Direct and portfolio investment

Throughout most of the twentieth century, direct investment has been an important source of capital, technology, and expertise for countries in the process of development. In the early years of the century, foreign investors built railroads and electric power systems and invested in plantations and mines to produce for export markets. Later, direct investment in manufacturing industries and services became more common. Portfolio investment, in contrast, is a relatively new phenomenon that has only assumed significance with the growth of large public companies in developing countries and the emergence of local stock markets. Direct investment normally involves an ownership interest and an effective voice in the management of an enterprise, while portfolio investment entails a share in ownership but no significant influence over the enterprise’s operations.

Many developing countries have recently made policy reforms that, among other things, give more scope for private sector activities. They have also become more receptive to foreign direct investment as lending by banks has declined. In the light of these changes, this chapter examines whether equity forms of investment can expand to provide a larger amount of capital to developing countries. It concludes that equity investment is beneficial to developing countries and can be increased, but that it is largely a complement to commercial bank lending, not a substitute for it. Because it is narrowly concentrated in countries and sectors, its potential for expansion is limited. To maximize that potential, developing countries need policies that promote trade, plus a stable economic and political environment that does not discriminate against foreign investment. For their part, industrial countries can support direct investment in developing countries by liberalizing their own trade and investment policies.

The nature and role of direct investment

Unlike commercial bank lending, direct investment provides finance as part of a package of technology and management, both of which can increase the productivity of the capital. In addition, like portfolio investment, direct investment shares in both the risks and rewards of each particular project. The financial value of direct investment therefore normally understates its overall benefits to the recipient country.

Direct investment and other types of foreign capital are not necessarily substitutes; indeed, they often complement each other. For example, only about 60 percent of the external finance for the Latin American subsidiaries of American companies has come from their parent firms. The rest has come from commercial banks (both local and foreign) and trade credit. Roughly three-quarters of all the borrowing done by those subsidiaries has been in the form of trade credit. Other forms of international capital—such as bilateral and multilateral aid—have also facilitated direct investment by helping to create investment opportunities and by financing essential infrastructure.

The bulk of direct investment is done by a relatively small number of large firms. The 380 largest transnational corporations had foreign sales of about $1,000 billion in 1980, almost $3 billion a firm. They are usually attracted to invest abroad by a country’s natural resources or its favorable economic environment; occasionally they are also attracted by the special inducements offered by host countries.

One common motive for a company to undertake foreign investment is a threat to an existing export market. The threat might come either from the actions of a competitor or from measures restricting the market to local producers. The only way to avoid the trade barriers is to be inside them. Companies are also keen to invest abroad when there are clear cost advantages from doing so. Direct investments in manufacturing and services are often made by firms with some kind of special advantage that is best utilized by maintaining management control of operations in foreign countries. Such advantages may be a superior product or production process, or a product that the for-
Table 9.1  Direct foreign investment in selected country groups, 1965–83

<table>
<thead>
<tr>
<th>Country group</th>
<th>Average annual value of flows</th>
<th>Share of flows</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(billions of dollars)</td>
<td>(percent)</td>
</tr>
<tr>
<td>Industrial countries</td>
<td>5.2 11.0 18.4 31.3</td>
<td>79 86 72 63</td>
</tr>
<tr>
<td>Developing countries</td>
<td>1.2 2.8 6.6 13.4</td>
<td>18 22 26 27</td>
</tr>
<tr>
<td>Latin America and Caribbean</td>
<td>0.8 1.4 3.4 6.7</td>
<td>12 11 13 14</td>
</tr>
<tr>
<td>Africa</td>
<td>0.2 0.6 1.0 1.4</td>
<td>3 5 4 3</td>
</tr>
<tr>
<td>Asia, including Middle East</td>
<td>0.2 0.8 2.2 5.2</td>
<td>3 6 9 11</td>
</tr>
<tr>
<td>Other countries and estimated unreported flows</td>
<td>0.2 -1.0 0.6 4.8</td>
<td>3 -8 2 10</td>
</tr>
<tr>
<td>Total</td>
<td>6.6 12.8 25.6 49.4</td>
<td>100 100 100 100</td>
</tr>
</tbody>
</table>

a. Figures converted from billions of SDR to billions of U.S. dollars based on average IMF-IFS exchange rates.
b. Total includes IMF estimates for unreported flows.

