integrated into the global economy and thus how exposed they are to any financial shock. Indeed, in some countries, foreign capital is supplanting (rather than supporting) domestic capital as the main source of investment.

Given the volatility associated with capital flows, it is hardly surprising to find that economic growth in these countries is also highly volatile. Such volatility means that governments can scarcely predict how much capital is available to them to plan a sustainable growth strategy, which is ironic, since many LICs are outbidding themselves to attract foreign capital. Moreover, the development paybacks associated with capital flows have so far been less than promising.

For these reasons, policy measures to build a country’s resilience to private capital related shocks have focused on:

- Strengthening domestic resource mobilization in order to reduce dependence on external sources of investment
- Stabilizing the volatility associated with PCF
- Maximizing the development payback of these flows and enhancing their linkages with growth and poverty reduction outcomes

*Between 1995 and 2009, total PCF to developing countries increased almost fivefold, with much of the increase taking place in the period 2002–2007.*



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

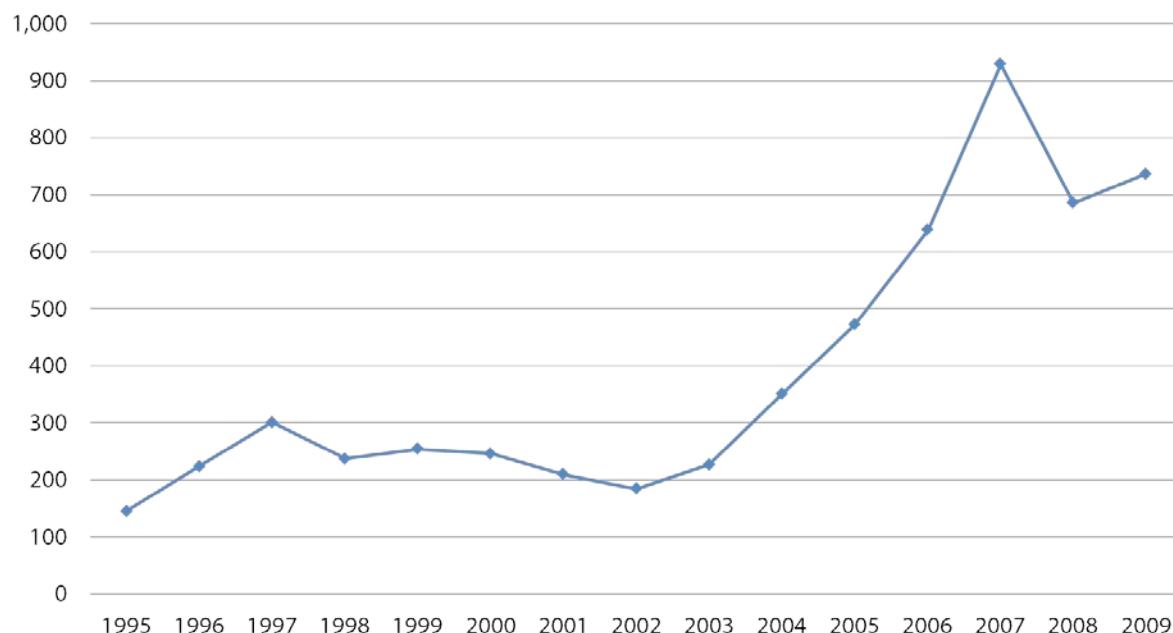
## Trends and Composition of Private Capital Flows

Between 1995 and 2009, total PCF to developing countries increased almost fivefold (Chart 3.1), with much of the increase taking place in the period 2002–2007 (incidentally also the commodity price boom period). Private capital flows increased from \$184 billion in 2002 to \$929 billion in 2007 (a 404 percent increase in 6 years). As the financial crisis began to unfold, these flows fell by 26 percent between 2007 and 2008. Private capital flows began to recover slowly, increasing by 7 percent in 2009 from \$686 billion in 2008 to \$737 billion in 2009.

In terms of composition (Chart 3.2), FDI increased fourfold (a cumulative increase of 395 percent) and was the most important investment channel throughout the period. Between 1995 and 2003, FDI increased from \$111 billion to \$182 billion, soaring thereafter to reach \$704 billion in 2007. The growth in FDI slowed significantly in 2008 due to the global crisis and 2009 saw a 28 percent decline in FDI inflows.

Portfolio investment comprised the smallest share of PCF throughout this period and these flows were significantly more volatile than FDI. After a brief rise from \$33 billion in 1995 to \$120 billion 1997, PIs collapsed on the heels of the Asian financial crisis to reach just \$5 billion by 2001. By 2007, however, PIs had rebounded, reaching \$225 billion — a 44-fold increase. As the most recent crisis unfurled, PIs crashed and, by 2008, registered a reversal of investments of \$80 billion.<sup>3</sup> In 2009, PIs bounced back to \$188 billion. Low return on assets and slow economic growth in advanced economies led to the strong and fast rebound in equity PI inflows to developing economies.

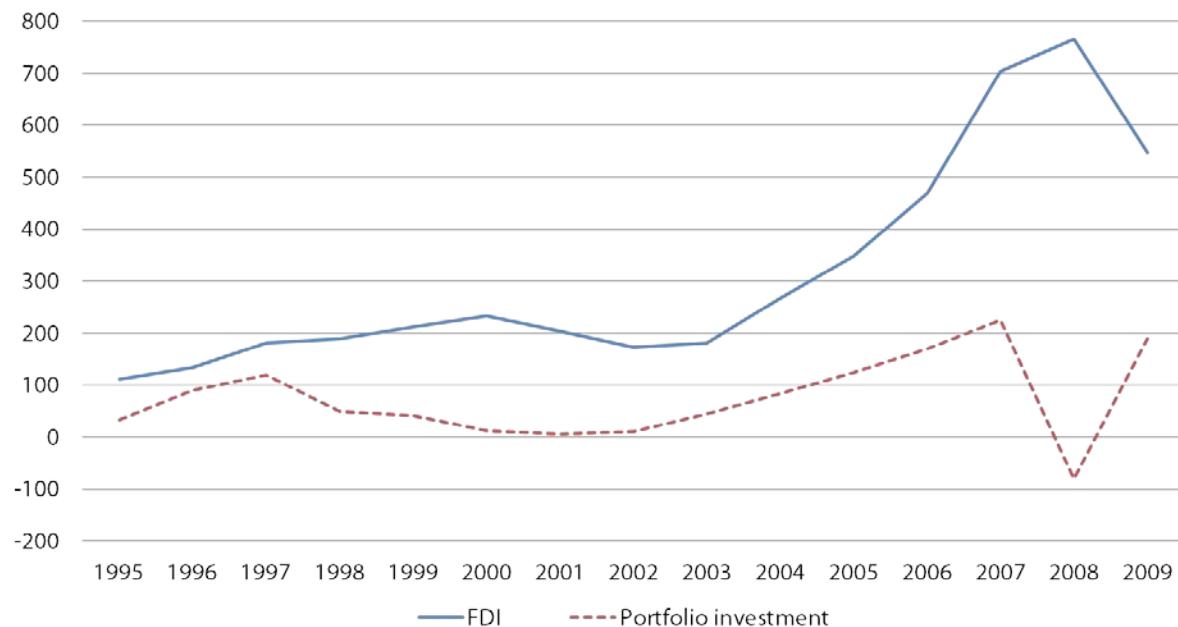
**Chart 3.1: Private capital flows to all developing economies, 1995–2009  
(US\$ billions)**



**Source:** Calculated using data from World Bank, *Global Finance for Development*, and IMF, *Balance of Payment Statistics 2009*



**Chart 3.2: Composition of private capital flows, 1995–2009 (US\$ billions)**



**Source:** Calculated using data from World Bank, Global Finance for Development, and IMF, Balance of Payment Statistics 2009

## Foreign Direct Investment

FDI is by far the most important component of PCF to developing (and transition) economies. By 2009, these economies absorbed almost half of global FDI inflows (UNCTAD 2010a).

The inflows of FDI by region (Chart 3.3) indicate that the CIS region benefited most from the surge in inflows during the period 1995–2009. FDI inflows to the CIS grew by 1,620 percent in 15 years, increasing from \$4.1 billion in 1995 to \$69.9 billion in 2009. Africa followed with a growth rate of 936 percent, with FDI inflows rising from \$5.7 billion in 1995 to \$58.6 billion in 2009. For Latin America and the Caribbean, FDI inflows grew more slowly (295 percent), increasing from \$29.5 billion in 1995 to \$116.6 billion in 2009. FDI inflows to Asia grew by 276 percent from \$80.1 billion in 1995 to \$301.4 billion in 2009. The Pacific Islands had the slowest rate of FDI growth (170 percent) during the period, rising from \$0.7 billion in 1995 to \$1.9 billion in 2009.

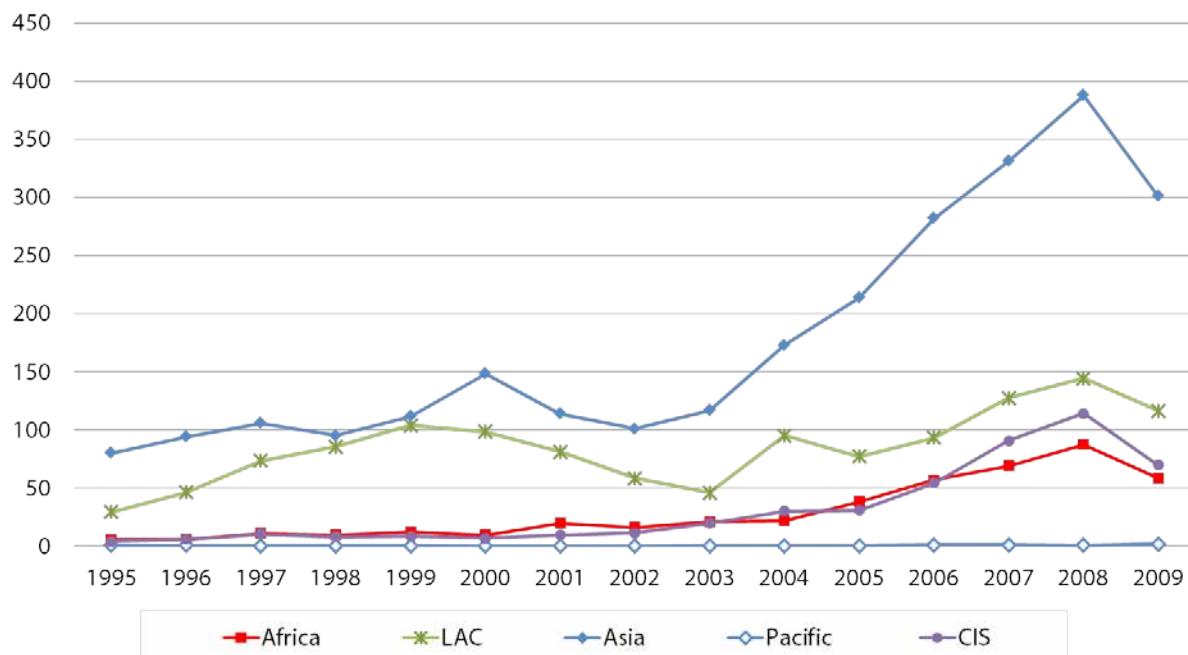
Despite the differential in growth rates during the period, as of 2009, Asia received 55 percent of all FDI inflows to developing countries. Latin America and the Caribbean was the second biggest recipient (21 percent), followed by the CIS (13 percent), Africa (11 percent) and the Pacific Islands (0.3 percent). In other words, Asia received over half of all FDI inflows and, within Asia, China and Hong Kong (SAR of China) received 48 percent of the total FDI in 2009.

FDI inflows declined sharply as a result of the latest global crisis. Regions that had the highest growth in FDI during the boom years and were also most dependent on FDI for investment (namely CIS and Africa regions) had the biggest decline in FDI inflows after the crisis. The CIS and Africa regions were the worst affected



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

**Chart 3.3: FDI inflows by region, 1995–2009 (US\$ billions)**



**Source:** Calculated using data from UNCTAD, *World Investment Report 2010*

(39 percent and 35 percent, respectively). In contrast, the decline was lower in Asia and the Latin America and the Caribbean regions (22 percent and 19 percent, respectively).

The Pacific Islands, which represent a very small fraction of total FDI inflows, had an increase in FDI inflows between 2008 and 2009 of 111 percent.

To sum up, despite the increase in FDI across all developing regions, these flows remain quite concentrated. Of all FDI inflows received by developing economies in 2009, 55 percent went to just 10 countries (Table 3.1). China was the single biggest receiver, with 17 percent.

By development status (Chart 3.4), high-income developing economies received more FDI flows than any other development group for most of the period, in part because “new investment is more productive in countries with a skilled workforce and well-developed infrastructure” (Mishra et al. 2001). Inflows to the high-income developing economies increased from \$41.8 billion in 1995 to \$200 billion in 2009 (a growth rate of 379 percent).