A foreign company can differentiate from those of competitors.

Growth and concentration

While the nominal value of direct investment in developing countries grew by 10 percent a year between 1967 and 1982, its real value hardly increased at all. By contrast, the amount of medium- and long-term finance for developing countries from private lenders increased by about 9.5 percent a year in real terms. More than half of the measured flow of direct investment now takes the form of reinvested earnings from existing subsidiaries.

Table 9.1 shows that about three-quarters of foreign direct investment has gone to industrial countries on average since 1965. The remainder has been concentrated for the most part in a few developing countries, predominantly the higher-income countries of Asia and Latin America. In particular, Brazil (see Box 9.1) and Mexico have received large volumes of direct investment. Within Asia, Hong Kong, Malaysia, the Philippines, and Singapore have been the largest recipients; Singapore alone has accounted for nearly one-half of total Asian receipts of foreign direct investment in recent years. Among those developing countries that have accumulated a large volume of external liabilities there are marked differences in the share of direct investment in the total (see Figure 9.1).

Direct investment has provided very little capital for the low-income countries. This often reflects the small size of their domestic markets and their lack of skilled manpower; in India’s case, it has reflected in part the strong public sector bias of its industrial policies and in part a search for economic self-reliance (see Box 9.2).

Direct investment in developing countries comes almost entirely from industrial countries. Although companies from the United States and the United Kingdom are the largest foreign investors in developing countries, their relative status has declined. Companies from the Federal Republic of Germany and, until recently, Japan (see Box 9.3) have substantially increased their investment in developing countries. Together, these four countries have supplied more than three-quarters of direct investment in developing countries, with the United States alone accounting for nearly one-half of the total.

Almost all investing countries have a regional bias in their investment in developing countries.
Box 9.1 Direct foreign investment in Brazil

Brazil has received more direct foreign investment than any other developing country. At the end of 1983, the stock of direct foreign investment in Brazil totaled almost $22.3 billion. This is a big amount, even allowing for the large size of Brazil compared with other developing countries. In the next largest recipient, Mexico, the stock was only half that size. Over the past decade, flows of direct investment to Brazil have been consistently positive and have risen every year except for 1980 and 1983. About two-thirds of this investment was new inflows, with the rest coming from reinvested earnings. While the rate of growth of direct investment has been much slower than other forms of foreign capital, it has also been much less erratic (see Box figure 9.1A).

For foreign investors, Brazil’s attractions include a large and growing local market and policies that generally encourage foreign investment. Most foreign investments are not restricted, though a few—such as the production and marketing of minicomputers and microcomputers—are closely controlled and increasingly restricted to Brazilian-owned firms.

The United States is the largest single source of foreign investment in Brazil, with about one-third of the stock of assets; its share has recently been rising. Germany is second with about 13 percent, followed by Japan with 9 percent.

Nearly 75 percent of direct investment in Brazil is in manufacturing, and these foreign manufacturers have a big weight in the whole economy. The UN Centre for Transnational Corporations estimates that in 1977 nearly 45 percent of the local sales of manufactured goods were by foreign-controlled companies. They seem to have accounted for roughly the same proportion of exports of manufactures.

The United States’ investment is largely in Latin America, while Japan’s investment goes mainly to its Asian neighbors. Similarly, much of the United Kingdom’s investment goes to Commonwealth nations, and France has focused on countries with past colonial ties, mainly in Africa.

Direct investment is also concentrated in a few economic sectors. Figure 9.2 shows that investment by U.K. and German firms in particular has been mainly in manufacturing; while U.S. and Japanese investment, although more evenly spread over the major economic sectors, has a bias toward manufacturing and the primary industries. And within manufacturing, direct investment has been mainly in transportation equipment, chemicals, and machinery (which includes electronics).