For the MICs, FDI inflows increased from \$22.1 billion in 1995 to \$97.3 billion in 2009 (a growth rate of 339 percent), whereas inflows to LICs increased from \$52.1 billion in 1995 to \$181 billion in 2009 (a growth rate of 248 percent). Although the growth in FDI inflows was least for the set of LICs, it is striking that the LDCs—a subset of LICs—recorded the biggest growth in FDI inflows, registering an increase of 1,489 percent (from \$1.8 billion in 1995 to \$28 billion in 2009). The reason for this is that the LDCs account for only 15 percent of total low-income country FDI inflows while China by itself accounts for 52 percent of all inflows to LICs.

# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

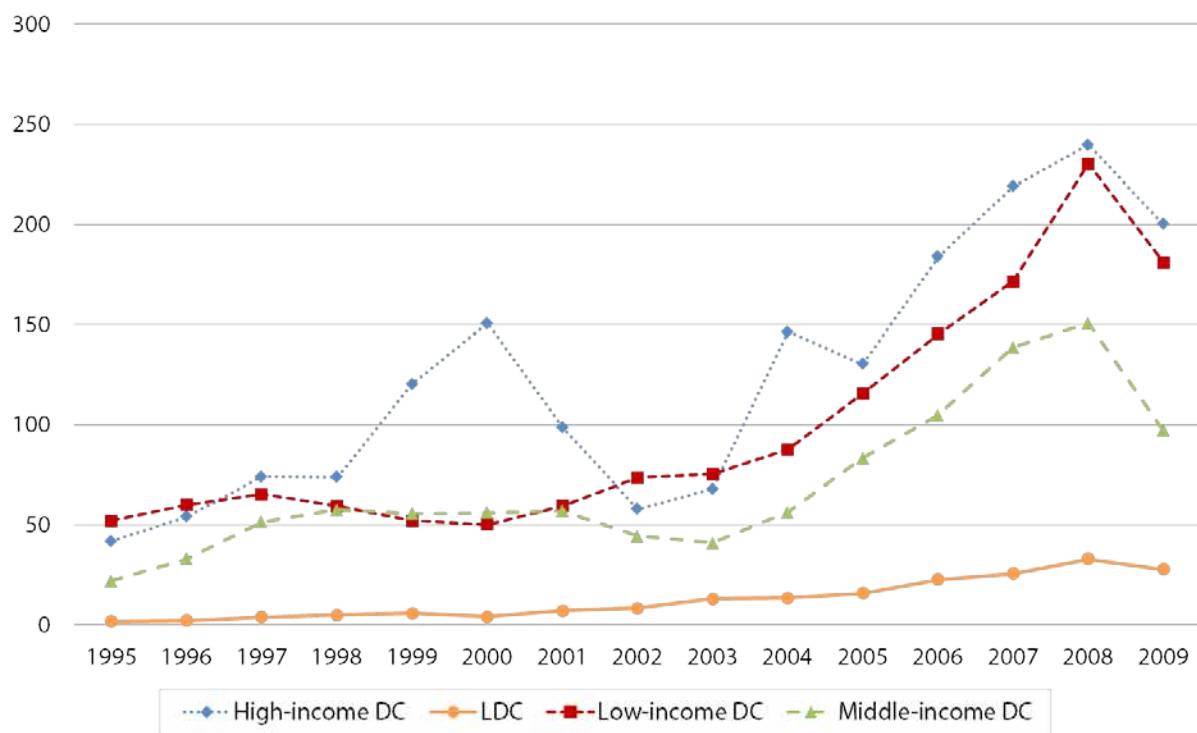


**Table 3.1: Top 10 Recipients of FDI Inflows (2009)**

Rank	Country	Share of FDI
1	China	17.30%
2	Hong Kong, SAR of China	8.80%
3	Saudi Arabia	6.50%
4	India	6.30%
5	Brazil	4.70%
6	Singapore	3.10%
7	Angola	2.40%
8	Chile	2.30%
9	Mexico	2.30%
10	Turkey	1.40%
<b>Total</b>		<b>55.10%</b>

**Source:** Calculated using data from UNCTAD, World Investment Report 2010

**Chart 3.4: FDI inflows by development status, 1995–2009 (US\$ billions)**



**Source:** Calculated using data from UNCTAD, World Investment Report 2010



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

The most recent global crisis led to a decline in FDI inflows for all development groups. Between 2008 and 2009, FDI inflows declined in MICs by 35 percent, followed by LICs, where FDI declined by 21 percent. For the high-income group of countries, FDI declined by 17 percent and FDI inflows in LDCs fell least (15 percent).

As of 2009, though, both high-income and low-income developing countries recorded significantly higher levels of FDI inflows (40 percent and 38 percent, respectively) than the MICs, where FDI inflows increased by 20 percent.

## *Sources of Foreign Direct Investment*

Development finance has generally been characterized as a one-way flow of capital from the advanced economies to the developing world. Although the majority of PCF are sourced from the advanced countries, significant shares of FDI have more recently been coming from non-OECD countries and this trend has accelerated in the last decade. In fact, overall, “growing FDI between developing countries in recent years has sometimes compensated for reductions in FDI flows from high-income countries” (World Bank 2006).

The growing role of developing economies as sources of FDI is confirmed by investment promotion agencies (IPAs). As of 2009, developing and transition economies account for three of the top ten most promising investors and seven of the top twenty (UNCTAD 2010b). With respect to South-South flows, three trends

appear to be strongly evident: (1) There is rapidly growing intra-regional investment in Africa and Latin America; in Latin America, for instance, Argentina, Brazil and the Bolivarian Republic of Venezuela are investing heavily in Bolivia; (2) some countries are succeeding in attracting non-regional flows; such is the case with the Gambia, which has a 45 percent share of investors from the Middle East and North Africa; and (3) many countries continue to record significant amounts channelled via tax havens (Bhinda and Martin 2009).

*It is important to note that FDI outflows from developing countries have shown less volatility than FDI outflows from advanced economies.*

Evidence also shows that TNCs from developing and transition countries have increasingly been investing in Africa over the past few years. “They accounted for 21 percent of flows to the region over the 2005–2008 period, compared to 18 percent in 1995–1999. Investors from China, Malaysia, India and the Gulf Cooperation Council (GCC) are among the most active—although Africa still makes up only a fraction of their FDI” (UNCTAD 2010a). As a result, the share of non-OECD countries in total FDI stock varies from 30 percent in Malawi to as high as 60 percent in the Gambia.

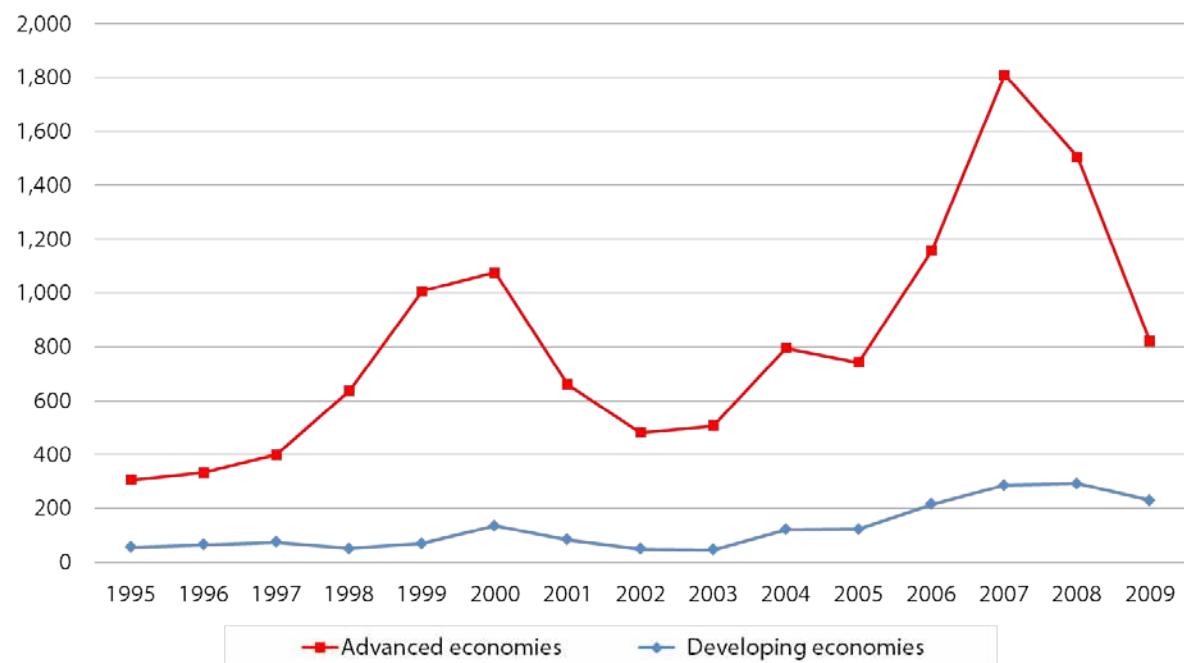
The increase in South-South FDI flows is corroborated by data on FDI outflows (Chart 3.5), which shows that the developing world represented a bigger share of total FDI outflows in 2009 than in 1995. Specifically, total FDI outflows from developing countries in 1995 were only \$55 billion, representing 15 percent of total world FDI. By 2009, FDI outflows from developing countries were \$229 billion, representing 22 percent of total world FDI.

Although advanced countries still account for 78 percent of total FDI outflows, outflows from the developing countries have been growing at nearly twice the rate as that from advanced countries. Between 1995 and 2009, FDI outflows from advanced countries grew by 168 percent, compared to a 317 percent increase in the outflows of FDI from developing countries.

# Private Capital Flows: Foreign Direct Investment and Portfolio Investment



**Chart 3.5: FDI outflows, 1995–2009 (US\$ billions)**



**Source:** Calculated using data from UNCTAD, *World Investment Report 2010*

The regional breakdown of FDI outflows (Annex 3.A) shows that Asia has the biggest share of FDI outflows. As of 2009, Asia contributed 63 percent of FDI outflows, followed by the CIS region with 18 percent, and Latin America with 17 percent of FDI outflows from the developing economies.

The biggest increase during the period was in the CIS region, where FDI outflows increased by 80 times, from \$0.6 billion in 1995 to \$49.7 billion in 2009. Latin American FDI outflows grew by 535 percent, from \$7 billion in 1995 to \$47 billion in 2009. Asian FDI outflows grew by 296 percent, from \$45 billion in 1995 to \$177 billion in 2009. Africa had a 69 percent increase in FDI outflows, from \$2 billion in 1995 to \$5 billion in 2009. The Pacific Islands had very negligible amounts of FDI outflows (less than \$1 billion).

It is important to note that FDI outflows from the developing countries have shown less volatility than FDI outflows from advanced economies. Between 2008 and 2009, FDI outflows from advanced economies (where the shock originated and had the biggest impact) declined by 46 percent, while, in the developing countries, the decline was only 22 percent. This trend is different in this crisis when compared to other ‘busts’ of the last 15 years. Between 1997 and 1998 during the Asian crisis, FDI outflows from the developing countries declined by 31 percent, while they continued rising in advanced economies. In the 2001 crisis, all FDI flows fell by 39 percent, regardless of the originating economy.

By development status (Annex 3.B), FDI outflows increased fastest for low-income developing economies, rising by 1,685 percent (from \$4 billion in 1995 to \$67 billion in 2009), mainly because of the growth in Chinese FDI outflows. For high-income developing economies, FDI outflows grew by 242 percent (from \$43 billion in



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

1995 to \$148 billion in 2009), whereas MICs saw a more modest increase of 75 percent in FDI outflows (from \$8 billion in 1995 to \$14 billion in 2009).

Middle-income countries also had the lowest share of total FDI outflows in 2009 (6 percent), while the share for LICs was 29 percent. High-income developing economies accounted for the remaining 65 percent of FDI outflows in 2009.

## *Destination of Private Capital Flows by Sector*

Although it is generally assumed that the bulk of foreign investment, especially in LICs, goes to the primary sector, the evidence (Table 3.2) indicates that there has been considerable diversification into non-primary sectors since the 1990s. During the last two decades, FDI inflows to the services sector have been gaining ground at the expense of FDI inflows into the manufacturing sector: between 1989 and 1991, services accounted for only 35 percent of total FDI flows, while manufacturing accounted for 52 percent of FDI inflows. By 2005–2007, though, the manufacturing sector received only 37 percent of FDI inflows, whereas the services sector recorded the biggest share of FDI inflows (49 percent).

The share of FDI going to the primary sector was 13 percent in 1989–1991 and by 2005–2007, inflows to the primary sector (agriculture and extractive industries) had increased to 14 percent of total FDI inflows.

**Table 3.2: FDI Inflows to Developing Countries by Sector (US\$ billions)<sup>4</sup>**

	Primary	Manufacturing	Services <sup>5</sup>
1989–1991	3.9	16.1	9.3
2005–2007	46.8	121.0	161.4

**Source:** Calculated using data from UNCTAD, *World Investment Report 2009*

In terms of the absolute level of inflows by sector, FDI into the services sector increased the most during the period (nearly seventeenfold), from \$9.3 billion in 1989–1991 to \$161 billion in 2005–2007.

Inflows into primary activities increased elevenfold, from \$3.9 billion in 1989–1991 to \$46.8 billion in 2005–2007. Most of this increase was in the mining, quarrying and petroleum industries (where FDI grew fourteenfold during the period). Mining, quarrying and petroleum represented 93 percent of all FDI in the primary sector. FDI into the manufacturing sector had the lowest rate of increase (sixfold) during the period, rising from \$16.1 billion in 1989–1991 to \$121 billion in 2005–2007.

Country case studies also verify the diversification of FDI away from primary resources. For instance, FDI is going to non-resource-based sectors such as real estate banking and tourism in the Gambia, construction in Ghana, manufacturing in Malawi, new industries in Nicaragua, and telecommunications and commerce in Uganda. In other words, some countries have enhanced the diversification of their FDI or kept it well diversified. A survey of 22 LICs showed that all countries “have identified scope for further diversification into ‘under-invested’ sectors. In all countries these include agriculture, which has suffered from under investment due to lack of credit, infrastructure, inputs and fertiliser, and extension services, poor information for foreign investors on the sector, and land rights issues. Other priorities are tourism in Zambia, manufacturing in the Gambia and Zambia.” (Bhinda & Martin 2009).

# Private Capital Flows: Foreign Direct Investment and Portfolio Investment



## FDI as a Source of Investment

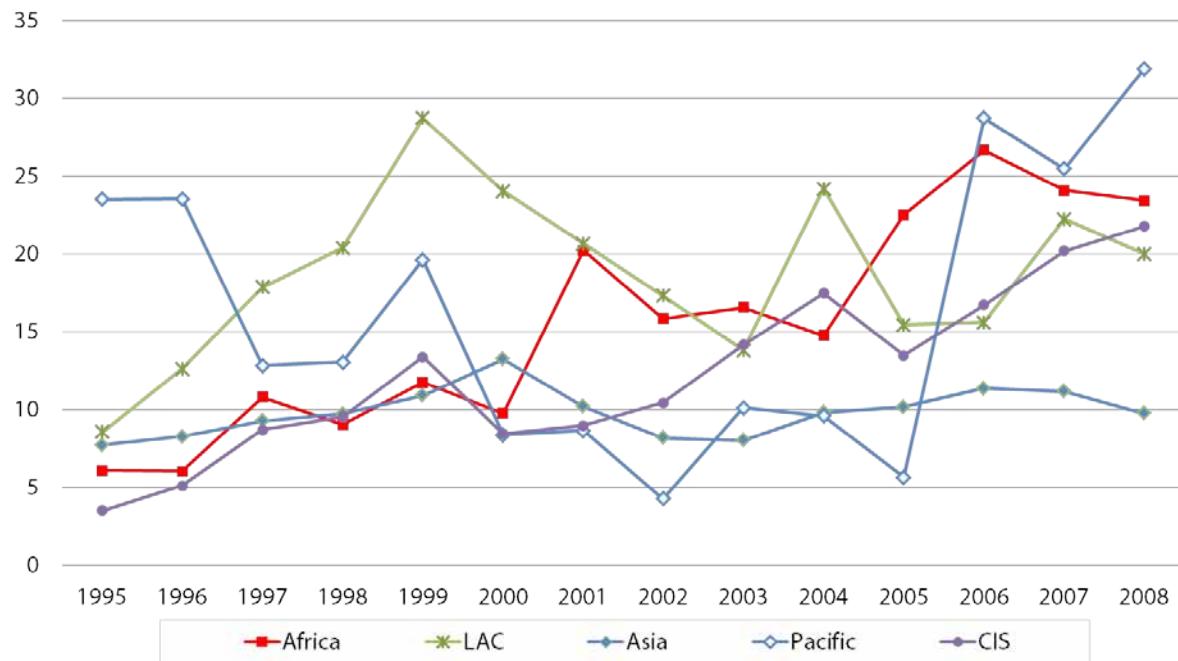
Earlier, it was noted that many LICs are increasingly relying on these sources of capital to finance investment and stimulate economic growth. Examining FDI as a share of gross fixed capital formation (GFCF) (Chart 3.6) clearly shows the growing reliance on such sources of finance for investment — relative to domestic sources — across all developing regions. In short, FDI appears to be substituting for domestic capital as a source of investment in many developing countries.

As of 2008, FDI represented, on average, 20 percent of GFCF in all developing regions except Asia. The CIS region witnessed the biggest rate of increase in FDI as a share of GFCF, from 3.5 percent in 1995 to 21.8 percent in 2008, and, in Africa, where FDI used to represent 6.1 percent of GFCF in 1995, the share increased to 23.4 percent by 2008. Both regions surpassed Latin America and the Caribbean and Asia in terms of FDI as a share of GFCF by 2008. For Latin America and the Caribbean, FDI grew from 8.6 percent of GFCF in 1995 to 20 percent in 2008. FDI inflows as a share of GFCF were by far the highest for the Pacific Islands, rising from 23.5 percent in 1995 to 31.9 percent in 2008.

In Asia, FDI inflows as a share of GFCF in 1995 were higher than for Africa and the CIS, but, by 2008, Asian investments became the least dependent on FDI inflows. FDI inflows to Asia as a share of GFCF grew from 7.7 percent in 1995 to 9.8 percent in 2008.

*Most discussions on volatility have assumed that the PI component of PCF is volatile. FDI is assumed to be relatively stable. Evidence, however, indicates that even FDI is subject to considerable volatility.*

**Chart 3.6: FDI inflows as a share of GFCF by region, 1995–2008 (in percent)**

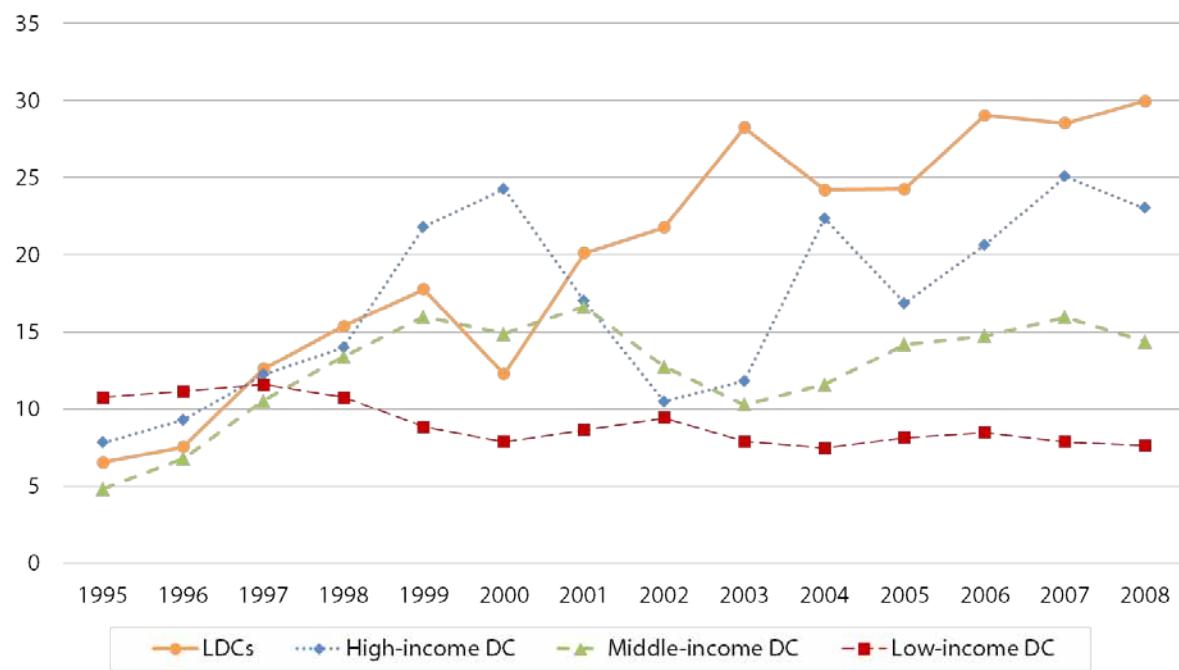


**Source:** Calculated using data from UNCTAD, *World Investment Report 2010*



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

**Chart 3.7: FDI as a share of GFCF by development status, 1995–2008  
(in percent)**



**Source:** Calculated using data from UNCTAD, *World Investment Report 2010*

To sum up: the share of FDI in GFCF in 2008 ranged from a high of 32 percent in the Pacific Islands to 23 percent in Africa, 22 percent in the CIS and 20 percent in Latin America. Asia was significantly less dependent on FDI for investment, with the share of FDI in GFCF being just 10 percent.

By development group (Chart 3.7), the LDCs experienced the biggest increase in the importance of FDI inflows relative to GFCF during the period. In the LDCs, FDI as a share of GFCF increased by 358 percent, from 6.5 percent in 1995 to 30 percent in 2008. On the other hand, FDI as a share of GFCF in LICs fell by 29 percent, from 10.8 percent in 1995 to 7.6 percent in 2008 (consequent to China's reduction of its FDI-to-GFCF ratio). In high-income countries, FDI as a share of GFCF increased by 194 percent (from 7.8 percent in 1995 to 23 percent in 2008) and, in the MICs, FDI as a share of GFCF increased by 198 percent (from 4.8 percent to 14.4 percent during the same period). As of 2008, FDI as a share of GFCF was highest in LDCs (30 percent), followed by high-income countries (23 percent), the MICs (14.4 percent) and finally by the low-income development group (7.6 percent).

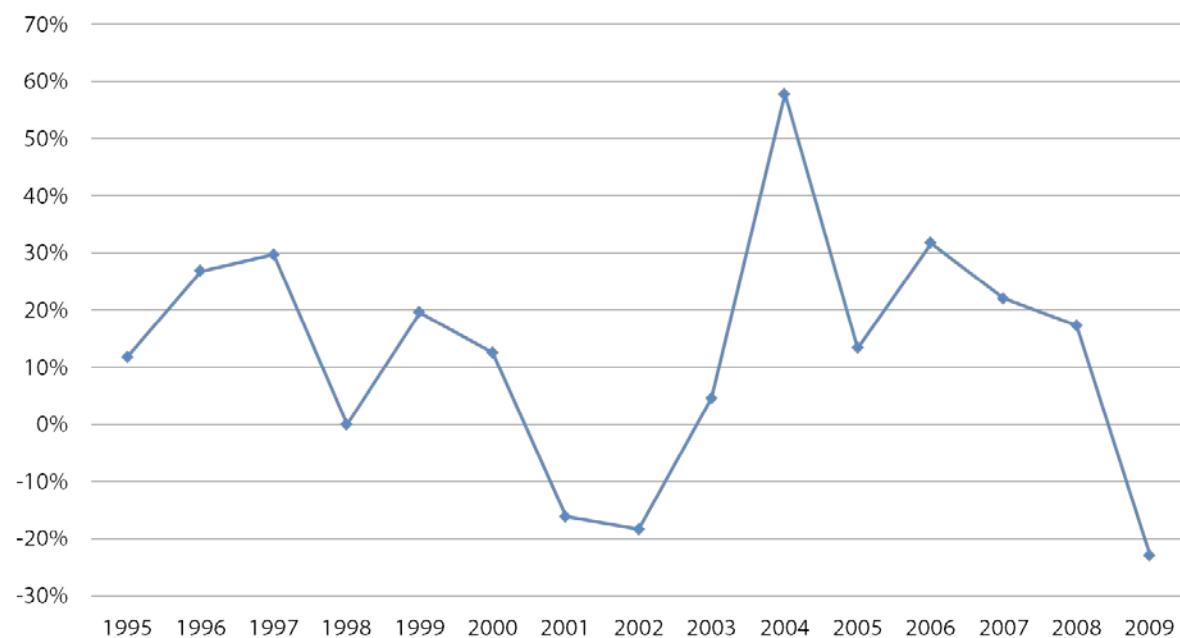
## Volatility in FDI Flows

It is well known that PCF tend to be highly volatile; even aid is less volatile and more predictable in most countries (Bhinda and Martin 2009). Most discussions on volatility, though, have assumed that the PI component of PCF is volatile. FDI is assumed to be relatively stable.

# Private Capital Flows: Foreign Direct Investment and Portfolio Investment



**Chart 3.8: Annual rate of change of FDI inflows to developing countries, 1995–2009**



**Source:** Calculated using data from IMF, *Balance of Payments Statistics 2009*

Evidence (Chart 3.8), however, indicates that even FDI is subject to considerable volatility. For instance, even at the aggregate level of all developing countries, FDI inflows can rise by as much as 58 percent in a boom year (such as 2004) and can fall by 23 percent in a bust year (such as 2009).