Box figure 9.1A Capital flows to Brazil, 1974–83

<table>
<thead>
<tr>
<th>Billions of dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
</tr>
<tr>
<td>8</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>-4</td>
</tr>
</tbody>
</table>

Note: Long-term flows include direct foreign investment.


Causes of stagnation

The near stagnation of direct investment in the 1970s reflected the increased availability of bank lending and the low real interest rates on bank loans. Returns required by private investors are estimated to have been much higher than those on bank loans.

At the same time, many developing countries increased restrictions on direct investment, reducing the range of industries in which foreigners could invest and raising local ownership requirements. Some policymakers in developing countries questioned the contribution that direct investment could make to economic development.

The reasons for their skepticism have always started with political opposition to letting national resources be controlled from abroad. In addition, critics charge that multinational companies use inappropriate technologies and that their centralized management structures prevent the development of local initiative. They also say that multinationals often fund themselves in the local capital market, crowding out potential domestic borrowers. Finally, they suggest that direct investors use transfer prices, royalty and interest payments, management fees, and other means to avoid price...
Box 9.2  Direct foreign investment in India

The Indian government has traditionally been cautious about foreign investment. However, it has recently recognized that joint ventures—or collaborations—can be useful in bringing in new technologies, increasing exports, and creating domestic employment (see Box figure 9.2A). Regulations have therefore begun to be eased.

- While direct foreign investment still constitutes a small proportion of India's foreign capital flows, the number of collaborations and the amount of foreign investment approved by the government have risen significantly in recent years. Procedural simplification, improved industrial policy environment, and favorable reassessment of India's economic management and prospects have been major factors in this upsurge.

- Several industries are reserved to the public sector and therefore are closed to private domestic and foreign investment. Elsewhere, foreign ownership is normally restricted to 40 percent of a company's equity, though a higher percentage may be allowed if the venture is largely export oriented or brings with it a highly desired kind of technology. Companies exporting all their output can be wholly foreign owned.

- Corporate income taxes are high, and tax laws are complex. However, new companies can obtain various incentives that tend to reduce their potential tax liability in the first five years of their operations.

- Procedures governing inward investment and repatriation are elaborate and time consuming, though the government is now trying to streamline them. All applications for industrial approvals, including the granting of industrial licenses, the approval of foreign collaborations, and the import of capital goods, can now be made to one agency—the Secretariat for Industrial Approvals. The Indian Investment Centre meanwhile acts as a separate promotional agency operating alongside the existing regulatory structures.

Once the government approves a foreign investment, remittance of royalties and dividends are unrestricted. Repatriation of capital invested by foreigners is allowed subject to the provisions of the Foreign Exchange Regulation Act of 1973. This act, enforced by the Reserve Bank of India, governs the entry of foreign investment, the activities of resident foreigners, and the holding of and payments in foreign exchange.

Because of restrictions on foreign ownership and expansion, many multinational firms prefer to license their products in India. However, royalties and fees paid by Indian licensees are also subject to close scrutiny by the authorities. The royalty allowed in a technical collaboration will depend on the nature of the technology, but will normally not exceed 8 percent of the ex-factory value of production.

Box figure 9.2A  Direct foreign investment in India, 1978–83

<table>
<thead>
<tr>
<th>Millions of dollars</th>
<th>Number of collaborations</th>
</tr>
</thead>
<tbody>
<tr>
<td>70</td>
<td>700</td>
</tr>
<tr>
<td>60</td>
<td>600</td>
</tr>
<tr>
<td>50</td>
<td>500</td>
</tr>
<tr>
<td>40</td>
<td>400</td>
</tr>
<tr>
<td>30</td>
<td>300</td>
</tr>
<tr>
<td>20</td>
<td>200</td>
</tr>
<tr>
<td>10</td>
<td>100</td>
</tr>
</tbody>
</table>


controls, foreign exchange regulations, local taxes, and limits on profit remittances.