The actual volatility faced by a single economy can be much higher. On average, the annual rate of change of FDI inflows into any given country was 163 percent (see Annex 3.C). In other words, in a single developing economy, FDI inflows could rise or fall by as much as 163% in a year.

**Table 3.3: Volatility of FDI Inflows by Region**

Region	Average Absolute Annual Rate of Change in FDI Inflows
All Developing	163%
A&P	113%
Africa	204%
Arab States	406%
ECIS	93%
LAC	107%

**Source:** Calculated using data from UNCTAD, *World Investment Report 2010*



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

An examination of the volatility of FDI inflows by region<sup>6</sup> (Table 3.3) shows that the fluctuations in FDI inflows from 1995 to 2008 appear to be most volatile for the Arab States, followed by Africa, Asia Pacific, Latin America and the Caribbean, and, finally, Europe and the Commonwealth of Independent States (ECIS). In other words, FDI inflows into Latin America and the Caribbean and the ECIS region appear to be the least volatile.

**Table 3.4: Volatility of FDI Inflows by Development Status**

Development Status	Average Absolute Annual Rate of Change
High-income DC	176%
Middle-income DC	146%
Low-income DC	207%
LDC	300%

**Source:** Calculated using data from UNCTAD, *World Investment Report 2010*

By development status (Table 3.4), it appears that FDI inflows are significantly more volatile for the LICs compared to the middle-income or high-income developing countries. As a group, the LDCs faced the highest degree of volatility (300 percent)—nearly double the average for all developing countries. In other words, the LDCs—the poorest group of countries—recorded the highest inflows of FDI between 1995 and 2008 and were also those most exposed to the volatility of such flows.

**Table 3.5: FDI as a Share of GFCF and Growth Volatility by Region**

Region	FDI/GFCF	Standard Deviation of Growth
Arab States	15%	4.8
A&P	19%	3.3
LAC	23%	3.3
Africa	24%	4.7
ECIS	28%	5.7
All Developing	22%	4.3

**Source:** Calculated using data from UNCTAD, *World Investment Report 2010* and World Bank, *World Development Indicators 2009*

Given the considerable volatility of FDI inflows, it is hardly surprising that regions most dependent on such external finance for funding investment would experience more growth volatility relative to other regions. The evidence (Table 3.5) corroborates this: regions most dependent on FDI for investment during 1995 and 2008 (ECIS with an FDI/GFCF ratio of 28 percent and Africa with an FDI/GFCF ratio of 24 percent) also had the highest volatility in growth. In contrast, Asia and the Pacific, the region least dependent on FDI for investment, had less growth volatility.

# Private Capital Flows: Foreign Direct Investment and Portfolio Investment



The Arab States, although not highly dependent on FDI, nonetheless experienced considerable growth volatility, mainly on account of the volatility in oil prices during this period.

**Table 3.6: FDI as a Share of GFCF and Growth Volatility by Development Status**

Development Status	FDI/GFCF	Standard Deviation of Growth
Middle-income DC	19	3.5
Low-income DC	21	4.4
LDC	24	4.8
High-income DC	25	4.1
Transition	26	6.6

**Source:** Calculated using data from UNCTAD, *World Investment Report 2010* and World Bank, *World Development Indicators 2009*

An examination of the relation between growth volatility and the FDI-to-GFCF ratio by development status (Table 3.6) clearly shows that the transition economies experienced the greatest growth volatility, whereas the MICs, which, as a group, have the lowest FDI-to-GFCF ratio (19%), also experienced the least growth volatility.

## *Causes of Volatility*

Generally, the volatility of PCF is attributed to the fact that capital is mobile and will move to countries where returns to its investment are likely to be higher. Others have attributed volatility to domestic and international policy shifts: domestic policy shifts, when frequent or unpredictable, will result in high volatility and low growth. Moreover, the volatility of PCF reflects changes in global liquidity conditions and investment behaviour (Mishra et al. 2001).

A closer scrutiny reveals other important reasons for the volatility in flows such as FDI:

### (a) *Financing of Foreign Direct Investment*

FDI is made up of equity (shares, retained earnings and other capital reserves) and debt (long- and short-term borrowing and supplier credits) from affiliated enterprises.<sup>7</sup> Clearly, a higher debt component produces greater volatility of such flows when there is a tightening in capital markets. Typically, though, it is assumed that FDI is largely equity and hence a stable source of PCF. This is also why most developing countries have encouraged FDI. However, a closer look reveals that equity investors have relied heavily on loan financing contracted overseas (i.e., there is a high degree of debt financing used for what appear to be 'equity' projects). This, in turn, makes countries that are dependent on external finance much more vulnerable to volatility (because debt is the most volatile type of flow) and to a potential debt crisis provoked by the private sector, given that, in many (especially low-income) countries, this debt is between 33 percent and 75 percent of public sector debt levels (Bhinda and Martin 2009).



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

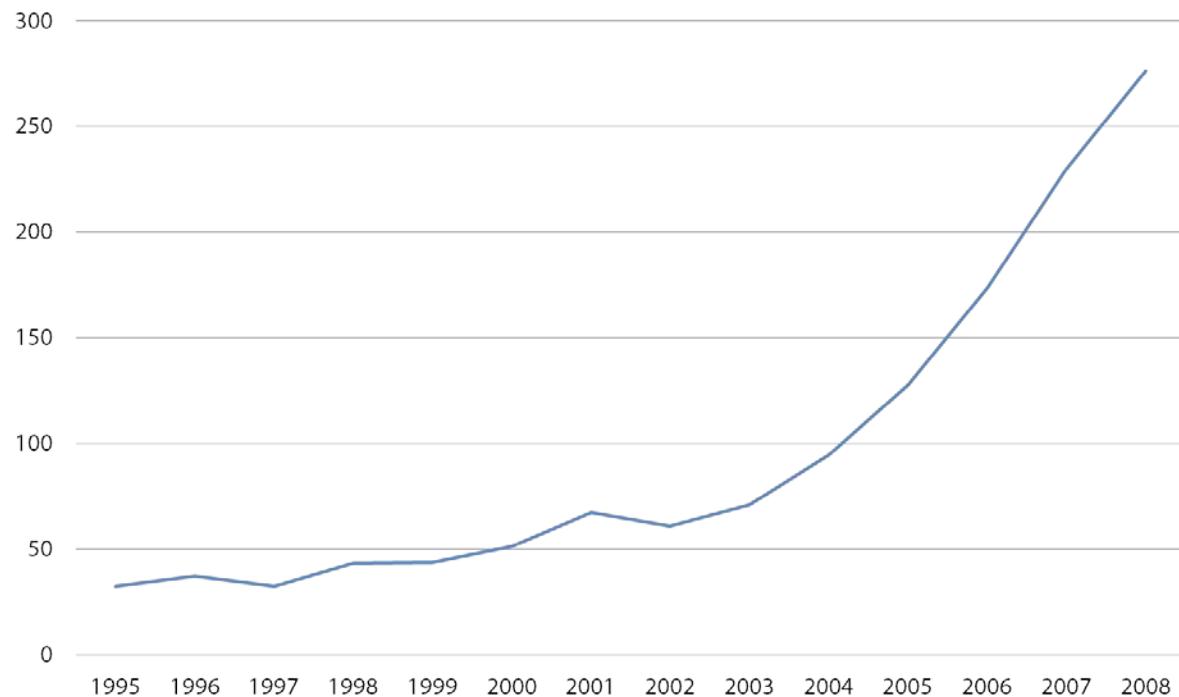
## (b) Profit Repatriation

Nor should it be simply assumed that direct equity is necessarily more stable than loans or portfolio flows. A study of PCF flows to 22 LICs in sub-Saharan Africa and Latin America and the Caribbean found that profits repatriated on FDI were high in most countries; indeed, several countries (Bolivia, Côte d'Ivoire, Mali, Senegal, Cameroon and Gabon) saw income payments in excess of FDI inflows in order to offset economic and political uncertainties or to ensure that projects repaid their investments rapidly. Outflows were lower where investors were confident enough in the investment climate and future opportunities to reinvest their profits (e.g., Nicaragua, Uganda, the United Republic of Tanzania), but even countries with rapid FDI increases in mid-decade saw sharp increases in repatriation in the crisis, as parent companies asked for higher repatriation of profits or dividends or faster repayment of loans.

Rising rates of profit and capital repatriation can generate balance of payment problems, especially if new inflows decline. In Latin America and the Caribbean, for instance, FDI reached record levels by 2007, but, by 2006, repatriated profits equalled the inflows. This indicated that any reduction in new investment might cause problems for balance of payments sustainability. Sub-Saharan Africa also witnessed record FDI inflows, but "these were often exceeded or matched by profits remitted, raising serious questions about the sustainability of FDI" (Bhinda & Martin 2009).

For developing countries as a whole, profits repatriated from FDI investments grew notably between 1995 and 2008 (Chart 3.9). Repatriated income from FDI in the developing world increased 747 percent, from

**Chart 3.9: FDI income repatriated, 1995–2008 (US\$ billions)**



**Source:** Calculated using data from IMF, Balance of Payments Statistics 2009



\$33 billion in 1995 to \$276 billion in 2008. In other words, repatriated profits are growing faster than FDI inflows. In 1995, repatriated profits represented 29 percent of FDI inflows, but, by 2008, repatriated profits represented 36 percent of FDI inflows.

(c) *Mode of Entry of Foreign Direct Investment*

Not all FDI inflows constitute Greenfield investments.<sup>8</sup> As of 2008, 20 percent of FDI inflows comprised mergers and acquisitions projects and, as is well known, M&A is much more volatile relative to other forms of FDI. As indicated by the data (Table 3.7), M&A agreements react much faster to global downturns relative to Greenfield projects that usually require long-term planning and commitment. For example, M&A FDI inflows started to decline as soon as the crisis hit in 2008 (4 percent decline relative to 2007), while other forms of FDI continued their growth, although at a declining rate (19 percent increase relative to 2007).

**Table 3.7: Mergers & Acquisitions in Developing Countries**

Year	M&A	Non-M&A FDI	FDI	M&A	Non-M&A FDI	FDI
<b>US\$ billions</b>				<b>Annual change in %</b>		
2007	130	526	656			
2008	125	628	753	-4%	19%	15%
2009	46	502	548	-63%	-20%	-27%

**Source:** Calculated using data from UNCTAD, *World Investment Report 2010*

Between 2008 and 2009, M&A inflows declined by 63 percent, compared to 20 percent for all other non-M&A FDI inflows.

*Development Impact of FDI*

In order to raise overall investment, many developing countries offer incentive packages to external investors. These incentives range from fiscal incentives (such as subsidies or tax relief) to financial incentives (such as grants, credits, or equity) to subsidized infrastructure, market preferences, labour training and R&D.

However, there appears to be a consensus that these incentives “at most tip the balance in favour of one location among a group of countries that are perceived to have broadly equivalent enabling environments” (OECD 2003). In short, the role of incentives in attracting investment has been limited, yet many countries pay them much attention. It appears “that many of the ‘boom’ sectors for FDI were not—even before the crisis—providing sustainable benefits for growth and poverty reduction, in terms of employment, budget revenue, and transfer of technology and skills” (Bhinda and Martin 2009).

Worse, it has been pointed out that these incentives can also be wasteful if they are ineffective, inefficient (if benefits are not fully realized), have high opportunity cost,

*An increasing number of studies show that the benefits of financial liberalization for development seem vastly overrated and the majority of empirical studies are unable to find robust evidence in support of the growth benefits of capital account liberalization.*



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

or trigger competition with other nations. The danger of the latter is a race to the bottom, where countries undercut each other at the cost of lower health, safety, labour or environmental standards. For this reason, regional groupings such as the East African Community are being urged to agree to coordinated codes of conduct to providing incentives (IMF 2008).

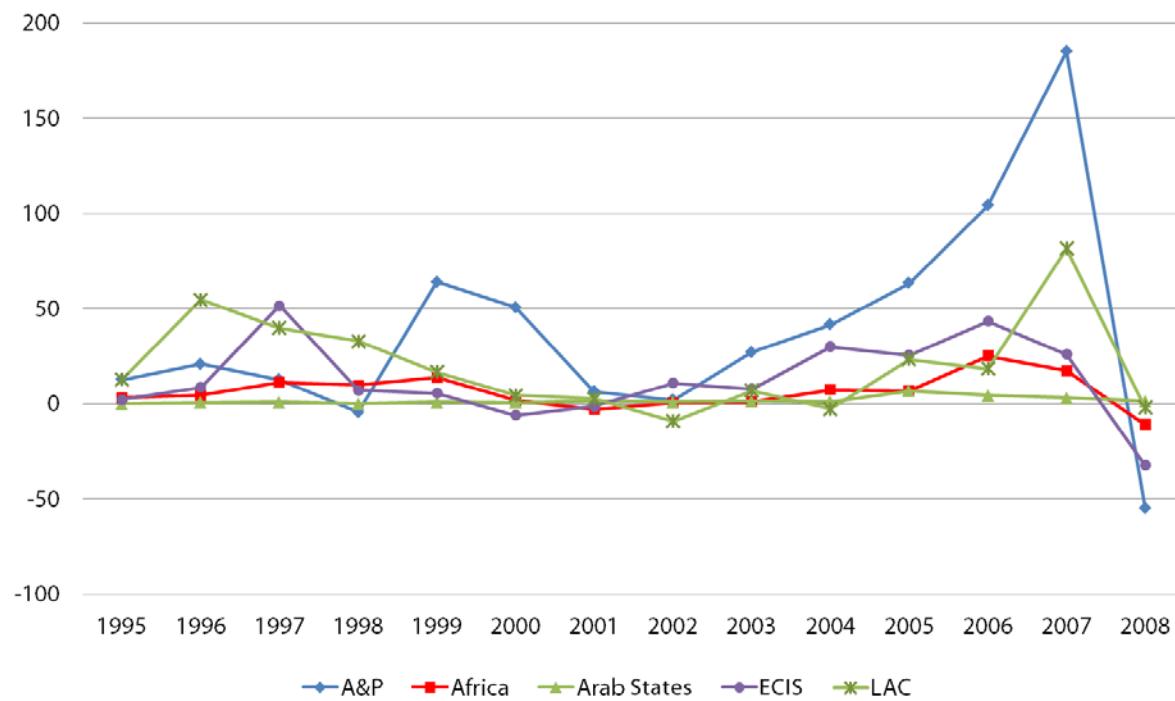
Even worse is the fact that the development paybacks expected from such incentives have failed to materialize. An increasing number of studies show that the benefits of financial liberalization for development seem vastly overrated and the majority of empirical studies are unable to find robust evidence in support of the growth benefits of capital account liberalization (Rodrik and Subramaniam 2008, Kose and Prasad 2002).

## Portfolio Investment

Portfolio investments have long been known to be extremely volatile. In fact, sharp reversals of portfolio flows in times of national or global crisis have underlined earlier lessons about the high volatility of these flows. As increasing numbers of developing countries receive more of these flows, they risk becoming much more vulnerable to financial shocks. Chart 3.10 amply demonstrates the volatility of PI.

Total portfolio inflows (both equity and debt instruments) in all regions except for the Arab States witnessed a very significant decline between 1995 and 2008. In the Arab States, PI inflows actually increased during the period, from \$0.01 billion in 1995 to \$1.4 billion in 2008.

**Chart 3.10: Portfolio inflows by region (US\$ billions)**



**Source:** Calculated using data from IMF, Balance of Payments Statistics 2009

# Private Capital Flows: Foreign Direct Investment and Portfolio Investment



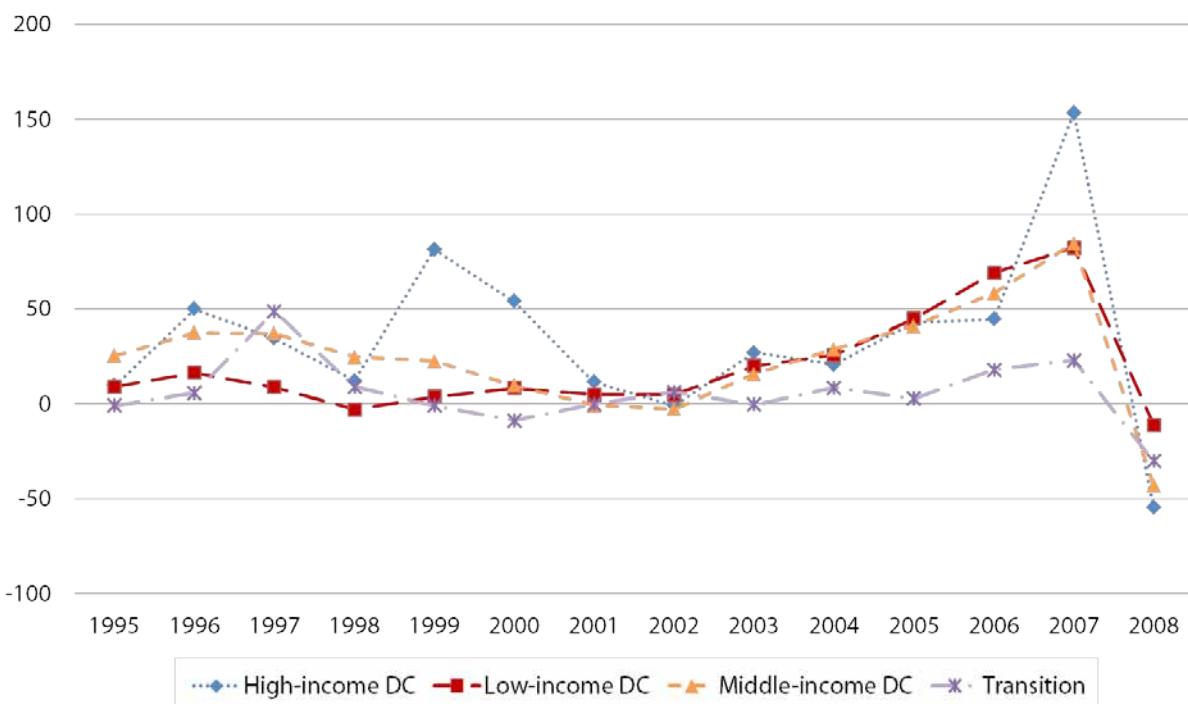
In the Asia and Pacific region, which receives the majority of PI, inflows declined by 535 percent (from \$12.6 billion in 1995 to -\$54.7 billion in 2008), followed by Africa, where PI inflows declined by 441 percent (from \$3.2 billion in 1995 to -\$11 billion in 2008).

For the Latin America and the Caribbean region, PI inflows declined by 116 percent (from \$13 billion in 1995 to -\$2 billion in 2008). The worst affected was the ECIS region, where PI inflows declined by 1,505 percent, from \$2.3 billion in 1995 to -\$32.2 billion in 2008.

As Chart 3.10 indicates, PIs are highly prone to volatility. Portfolio investments increased after the end of the Asian crisis in 1998, only to collapse in 2001 and further in 2002 after the 2001 crisis. During the boom period of 2002 through 2007, PIs increased dramatically in most regions (89 times in Asia and the Pacific, 29 times in Africa, 10 times in Latin America and the Caribbean, 2.8 times in the Arab States, and 1.4 times in the ECIS).<sup>9</sup> But, as the boom ended in 2007, PIs crashed in most regions to below zero (more than 100 percent decline). In the Asia and Pacific region, for example, PIs fell from \$185 billion in 2007 to -\$55 billion in 2008. The ECIS region PI fell from \$26.1 billion in 2007 to -\$32.2 billion in 2008.

The breakdown by development status (Chart 3.11) shows that all groups shared very similar experiences. All development groups saw a decline in inflows from 1995 to 2008. In high-income developing countries, portfolio inflows fell by 667 percent (from \$9.6 billion in 1995 to -\$54.6 billion in 2008). For transition economies, portfolio inflows declined the most — by 4,100 percent (from -\$0.7 billion in 1995 to -\$30.3 billion in 2008). For MICs, portfolio inflows fell by 268 percent (from \$26 billion in 1995 to -\$43 billion in 2008) and for LICs, portfolio inflows fell by 224 percent (from \$9 billion in 1995 to -\$11 billion in 2008).

**Chart 3.11: Portfolio inflows by development status (US\$ billions)**



**Source:** Calculated using data from IMF, Balance of Payments Statistics 2009



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

## *Volatility of Portfolio Investments*

The volatility of PIs is excessively high, with frequent reversals in the direction of flows. Regional averages<sup>10</sup> (Table 3.8) show that the Latin America and Caribbean region has the highest volatility of PIs, followed by the ECIS region, the Arab States, and Africa; the Asia and Pacific region is the least volatile.

**Table 3.8: Change in Portfolio Investments by Region**

Region	Average Absolute Change in Portfolio Investments
A&P	388%
Africa	1,118%
Arab States	2,347%
ECIS	3,176%
LAC	4,524%

**Source:** Calculated using data from IMF, Balance of Payments Statistics 2009

An examination of volatility by development status (Table 3.9) shows that PIs in the MICs seem to be more volatile than in other development groups. Transition economies come second, followed by the high-income and LICs.

**Table 3.9: Change in Portfolio Investments by Development Status**

Development Status	Average Absolute Change in Portfolio Investments
High-income DC	890%
Middle-income DC	5,009%
Low-income DC	561%
Transition	3,428%
All Developing	2,733%

**Source:** Calculated using data from IMF, Balance of Payments Statistics 2009

In conclusion, the evidence points clearly to the substantial increase PCF (largely FDI) received by developing countries; over the past 15 years, this has been particularly true in the ECIS region and in LDCs in Africa. Despite the current concentration of PCF in a few countries, the data point to a clear trend in its diffusion across a larger number of developing countries during this time.

Additionally, the evidence shows starkly the considerable volatility of these flows. Portfolio investment is amply more volatile compared to FDI and the impact of the 2007 financial crisis on these flows was stupendous. Across the board, PIs fell—so much that they almost wiped out any gains made since 1995 in several developing countries. Indeed, as of 2008, PIs were flowing from developing countries rather



than flowing in. In effect, the positive contribution of PI to growth and development appears to have been minimal, if anything. FDI flows also demonstrate considerable volatility. This volatility essentially implies that governments can scarcely predict how much capital is available for them to plan a sustainable development and growth strategy, which is ironic, since so many poorer countries are outbidding themselves to attract such foreign investments.

More worrying is the fact that there appears to be a growing trend for developing countries to rely more on foreign capital relative to domestic capital for investment, and this trend appears to be more pronounced in those countries and regions that have attracted growing inflows of foreign investments (i.e., the ECIS region and LDCs mainly in Africa). Although foreign investments at the aggregate level account for approximately 20 percent of total investment, disaggregated information reveals major country differences. For instance, the share of foreign investment in total investment ranges from 91 percent in Tajikistan, 60 percent in the Congo and 89 percent in Trinidad and Tobago.

Significantly, Asia has depended least on foreign investments to drive growth: foreign capital has supported, not supplanted, domestic investments. The evidence is also clear that domestic sources of capital are much more stable relative to foreign sources. "The countries that have done best have primarily relied on their own resources for development, supplemented by foreign capital as needed, while those whose strategy or circumstances relied on opening up to international markets as a source of resources for development did not see benefits sufficient to compensate for the huge costs they are now experiencing" (Action Aid 2009).

This also means that the countries that receive high inflows of foreign capital are not uniquely most vulnerable to financial shocks: countries that received high inflows of foreign capital and relied on these funds increasingly to drive domestic investment and thereby growth are also vulnerable.

## **Building Resilience: Policy Options for Strengthening Domestic Resource Mobilization, Stabilizing Private Capital Flows and Maximizing their Development Benefits**

Not surprisingly, policy recommendations to build a country's resilience to private capital flow-related shocks have focused on three sets of issues: (1) strengthening domestic resource mobilization to reduce dependence on external finance; (2) stabilizing PCF (i.e., reducing the volatility associated with such flows); and (3) maximizing the development paybacks from such flows.

### *Strengthening Domestic Resource Mobilization*

As noted earlier, the evidence suggests that domestic capital is the most stable and has the biggest payoff for development. Consequently, countries should try to mobilize additional domestic resources by, for instance, increasing tax revenues from foreign investors and encouraging citizens to keep their money in local banks. Specific proposals include:

*Investment volatility essentially implies that governments can scarcely predict how much capital is available for them to plan a sustainable development and growth strategy, which is ironic, since so many poorer countries are outbidding themselves to attract such foreign investments.*



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

- Enforcing Corporate Social Responsibility. "Nothing better reflects the corporate responsibility of any company than its payment of taxes" (Kimmis 2005). Under current international accounting standards, TNCs are required to present consolidated accounts. "This makes it impossible to tell which companies are structuring their trade and investment flows through subsidiaries in tax havens, and manipulating intra-company transactions to gain tax advantages (i.e., reduce their tax liabilities)". This, in turn, limits the capacity of poor countries to raise revenue through taxation on foreign-owned enterprises and deprives them of the revenues they need to sustain investments in infrastructure and fund basic services. A recent study estimated that, if the problems of global tax evasion and avoidance could be addressed, the potential gain for developing countries would be in excess of \$200 billion a year (Cobham 2005).