These charges have been particularly common in countries where governments have used import restrictions to encourage local production. Inappropriate trade regimes sometimes provide foreign investors with financial rates of return that are markedly higher than the economic returns to the country. When governments attempt to control such profits, the controls provide incentives for firms to try to evade them. Open trade regimes increase the benefits to developing countries of foreign direct investment and reduce the problems associated with it.

The skepticism of developing countries was often echoed by potential investors. Faced with unreceptive host countries, volatile economic policies, and confusing combinations of incentives and restrictions, investors were wary of committing capital to developing countries. During the 1970s, multinational companies and developing-country governments put increased emphasis on unbundling the management, technology, and financial components of direct investment. Licensing and other contractual arrangements permitted developing countries to obtain some of the benefits of direct investment without incurring some of the perceived costs of foreign ownership. Recently,
however, there has been a positive shift in the receptivity of some countries to direct investment.

**Improving the environment for direct investment**

Countries with large internal markets and import-substituting strategies are among those that have received the largest amount of direct investment. They are also the countries where prices have been most distorted and where complaints about the development contribution of direct investment have been most common. Countries that have followed a more open development strategy have had fewer problems with direct investment. Their strategy makes production for domestic and export markets equally attractive and generally requires market prices to reflect relative scarcities. In these countries, governments have tended to lower tariffs and to allow real interest rates to be positive. As a result, the direct investment that has taken place has been geared more closely to the country’s comparative advantage. The contribution that direct investment makes to development therefore depends significantly on the policy framework in which it takes place.

**The policies of host countries**

All developing countries have policies and institutions for dealing with direct investment. These include investment incentives and the services and

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**Figure 9.2 Sectoral composition of direct foreign investment in developing countries by four source countries, 1980**

<table>
<thead>
<tr>
<th>Source</th>
<th>Manufacturing</th>
<th>Mining and petroleum</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


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**Box 9.3 Japanese direct investment in manufacturing**

Japan’s overseas investment in manufacturing industries only became sizable in the late 1960s and early 1970s. Between 1971 and 1982 Japan’s cumulative investment in manufacturing was about $16 billion, compared with its total cumulative direct investment abroad of some $50 billion. Japanese investment in manufacturing has differed in several ways from that of the other OECD countries. For example, most American foreign investment was done by sizable multinational firms usually in a large industrial country, for the purpose of supplying the local market. Their investments were normally in capital-intensive industries and often involved sophisticated technology.

By contrast, Japanese foreign investment in manufacturing was made by a large number of small and medium-sized firms in labor-intensive and low-technology industries, initially in such countries as Korea and Hong Kong, and much of it was aimed at export markets. These characteristics can be attributed in part to labor shortages in Japan and a rapid rise in real wages that reduced the competitiveness of labor-intensive manufacturing. At the same time, large current account surpluses led the Japanese government to liberalize controls on overseas investment.

The pattern of Japanese direct investment is changing. Manufacturing investments are going more into industrial countries—especially North America—than developing countries. Between 1971 and 1980 Japanese direct investment in manufacturing in developing countries—the bulk of which was in Asia—represented 68 percent of cumulative investment in manufacturing worldwide. During 1981-82 this figure fell to 46 percent. This change is partly a reaction to the protectionist measures that some industrial countries have adopted to restrict Japanese imports; Japanese companies have sought to establish themselves inside the protectionist barriers. But it also reflects the view of many Japanese companies that the investment climate in developing countries has deteriorated as growth has slowed and some countries have run into debt-servicing difficulties.
infrastructure provided for foreign investors. They also include various restrictions on the way foreign companies can operate.

- **Incentives.** They are typically designed either to enhance the revenues of foreign firms or to reduce their costs. Revenue-enhancing incentives include import tariffs or quotas on the product concerned, tax breaks, and preferential treatments of various kinds. Among these none has been more influential than tariffs and other forms of protection covering products to be sold on the local market. Cost-reducing incentives include reduced tariffs on imports and exemptions from taxes on inputs. The nature of the incentives that a country offers will depend on the kind of investment it wishes to obtain and on competition from other countries to attract that type of investment. There are indications that incentives become less effective the greater their complexity and the more frequently they are altered. The impact of specific incentives for direct investment is uncertain. Numerous studies have suggested that business executives tend to ignore or downplay incentives in making decisions on where to invest. However, a study by the IFC suggests that incentives can influence the investment decision: other things being equal, companies might choose one country rather than another on the basis of the relative attractiveness of incentives.