## **Box 3.1: Combating Exploitative Transfer Pricing Practices**

Governments in developing countries need strong mechanisms to ensure that Transnational Corporations (TNCs) do not wrongfully shift profits outside of national jurisdictions and that the profits reported by TNCs accurately account for the taxable production that takes place within these borders. One way in which TNCs shift profits and evade tax liabilities is through the practice of transfer pricing, i.e., using differentiated pricing structures to take advantage of tax policies across national borders. While standard business practice enables TNCs to make transactions with affiliates, these practices can be manipulated to shift taxable profits towards low-tax countries regardless of where the profits were actually generated. Such exploitation of cross-border differentiation in tax policy can deprive development countries of properly generated tax revenues (AEO 2010).

While no global estimates of the tax revenue losses from transfer pricing are available, estimates suggest that exploitative transfer pricing affects nearly two thirds of all trade with African countries. For Latin America, estimates suggest that almost half of all goods and services traded are impacted by exploitative transfer prices (Gurtner 2008).

Awareness of the exploitation of transfer pricing and the potential developmental impact of such tax evasion

practices has grown over the past decade. The Tax Justice Network, for example, has called for better reporting standards from transnational corporations, emphasizing the need for detailed country-level reporting of operations and accounting. In January 2010, the OECD set up an informal task force on taxation and development to help developing countries achieve development goals by improving overall tax systems. Tackling issues related to exploitation of transfer pricing is one area that was pinpointed for attention (OECD 2010).

In April 2010, members of the African Civil Society signed the Nairobi Declaration on Taxation and Development, which "calls on African governments, African regional bodies, the international financial institutions, the UN, the OECD, aid donors and civil society to take steps to strengthen the transparency, accountability and overall integrity of tax systems and to recognise the crucial role played by tax in development processes" (Tax Justice Network Africa 2010). While the Declaration seeks broad reform of the international tax system with emphasis on helping African governments to strengthen their systems and tax codes, a direct appeal was made in this statement for donors to help African countries monitor TNCs, particularly for exploitative transfer pricing.

**Source:** African Economic Outlook, 2010, *African Economic Outlook*, 2010, Issy les Moulineaux, France; Gurtner, Bruno, 2008, 'Abusive Transfer Pricing is Widespread, Media Orientation 'Conning the Congo' of Greenpeace International', July 30, AllianceSud, Zurich; OECD, 2010, *Co-Chair's Statement at the Joint Meeting on Tax and Development between the Committee on Fiscal Affairs (CFA) and the Development Assistant Committee (DAC)*, 27 January; Tax Justice Network Africa, 2010, *Nairobi Declaration on Taxation and Development*.



- Regulating Capital Flight. Studies of offshore wealth holdings have shown that rich individuals in developing countries tend to hold a far larger proportion of their wealth in offshore tax havens than their North American or European counterparts. For example, over 50 percent of the total holdings of cash and listed securities of individuals in Latin America are estimated to be held off-shore (Kimmis 2005). And again, capital flight can have significant social costs, especially for developing countries. The loss of needed government revenues and foreign exchange often results in lower levels of investment in infrastructure and human capital. Capital flight is also likely to have negative impacts on equality, as wealthy citizens escape taxation while poorer citizens face higher taxes or cuts in social expenditure to make up for shortfalls in government revenue (Epstein et al. 2005).

### *Stabilizing Private Capital Flows*

Policies to stabilize PCF will necessarily depend on country contexts, but will also depend on the specific type of PCF being considered. Specific measures to stabilize PCF could include:

- Focusing on the composition of inflows by encouraging inflows that have higher proportions of genuine fresh equity investments relative to debt. Much more attention should be paid to the composition of finances that developing countries are receiving, since debt financing is much more volatile compared to equity financing. In this context, it has been pointed out that Greenfield investments are not only less volatile than M&A investments, but also more consistent with development objectives.
- Tracking the sustainability of PCF in net terms, which requires looking at which policy measures are most likely to reduce the very high perceptions of risk and therefore rates of repatriation demanded by foreign investors, as well as reducing the scope for unfettered offshore tax evasion through havens, which is sometimes hidden within repatriation.
- Developing rapid response and early warning systems to help predict and deal with capital flow-related shocks. In particular, low-income developing countries need to be better equipped to monitor and analyse PCFs, since very many countries are still not monitoring or analysing flows well. The failure to track and analyse PCFs and to design policies to maximize their contribution to development has forced many of these economies to cope with unexpected booms and busts, disrupting their growth and reducing their prospects for achieving the MDGs. The current financial crisis underlines the need for countries to have timely and accurate data on capital flows in order to track the impact of exogenous shocks on capital flows and to design appropriate policy responses.
- Accelerating the diversification of sources and destinations for FDI. As noted earlier, PCF is increasingly being sourced from non-OECD countries. Yet, there remains a mismatch between the place in which most developing countries promote investment and the place from which investment is increasingly being sourced (i.e., primarily non-OECD countries, especially from within the same region). Some developing countries have been diversifying their promotion efforts to capture these new sources, but others need to make much more effort and international institutions need to encourage this rather than only focus on the OECD. In part, over-concentration of OECD sources may have reflected a perception that OECD investment better contributes to growth or is more socially or environmentally responsible. However, country analysis provides evidence that South-South investment is less volatile than North-South investment and has been especially resilient during the global crisis, partly because it is less dependent on debt financing. It also does not indicate any systematic difference in sectors of investment, tax payments, employment levels, technology transfer or aspects of corporate responsibility.



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

## *Maximizing the Development Payback of Private Capital Flows*

Many country studies have pointed to the absence of a development payback with respect to PCF. To enhance the ability of host governments to maximize the development impact of foreign private capital, efforts to promote investor corporate responsibility must be fostered. These could include spending on environmental protection, human resources and infrastructure. It also entails maximizing efforts to ensure that external investments bolster low domestic savings or weak financial intermediation and realize positive spillovers via technology transfer and enterprise development. To ensure that local firms do not get crowded out, governments also need to invest much more in ensuring that local firms have the capability to invest in absorbing foreign skills and technologies.

Investment promotion authorities, in particular, need to look beyond the quantity of FDI they generate and should receive incentives through more qualitative targets for job creation, exports, budget revenues or technology transfers in their institutional frameworks.

In this context, incentives should be:

- Available to foreign and domestic investors equally
- Offered only under very specific circumstances, where investment makes a demonstrated net contribution to sustainable development efforts
- Cost-benefit reviewed before a project begins and regularly thereafter
- Integrated into a wider national plan and agreed on a regional level

## ***Box 3.2: Maximizing the Development Payback of Private Capital Flows***

Many country studies have pointed to the absence of a development payback with respect to private capital flows. To enhance the ability of host governments to maximize the development impact of foreign private capital, efforts to promote investor corporate responsibility must be fostered.

The Yugra charter is one example of a comprehensive effort by local governments to utilize FDI to ensure local communities benefit from investment and resource exploitation. The Khanty-Mansiisk Autonomous Region, also known as Yugra, lies in north-western Siberia. In 1989 and 1990, the regional government passed legislation requiring developers to work closely and in agreement with an indigenous community comprising 2 percent of the population. Such agreements emphasize practices that are

more likely to benefit this population through, for example, the construction of power lines, housing and cultural facilities; the provision building materials; and gas and oil refinement. Moreover, this agreement provides a quarterly financial compensation payment to local households; financing for higher education; health treatment, work training and employment placements; transportation of food to migrating herders; and the shipment of traditional craft products to markets. Many oil and gas companies in Yugra also support foundations that contribute to other local development projects. Last, local communities and regional development in this remote region also benefit from the Black Gold of Yurga, an annual competition that promotes foreign business investment by awarding prizes to companies for their regional community contributions.

**Source:** United Nations, 2007, 'CSR and Developing Countries: What scope for government action?', Sustainable Development Innovation Briefs, Issue 1.



## **Box 3.3: Targeted Domestic Development Promotion**

Some governments in developing countries have sought to promote specified national investment strategies by attracting foreign investors with specific social, environmental, or educational expectations or goals. The Peruvian investment promotion agency, Pro Inversion, is one example of such an agency, recruiting and promoting foreign investment targeted for positive local human capital development.

As an apparatus of national investment and growth policy, Pro Inversion aims to "attract investors able to transfer

state-of-the-art technology and to take responsibilities with respect to the development of their social environment." The agency is specific and targeted in its assistance to these investors, disseminating and assisting "in the disclosure, among potential investors, of the role and social commitment they have with the environment and people." Pro Inversion seeks to "to foster competitiveness and sustainable development in Peru to improve the welfare of the Peruvian people."

**Source:** United Nations, 2007, 'CSR and Developing Countries: What scope for government action?/ Sustainable Development Innovation Briefs, Issue 1.

Indeed, as PCF to many countries are becoming involved in almost all sectors, it is all the more vital to target incentives, so that FDI investors are encouraged to create joint ventures and backward and forward linkages to local inputs and value-added processes, so that a stronger transfer of technology and employment creation provide a better basis for crowding in domestic private investment rather than crowding it out.

Other ways of maximizing the development impact of such flows is to direct it to underinvested regions in a country. Typically, FDI tends to be concentrated in or around a single centre, usually the capital city and vicinity. The location of major mining and petroleum resources or other natural resources, such as wildlife for tourism, largely determine the more widespread regional distribution of investment. To the degree that FDI generates employment, infrastructure and other services, its absence from the poorer regions of countries can be a potential hindrance to overcoming income inequality and an incentive for greater migration to urban centres. In the absence of countervailing policies, it complicates the implementation of many countries' national poverty reduction strategies, which include a reduction in income inequality. Much more effort is needed to diversify PCF to underserviced regions within countries.

Finally, international policy efforts need to focus on providing:

### *Contingency Financing*

The unwillingness of the international community to provide financial assistance to countries in crisis can contribute to triggering and deepening a crisis. To reduce poverty and improve equity, the international community in general needs to have adequate financing facilities to prevent crises from occurring, deepening, and spreading through contagion.

One of the key lessons learned from past crises is that emergency financing needs to be on a large scale, rapidly disbursed, and made available to countries that may suffer contagion effects. Indeed, the failure to provide adequate and urgent liquidity is a key reason that many developing countries, especially in Asia, accumulated such high levels of foreign reserves as a form of self-insurance against possible future crisis.



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

## **Box 3.4: Attracting FDI in New Sectors**

With a significant proportion of FDI aiding existing large-scale projects and new investments in urban centres in developing countries, there is considerable need for alternative investments and policies that ensure the growth of human capital and other development benefits in remote areas and underserved communities. Rather than relying on investments that continue to focus on mineral and fossil fuel extraction, which contribute minimally to long-term employment or other development goals particularly in LDCs, new efforts are needed to identify and develop sectors of the economy in outlying regions and to promote FDI in these areas (UNCTAD 2011). Such investments could help to reduce income inequality by reducing rural poverty.

By generating employment and encouraging education and transfer of skills, FDI in low-income developing countries directed toward agriculture, tourism, and telecommunications has been found in some cases to have larger development impacts than natural resource extraction (UNCTAD 2008). Telecommunication investment, in particular, comprehensively affects economies of

all sizes by improving the efficiency of commercial business transactions, facilitating access to both lenders and potential markets, enabling the rapid and accurate exchange of information, and improving transportation and delivery chains.

In Africa, for example, policy-guided FDI has helped some remote areas gain access to telecommunications, particularly in places where challenging terrain and poor projected profit margins have traditionally constrained investment. Uganda is an example of a country where government policies, which required companies to provide universal access, attracted FDI in telecommunications even in rural areas. TNCs have also created sub-regional telecommunications markets by removing roaming charges on service. In 2006, for example, One Network in East Africa by Celtel created a borderless mobile network among six countries—the Congo, the Democratic Republic of the Congo, Gabon, Kenya, Uganda and the United Republic of Tanzania—the first such network of its kind (UNCTAD, 2008).

**Source:** UNCTAD, 2011, *Foreign Direct Investment in LDCs: Lessons Learned from the Decade 2001–2010 and the Way Forward*, UNCTAD, Geneva; UNCTAD, 2008, *World Investment Report 2008*, UNCTAD, Geneva.

This policy is not only costly for the countries concerned, but it is also creating huge global imbalances that significantly threaten international economic stability.

### *A Sovereign Debt Workout Mechanism*

Past financial crises have also highlighted the fact that public funds cannot necessarily be relied upon to offset the outflow of private money during a crisis. Economically troubled countries need to be able to reach agreements more quickly with their private creditors. This is important to prevent a crisis from deepening and, over the last decade, more people have become aware of the need to involve or ‘bail in’ the private sector at a much earlier stage of a crisis. However, the proposal for a sovereign debt workout mechanism has not yet been adopted and debt workout mechanisms have remained informal.



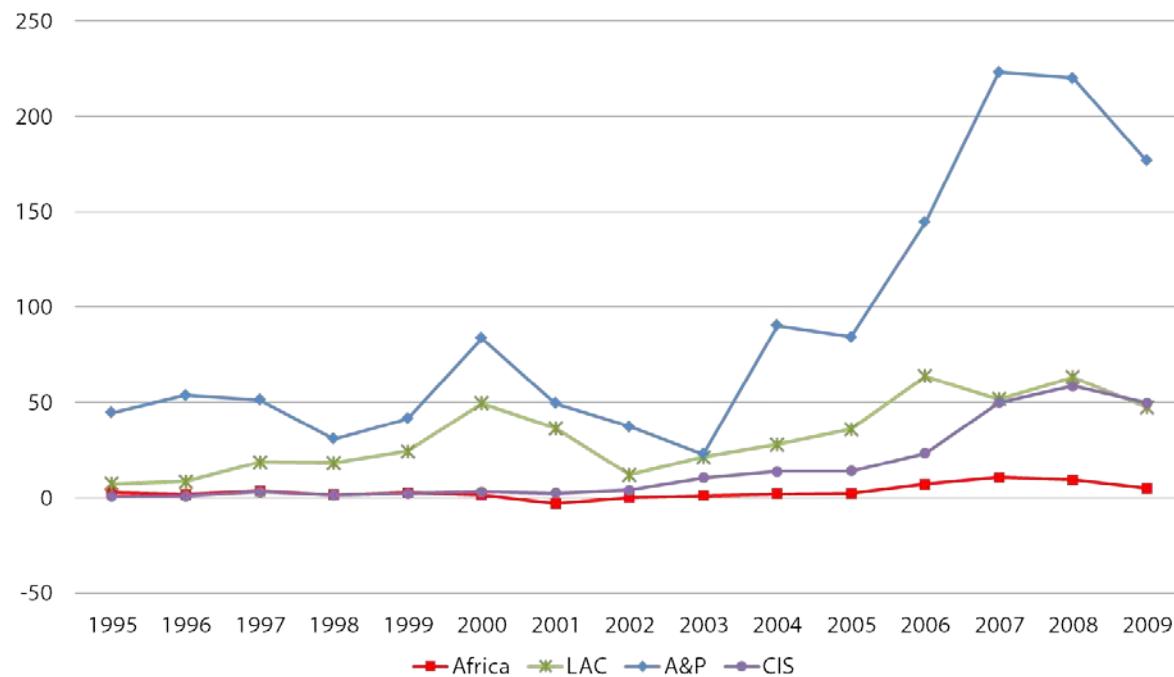
## Notes

1. Private capital flows are the sum of three sources of private capital: Foreign Direct Investment; Portfolio Investment; and Workers' Remittances. Since remittances are unlike FDI and PI both in terms of function and behaviour, they are treated in a separate chapter. The focus of this chapter is on FDI and PI. Foreign Direct Investment is the net inflow of investment so as to acquire a lasting management interest (10 percent or more) in an enterprise, operating in an economy not of the investor. It includes equity capital, reinvested earnings and other long- or short-term capital as shown in the balance-of-payments account of a country. Portfolio Investment includes investment in equity and debt securities. Equity securities cover all instruments and records acknowledging claims to the residual values of incorporated enterprises. Shares, stocks usually denote ownership of equities. Debt securities cover bonds, debentures, notes, money market or negotiable debt instruments, and financial derivatives or secondary instruments, such as options (IMF 1993).
2. Though the share of PCF going to developing countries has grown, the advanced countries still largely dominate PCF. As of 2008, the share of PCF directed to the advanced economies was 78 percent (IMF 2009a).
3. A reversal in PI is the same as outflows of PI. This is because portfolio investments are seen as “portfolio liabilities on the reporting economies by foreign residents” (IMF 2009). In other words, PI records what foreign investors are buying or selling. Hence, a positive number indicates an increase in liabilities for the host country (holdings of foreign citizens increase) and a negative number implies that liabilities have fallen (holdings of foreign citizens decline).
4. Only for developing countries where data was available (see Annex A.I.6 in World Investment Report 2009).
5. ‘Business activities’ that mostly represent inflows into Hong Kong investment holding companies are not included.
6. The regional classification used henceforth is with reference to UNDP’s classification of countries by region. See Annex 3.C.
7. Typically, foreign enterprises tend to favour borrowing from an affiliate because the terms are cheaper and far more flexible. Where this option is not available, they tend to borrow from non-affiliated sources. Foreign enterprises tend also to prefer borrowing from non-affiliated sources abroad rather than from domestic sources. Foreign debt is often cheaper and long-term debt is much more readily available. Further, banks in several LICs may not be geared to the size of borrowing that enterprises require. Even when domestic debt is available, foreign investors may find it difficult to obtain it if certain restrictions exist (e.g., if domestic loans are strictly tied to domestic collateral).
8. Greenfield investments are a form of FDI in which a parent company starts a new venture in a foreign country by constructing new operational facilities from the ground up.
9. The surge in PI flows can present substantial risks to developing countries: for instance, surges in PI have been associated with a “dramatic escalation of stock market prices and valuations in many developing countries (for example, in Asia) raising the risk of asset price bubbles” (World Bank 2006).
10. Refer to Annex 3.D for country-specific data on volatility.



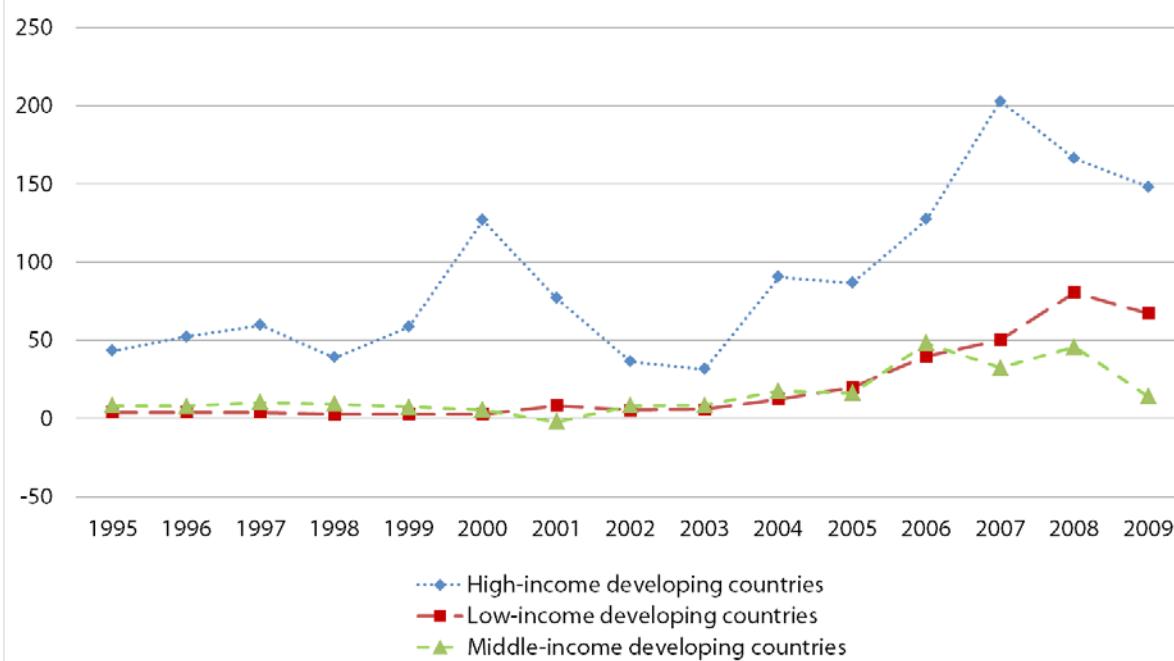
# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

## Annex 3.A: FDI Outflows by Region, 1995–2009 (US\$ billions)



**Source:** Calculated using data from UNCTAD, World Investment Report 2010

## Annex 3.B: FDI Outflows by Development Status, 1995–2009 (US\$ billions)



**Source:** Calculated using data from UNCTAD, World Investment Report 2010



## Annex 3.C: Volatility of FDI by Country and Territory

Country/Territory	Development Status	Region	LDC	Average absolute annual rate of change
Albania	Transition	ECIS		57%
Angola	Low-income DC	Africa	LDC	287%
Anguilla	High-income DC	LAC		41%
Antigua and Barbuda	High-income DC	LAC		66%
Argentina	High-income DC	LAC		55%
Armenia	Transition	ECIS		77%
Aruba	High-income DC	LAC		281%
Azerbaijan	Transition	ECIS		157%
Bahamas	High-income DC	LAC		45%
Bahrain	High-income DC	Arab States		106%
Bangladesh	Low-income DC	A&P	LDC	183%
Barbados	High-income DC	LAC		102%
Belarus	Transition	ECIS		140%
Belize	Middle-income DC	LAC		149%
Benin	Low-income DC	Africa	LDC	89%
Bolivia	Middle-income DC	LAC		80%
Botswana	Middle-income DC	Africa		163%
Brazil	Middle-income DC	LAC		48%
Cambodia	Low-income DC	A&P	LDC	45%
Cameroon	Low-income DC	Africa		390%
Cape Verde	Middle-income DC	Africa		87%
Chile	High-income DC	LAC		39%
China	Low-income DC	A&P		16%
Colombia	Middle-income DC	LAC		69%
Congo	Middle-income DC	Africa		670%
Costa Rica	Middle-income DC	LAC		26%
Côte d'Ivoire	Low-income DC	Africa		24%
Croatia	Transition	ECIS		73%
Dominica	Middle-income DC	LAC		45%
Dominican Republic	Middle-income DC	LAC		66%
Ecuador	Middle-income DC	LAC		246%
Egypt	Middle-income DC	Arab States		85%
El Salvador	Middle-income DC	LAC		334%
Fiji	Middle-income DC	A&P		704%
Georgia	Transition	ECIS		53%
Ghana	Low-income DC	Africa		73%

**Source:** Calculated using data from UNCTAD, World Investment Report 2010



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

Country/Territory	Development Status	Region	LDC	Average absolute annual rate of change
Grenada	Middle-income DC	LAC		35%
Guatemala	Middle-income DC	LAC		98%
Guyana	Low-income DC	LAC		34%
Honduras	Middle-income DC	LAC		39%
Hungary	Transition	ECIS		62%
India	Low-income DC	A&P		44%
Indonesia	Low-income DC	A&P		194%
Jamaica	Middle-income DC	LAC		31%
Jordan	Middle-income DC	Arab States		253%
Kazakhstan	Transition	ECIS		57%
Kenya	Low-income DC	Africa		218%
Kuwait	High-income DC	Arab States		731%
Kyrgyzstan	Transition	ECIS		177%
Libya	High-income DC	Arab States		104%
Malaysia	Middle-income DC	A&P		74%
Mali	Low-income DC	Africa	LDC	347%
Mauritius	Middle-income DC	Africa		158%
Mexico	High-income DC	LAC		25%
Moldova	Transition	ECIS		73%
Mongolia	Low-income DC	A&P		64%
Morocco	Middle-income DC	Arab States		133%
Mozambique	Low-income DC	Africa	LDC	70%
Namibia	Middle-income DC	Africa		105%
Netherlands Antilles	High-income DC	LAC		910%
Nicaragua	Low-income DC	LAC		32%
Niger	Low-income DC	Africa	LDC	351%
Nigeria	Low-income DC	Africa		36%
occupied Palestinian territory	Middle-income DC	Arab States		58%
Oman	High-income DC	Arab States		323%
Pakistan	Low-income DC	A&P		49%
Panama	Middle-income DC	LAC		113%
Paraguay	Middle-income DC	LAC		65%
Peru	Middle-income DC	LAC		42%
Philippines	Low-income DC	A&P		108%
Republic of Korea	High-income DC	A&P		56%
Romania	Transition	ECIS		74%

**Source:** Calculated using data from UNCTAD, World Investment Report 2010

# Private Capital Flows: Foreign Direct Investment and Portfolio Investment



<b>Country/ Territory</b>	<b>Development Status</b>	<b>Region</b>	<b>LDC</b>	<b>Average absolute annual rate of change</b>
Russian Federation	Transition	ECIS		55%
Rwanda	Low-income DC	Africa	LDC	113%
Saudi Arabia	High-income DC	Arab States		612%
Senegal	Low-income DC	Africa	LDC	236%
Seychelles	High-income DC	Africa		54%
Sierra Leone	Low-income DC	Africa	LDC	681%
Singapore	High-income DC	A&P		51%
Slovakia	Transition	ECIS		132%
Solomon Islands	Low-income DC	A&P	LDC	170%
South Africa	Middle-income DC	Africa		439%
Sri Lanka	Low-income DC	A&P		47%
St. Kitts and Nevis	High-income DC	LAC		40%
St. Lucia	High-income DC	LAC		56%
St. Vincent & the Grenadines	Middle-income DC	LAC		51%
Sudan	Low-income DC	Arab States	LDC	2,081%
Suriname	Middle-income DC	LAC		206%
Swaziland	Middle-income DC	Africa		210%
Tanzania	Low-income DC	Africa	LDC	30%
Thailand	Middle-income DC	A&P		37%
The FYR of Macedonia	Transition	ECIS		162%
Togo	Low-income DC	Africa	LDC	34%
Trinidad and Tobago	High-income DC	LAC		32%
Tunisia	Middle-income DC	Arab States		72%
Turkey	Middle-income DC	ECIS		70%
Uganda	Low-income DC	Africa	LDC	25%
Ukraine	Transition	ECIS		64%
Uruguay	High-income DC	LAC		43%
Vanuatu	Middle-income DC	A&P	LDC	45%
Venezuela	High-income DC	LAC		98%
Viet Nam	Low-income DC	A&P		29%
Yemen	Low-income DC	Arab States	LDC	312%