- **Regulations.** These can take many forms. Some countries—including Brazil, Egypt, India, and Mexico—reserve key industries for local (and often state-owned) enterprises. Some countries allow foreign investors to hold only a minority stake in a company, unless the industry is defined as "high priority" or the production is mainly for export. In other countries—especially in Latin America—foreign companies are required to dilute ownership and control gradually through the sale of shares to residents.

Many developing countries restrict remittances of interest and dividends. This can be a major disincentive to foreign companies and has encouraged such practices as the manipulation of transfer pricing. Some governments in developing countries (Latin America, for instance) also stipulate performance requirements, so a company has to export a minimum proportion of its output or use a certain amount of local components, labor, and so on. Countries such as Argentina, Kenya, Peru, and Turkey have limited the amount of local borrowing that foreign investors can do. The IFC study showed that companies tend to take these requirements into consideration in choosing where to locate.

The specific incentives and regulations governing direct investment have had less effect on how much investment a country receives than has its general economic and political climate, and its financial and exchange rate policies. This conclusion can be illustrated by the varying experience of many different countries. Despite offering substantial incentives to potential investors, countries in Africa and the Caribbean—with small domestic markets and limited natural resources—have not attracted much direct investment. India, Nigeria, and several Latin American countries have had the potential to obtain direct investment for import-substitution purposes. They, too, have had only modest success because they have chosen to impose restrictions and performance requirements on foreign companies.

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**Box 9.4 Turkish seed production**

When the World Bank was reviewing its lending plans for Turkey's agriculture in 1981, it concluded that farmers would benefit considerably if the quality of seed was improved. The Bank judged that the most effective way of doing this would be to promote a private sector seed industry, with the participation of foreign companies.

However, government policies toward the seed industry had discouraged direct investment by foreign firms and limited the supply and range of seeds that farmers could buy. These policies included price controls on seeds; restrictions on importing seeds for testing and market development; a government monopoly on testing; and lengthy and complicated certification procedures before a new seed could be sold.

Partly as a result of initiatives by the Bank and the IFC, the government has changed many of these policies. Price controls have been abolished. Seed may be imported more freely into Turkey, and testing and certification procedures have been liberalized.

Eleven foreign seed companies have begun working in Turkey, importing seeds and testing them in local conditions. They then plan to develop distribution channels, importing the best varieties and selling them to test the market. Once a market is established, the companies intend to set up local growing and processing operations. Ultimately, they may establish local research facilities to develop new varieties.
By contrast, some of the newly industrializing countries in East Asia—Malaysia and Singapore, for instance—have obtained considerable inflows without offering significant incentives. Their export-oriented development policies have been the attraction. They prove a general rule: what is good policy for domestic investors is also good for foreign investors.

Although the macroeconomic climate is of prime importance, policies for specific sectors and industries can determine whether investments are actually made. Box 9.4 describes one case, the seed industry in Turkey, where sector-specific policies were crucial. Once policy failings were identified and acted upon, substantial new foreign investment took place in the industry.

The policies of industrial countries

As with the policies of host countries, it is the general economic policies of the industrial countries that have the most effect on the amount of direct investment going to developing countries. Lower rates of economic growth and high production costs at home will increase the attraction of foreign investment.

At the same time, the efforts of industrial countries to encourage and protect production at home have sometimes discouraged investment in developing countries. Some industrial countries provide generous concessions to attract investment from abroad. Although many of these incentives are directed toward specific industries, usually high technology ones, they can be directly competitive with the incentives offered by developing countries. Direct and indirect subsidies to ailing industries have also reduced the incentives for firms in these industries to consider investing in developing countries. Restrictions on trade flows have had similar effects. The 1982-85 restrictions on Japanese automobile exports to the United States, for instance, reduced the incentive for U.S. producers to seek lower-cost manufacturing bases in developing countries to produce parts and components. To increase investment in developing countries, it would clearly be desirable to remove the subsidies and tariffs that protect domestic industry in the industrial economies.