**Source:** Calculated using data from UNCTAD, World Investment Report 2010



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

## Annex 3.D: Volatility of PI by Country and Territory

Country/ Territory	Development Status	Region	Average Absolute Change in Portfolio Investment
Antigua and Barbuda	High-income DC	LAC	302%
Argentina	High-income DC	LAC	151%
Armenia	Transition	ECIS	710%
Aruba	High-income DC	LAC	248%
Bangladesh	Low-income DC	A&P	217%
Belarus	Transition	ECIS	361%
Belize	Middle-income DC	LAC	183%
Benin	Low-income DC	Africa	315%
Botswana	Middle-income DC	Africa	203%
Brazil	Middle-income DC	LAC	186%
Chile	High-income DC	LAC	419%
China	Low-income DC	A&P	258%
Colombia	Middle-income DC	LAC	292%
Costa Rica	Middle-income DC	LAC	236%
Côte d'Ivoire	Low-income DC	Africa	177%
Croatia	Transition	ECIS	1560%
Dominica	Middle-income DC	LAC	1413%
Ecuador	Middle-income DC	LAC	14061%
Egypt	Middle-income DC	Arab States	8169%
El Salvador	Middle-income DC	LAC	230%
Guatemala	Middle-income DC	LAC	848%
Guyana	Low-income DC	LAC	622%
Hungary	Transition	ECIS	180%
India	Low-income DC	A&P	156%
Indonesia	Low-income DC	A&P	96%
Kazakhstan	Transition	ECIS	421%
Kenya	Low-income DC	Africa	262%
Kyrgyzstan	Transition	ECIS	33829%
Malaysia	Middle-income DC	A&P	200%
Mali	Low-income DC	Africa	296%
Mauritius	Middle-income DC	Africa	211%
Mexico	High-income DC	LAC	980%
Moldova	Transition	ECIS	1058%
Morocco	Middle-income DC	Arab States	756%

**Source:** Calculated using data from World Bank, Global Finance for Development, and IMF, Balance of Payment Statistics 2009

# Private Capital Flows: Foreign Direct Investment and Portfolio Investment



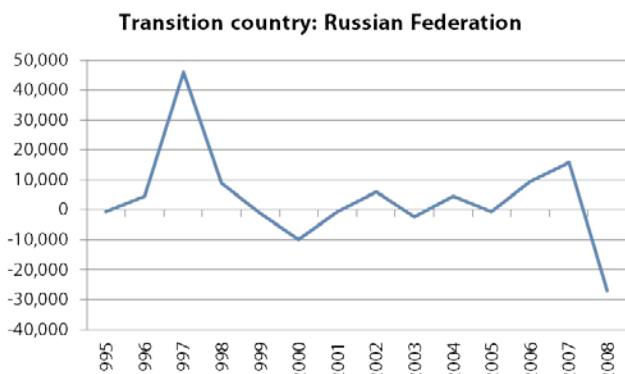
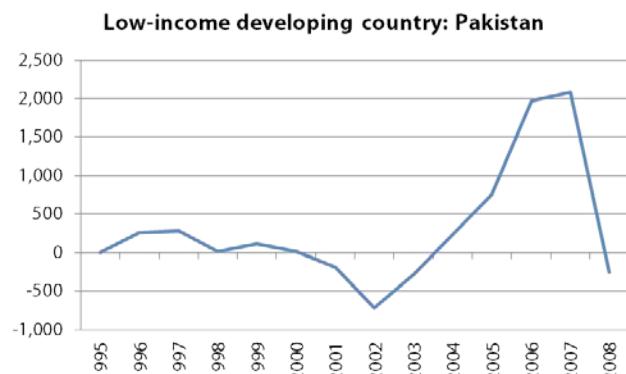
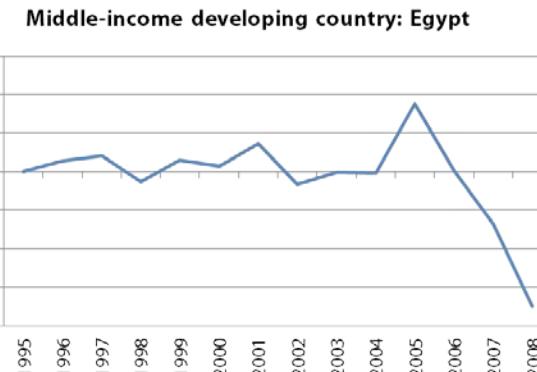
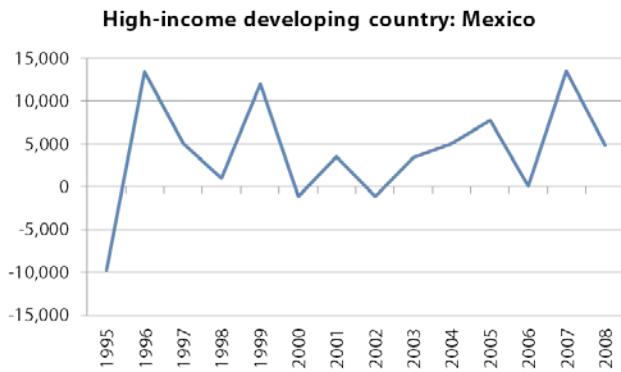
Country/Territory	Development Status	Region	Average Absolute Change in Portfolio Investment
Namibia	Middle-income DC	Africa	99%
Netherlands Antilles	High-income DC	LAC	526%
Nicaragua	Low-income DC	LAC	234%
Oman	High-income DC	Arab States	322%
Pakistan	Low-income DC	A&P	843%
Panama	Middle-income DC	LAC	81152%
Peru	Middle-income DC	LAC	644%
Philippines	Low-income DC	A&P	235%
Republic of Korea	High-income DC	A&P	164%
Romania	Transition	ECIS	612%
Russian Federation	Transition	ECIS	451%
Senegal	Low-income DC	Africa	4568%
Seychelles	High-income DC	Africa	6594%
Singapore	High-income DC	A&P	1675%
Slovakia	Transition	ECIS	311%
South Africa	Middle-income DC	Africa	158%
Sri Lanka	Low-income DC	A&P	80%
St. Kitts and Nevis	High-income DC	LAC	520%
St. Lucia	High-income DC	LAC	186%
St. Vincent & Grens.	Middle-income DC	LAC	262%
Swaziland	Middle-income DC	Africa	477%
Thailand	Middle-income DC	A&P	124%
The FYR of Macedonia	Transition	ECIS	1334%
Togo	Low-income DC	Africa	55%
Tunisia	Middle-income DC	Arab States	141%
Turkey	Middle-income DC	ECIS	148%
Ukraine	Transition	ECIS	307%
Uruguay	High-income DC	LAC	127%
Venezuela	High-income DC	LAC	240%

**Source:** Calculated using data from World Bank, Global Finance for Development, and IMF, Balance of Payment Statistics 2009



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

## Annex 3.E: Portfolio Investments for Sample of Developing Countries (US\$ millions)



**Source:** Calculated using data from IMF, Balance of Payments Statistics 2009



## References

- Action Aid, 2009, *Where Does it Hurt? The Impact of the Financial Crisis on Developing Economies*, Action Aid, Johannesburg.
- Bhinda, N. and Martin, M., 2009, *Private Capital Flows to Low Income Countries: Dealing with Boom and Bust*, Debt Relief International, London.
- Calvo, G., Liederman, L. and Reinhart, C.M., 1994, 'The Capital Inflows Problem: Concepts and Issues', *Contemporary Economic Policy*, Vol. 12, Issue 3, pp. 54–66.
- Cobham, A., 2005, 'Tax evasion, tax avoidance, and development finance', Queen Elizabeth House Working Paper Series Number 129, University of Oxford, United Kingdom.
- Epstein, G. (ed.), 2005, *Capital Flight and Capital Controls in Developing Countries*, Edward Elgar Publishing, Cheltenham, United Kingdom.
- Fallon, P. and Lucas, R., 2002, 'The Impact of Financial Crises on Labor Markets, Household Incomes and Poverty: A Review of Evidence', *World Bank Research Observer*, Vol. 17, Issue 1, World Bank, Washington, DC.
- Griffith-Jones, S., 2002, *Capital Flows to Developing Countries: Does the Emperor Have Clothes?*, Institute of Development Studies, Brighton.
- Honohan, P and Klingebiel, D., 2000, *Controlling the Fiscal Costs of Banking Crises*, World Bank, Washington, DC.
- Institute of International Finance, 2009, *Capital Flows to Emerging Market Economies*, Institute of International Finance, Washington, DC.
- Institute of International Finance, 2010, *Capital Flows to Emerging Market Economies*, Institute of International Finance, Washington, DC.
- International Monetary Fund, 1993, *Balance of Payments Manual: 5th Edition*, International Monetary Fund, Washington, DC.
- International Monetary Fund, 2008, 'Kenya, Uganda, and United Republic of Tanzania: Selected Issues', IMF Country Report No. 08/353, International Monetary Fund, Washington, DC.
- International Monetary Fund, 2009a, *Balance of Payments Statistics 2009*, International Monetary Fund, Washington, DC.
- International Monetary Fund, 2009b, *World Economic Outlook Update: Contractionary Forces Receding but Weak Recovery Ahead*, International Monetary Fund, Washington, DC.
- Kimmis, J., 2005, 'Tax Us if You Can', A Tax Justice Network Briefing Paper, Tax Justice Network, London.
- Kimmis, J., 2008, *Financial Markets*, Background paper prepared for *From Poverty to Power: How Active Citizens and Effective States Can Change the World*, Oxfam International, United Kingdom.
- Kose, A. M., Prasad, E., Rogoff, K. and Wei, S.-J., 2006, 'Financial Globalization: A Reappraisal', IMF Working Paper WP/06/189, International Monetary Fund, Washington, DC.
- Lee, K. and Jayadev, A., 2005, 'Capital Account Liberalization, Growth and the Labour Share of Income: Reviewing and Extending the Cross-country Evidence', in G. Epstein (ed.) *Capital Flight and Capital Controls in Developing Countries*, Edward Elgar Publishing, Cheltenham, United Kingdom.



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

- Lustig, N., 2000, 'Crises and the Poor: Socially Responsible Macroeconomics', Sustainable Development Department Technical Paper Series, Inter-American Development Bank, Washington, DC.
- Mishra, D., Mody, A. and Murshid, A.P., 2001, 'Private Capital Flows and Growth', *Finance & Development*, Vol. 38, No. 2, International Monetary Fund, Washington, DC.
- Organisation for Economic Co-operation and Development, 2002, *Foreign Direct Investment for Development: Maximizing Benefits, Minimizing Costs*, Organisation for Economic Co-operation and Development, Paris.
- Organisation for Economic Co-operation and Development, 2003, *Checklist for Foreign Direct Investment Incentive Policies*, Organisation for Economic Co-operation and Development, Paris.
- Rodrik, D. & Subramiam, A., 2008, 'Why Did Financial Liberalization Disappoint?', IMF Staff Papers, International Monetary Fund, Washington, DC.
- Son, H. and Kakwani, N., 2006, 'Measuring the Impact of Price Changes on Poverty', Working Paper No. 33, International Poverty Centre, United Nations Development Programme, Brasilia.
- United Nations Conference on Trade and Development, 2005, *Economic Development in Africa: Rethinking the Role of Foreign Direct Investment*, United Nations Conference on Trade and Development, Geneva.
- United Nations Conference on Trade and Development, 2009a, *World Investment Report 2009*, United Nations Conference on Trade and Development, Geneva.
- United Nations Conference on Trade and Development, 2009b, *Trade and Development Report 2009*, United Nations Conference on Trade and Development, Geneva.
- United Nations Conference on Trade and Development, 2010a, *World Investment Report 2010*, United Nations Conference on Trade and Development, Geneva.
- United Nations Conference on Trade and Development, 2010b, *Trade and Development Report 2010*, United Nations Conference on Trade and Development, Geneva.
- World Bank, 2006, *Global Development Finance*, World Bank, Washington, DC.
- World Bank, 2009a, *World Development Indicators*, World Bank, Washington, DC.
- World Bank, 2009b, *Global Development Finance*, World Bank, Washington, DC.