Some policy initiatives in industrial countries have had positive effects on investment in developing countries. Governments and trade bodies have spread information about investment opportunities. They have negotiated procedures for settling disputes over investment with governments of developing countries. They have tax laws that make it attractive for individuals to work abroad in a multinational company. Such measures are valuable. But the most powerful stimulus to invest in developing countries comes from liberal trade policies, since companies can then manufacture abroad to produce for industrial-country markets. As pointed out in Box 9.3, Japanese textile firms made direct investments in Asian developing countries in order to remain competitive in export markets.

Investment protection and insurance

As direct investment is long term and usually takes the form of plant and machinery, it is exposed to political risk—the threat of expropriation, blocked currency, war, revolution, or insurrection. To reassure actual and potential investors, many developing countries have passed laws protecting them against expropriation; some have embodied the protection in their constitutions. Governments in industrial and developing countries have concluded some 200 bilateral treaties on investment protection, which cover, among other things, transfer and expropriation risks. In addition, twenty-two countries—almost all industrial countries, as well as India and the Republic of Korea—have set up investment guarantee schemes.

These schemes offer guarantees to companies and individuals from each guaranteeing country against political risks abroad. National schemes differ appreciably in their terms and conditions, scope of coverage, and administrative practices. As a result, their coverage of direct foreign investment to developing countries ranges from less than 5 percent to more than 50 percent. In all, some 10 to 15 percent of direct foreign investment to developing countries from countries with national schemes was guaranteed in 1977-81. By the end of 1981, about 9 percent of the stock of direct foreign investment was covered by national guarantees.

Another approach to mitigating political risk has been through private insurance. In the early 1970s, underwriters and brokers of Lloyd’s of London pioneered political risk insurance for overseas investments and export contracts. Since then, the practice has grown substantially. In 1973, private insurers received premiums of $2 million to $3 million from underwriting political risk, and their underwriting capacity did not exceed $8 million for each project. In 1982, total premiums were worth an estimated $95 million, the underwriting capac-
Box 9.5  A multilateral investment guarantee agency

The proposal to establish a multilateral facility for guaranteeing international investment has been discussed periodically since the early 1960s. One regional agency, the Inter-Arab Investment Guarantee Agency, was established in 1974 and has operated successfully since then. However, its operations are limited to investments between its various Arab member countries. In 1981, the Bank's management resumed the initiative to create a multilateral investment guarantee agency (MIGA) under the auspices of the World Bank. Since then, Bank management has presented a concrete proposal and has had consultations on it with member governments and in business circles. In the light of these consultations, it has prepared a draft Convention as a basis for negotiations.

As proposed, MIGA would aim to improve the investment climate in developing countries through (a) issuing guarantees for foreign investment against noncommercial risks, and (b) supplementing the activities of the Bank and the IFC in promoting such investments by carrying out research, providing information, rendering technical assistance, and encouraging policy cooperation. While the ideas previously discussed within the World Bank envisaged a facility closely linked with the Bank and financed as well as controlled by industrial countries, the new proposal suggests an autonomous agency, with some link to the Bank, which would be financed and controlled jointly by home countries and host countries of investments. As such, MIGA would provide a confidence-building framework for policy cooperation between host and home governments and private investors.

MIGA would finance itself from its own revenues, notably from premiums charged for its guarantees. It would, however, have its own share capital and would become operational when a certain number of capital-exporting and capital-importing countries had ratified the Convention and subscribed to a minimum amount of MIGA's capital stock. Every member country, including every developing member country, would subscribe to a minimum number of shares. A small percentage of the

...
subscriptions would be paid in; the rest would be callable in case of need. MIGA’s underwriting capacity would be subject to ceilings that would maintain a sound ratio between its capital and its liabilities under issued guarantees. In addition to its own guarantees, MIGA would be authorized to issue guarantees on behalf of “sponsoring members,” which would recommend such guarantees and share in the risks on a pro rata basis. Under this additional window, guarantees of sponsored investments would have no ceiling.

In accordance with the proposed draft Convention, MICA would be subrogated to the relevant rights of indemnified investors against host countries. Disputes between the agency and host countries concerning such rights would be settled by negotiation and, ultimately, international arbitration. Host countries’ sovereignty would be safeguarded by the principle that both the investment and the agency’s guarantee must be approved by the host country concerned.

The World Bank has also taken some international initiatives over foreign investment. The establishment of the International Center for the Settlement of Investment Disputes (ICSID) in 1965 has helped to improve the framework for direct investment by providing acceptable procedures for the settlement of disputes between foreign investors and their host countries. It has thereby built a greater measure of confidence in the relationship between these two parties. The increasing membership of ICSID, now totaling seventy-eight countries, with four other signatories expected to become members soon, is evidence of the growing recognition of the relevance of this institution to the investors and the countries that wish to attract them. The Bank’s management has also proposed a multilateral investment guarantee agency (see Box 9.5).

**Foreign portfolio investment**

Portfolio investment has not yet provided much finance for developing countries, though its contribution is growing. An attractive feature is that it can provide equity finance for developing countries with fewer of the difficulties about foreign control that are associated with direct investment. However, many developing countries have been skeptical of the benefits of portfolio investment and so have restricted and regulated it. For their part, investors in the industrial countries have known little about the securities markets in developing countries and have been concerned about the perceived risks involved.

**The experience of host countries**

In many developing countries, companies have outgrown their domestic capital markets and would benefit from an injection of foreign equity. By the same token, more foreign investors would increase the demand for stocks in domestic capital markets. Greater market activity could ultimately lead to new stock issues and perhaps new investment. The secondary market would gain some much needed stability if purchases and sales by foreign investors helped to offset the cyclical behavior of domestic investors.

If developing countries are to obtain portfolio capital, they must take steps to attract it. At present, many have barriers against it, including:

- Capital gains taxes and unduly high withholding taxes on dividend income.
- Minimum periods during which foreign funds must remain invested.
- Foreign exchange restrictions on foreign portfolios.
- Restrictions on the types of shares that can be bought or held by foreign investors.
- Discriminatory treatment of foreign investors compared with domestic investors.

The removal of these barriers could facilitate a growth in portfolio investment.

**The perspective of international investors**

Portfolio investment offers the investor long-term returns and diversified risk without the responsi-
bility of management and control. Thus far, almost all portfolio investment has been in the markets of the major industrial economies or in a few developing countries (such as Malaysia and Mexico). During the past five years, however, a number of developing countries have emerged as potential markets for portfolio investment. For example, equity funds of Brazilian, Indian, Korean, and Mexican shares have been organized.

The total capitalization of the developing countries' equity markets amounted to $133 billion in 1983. This was more than one-quarter of the European market capitalization, and 10 percent of all the stocks quoted outside the United States. Excluding Hong Kong and Singapore, the capitalization of developing-country markets totaled $75 billion.

The IFC has supported the development of local markets by helping to establish specialized equity funds for individual countries. One example is the Korea Fund (see Box 9.6). The IFC has also proposed the formation of investment trusts through which commercial banks would be able to sell some of their loans to developing countries for shares. The trusts would then swap the loans bought from the banks for equity stakes in the borrowing entities.

In general, developing countries have a reputation as high-risk options for portfolio investors from industrial countries. However, such investment would allow investors to hold a broader range of international assets. Significantly, the returns from investing in the stock markets of the United States and other big industrial countries have not been synchronized with the returns from developing-country markets, so the widest spread of assets has also been the least risky. Furthermore, the returns obtainable from the emerging developing-country markets (excluding Hong Kong and Singapore) have recently been higher—in dollar terms on a cumulative basis—over the past eight years, more than double that of the world's major equity markets (see Table 9.2). However, devaluations and major economic changes in the developing countries mean that returns have been volatile.

Assessment

The following principal conclusions emerge from the preceding review.

- Equity forms of investment can clearly be beneficial to developing countries, and it is desirable that they be increased. Developing countries can reduce the level of risk attached to external capital inflows and secure the benefits of technology and expertise transfers by expanding the amount of direct investment in total external financing.
- Given that equity investment is desirable, there is a question of how developing countries

Box 9.6 The IFC and foreign portfolio investment: the Korean case

The Korea Fund is one example of the IFC's work in trying to stimulate foreign portfolio investment in developing countries. In the early 1980s the Korean authorities decided to open their securities market gradually to foreign investors. As a first step, two semi-open-end mutual funds (Korea Trust and Korea International Trust) were offered in the Euroequity market at the end of 1981. These offerings totaled $30 million (later doubled through a second tranche) and were underwritten by leading international securities houses. The minimum denominations of $10,000 were aimed at institutions and individuals with sizable portfolios. The funds are managed by two established Korean investment management companies.

As a second step, the Korea Fund was offered to the general public as well as institutional investors in mid-1984. This fund is a closed-end investment company, registered with the U.S. Securities and Exchange Commission and listed on the New York Stock Exchange. It is expected that normally at least 80 percent of the fund's assets will be invested in Korean listed stocks. The fund is managed by Scudder, Stevens & Clark, an American investment counseling firm, with the help of Daewoo Research Institute, an investment advisory firm in Korea. The IFC was involved from the beginning and acted as one of the colead managers of the underwriting.

In future years, foreign investment in Korean listed securities is likely to be liberalized further. As presently envisaged, the guidelines will say that total foreign investment should not exceed 10 percent of total market capitalization and that foreign holdings should not exceed 10 percent of the voting rights of any company, with a 5 percent restriction on any single foreign shareholder. As part of this development, leading Korean companies are expected to list their stocks on major international stock exchanges and offer their shares for public subscription in the Euroequity market. In addition, Korean securities firms are expected to allow international investment banks to take their shares.
might attract it and use it efficiently. Experience over the last decade suggests that countries with stable economic and political environments are the most successful in this regard. Some countries have succeeded in attracting direct investment by offering inducements of various kinds to compensate for inappropriate macroeconomic policies, but these normally encourage inefficient investment and malpractices in investing firms. Special incentives can be costly for individual developing countries and offsetting within developing countries as a group. In general, developing countries benefit most from equity forms of investment when the overall policy environment is favorable for investment and when the policies adopted toward foreign investors are the same as those under which domestic investors operate.

- Policies in industrial countries are also important for encouraging equity flows; liberal trade and industrial policies are most conducive to direct investment in developing countries. Bilateral understandings and insurance schemes have also proved useful in mitigating some of the risks inherent in direct investment. The World Bank has played an important catalytic role in fostering both direct and portfolio investment and in some instances has provided needed complementary financing to direct investment projects. While all of these factors could encourage a greater flow, direct investment, which is undertaken by relatively few companies in a narrow range of countries and industries, is likely to be relatively slow to respond.

- Foreign portfolio investment might be stimulated by the removal of restrictions, regulations, and tax barriers that impede international investors' access to domestic stock markets. Furthermore, major indigenous corporations might also
be permitted to list their shares on international stock exchanges. A more favorable climate for foreign portfolio investment might stimulate interest among investors and facilitate the establishment of emerging equity market funds. Pension funds in the industrial countries have assets worth $1.5 trillion, and they are increasingly seeking investment opportunities worldwide. A small shift in investment toward emerging markets could increase the volume of capital flowing to developing countries.

- Both direct and portfolio investment have the potential for covering a higher proportion of the funding needs of developing countries than they have hitherto. To realize this potential, however, requires a wholesale reassessment of the benefits of those types of investment in host and investing countries alike. It is necessary, however, to be realistic about its potential for providing large amounts of finance to a broad range of developing countries.