CHAPTER-II

ECONOMIC REFORMS AND FOREIGN INVESTMENT : A GLOBAL VIEW

Evolution of Economic Reforms : Stabilization and Structural Adjustment Programmes

Until the 1980s, countries encountering balance of payments difficulties could approach the IMF and adopt a stabilisation program, or they could themselves address their difficulties. The name "stabilization program" was consistent with an earlier held view that the underlying conditions giving rise to balance of payments difficulties were unsustainable macroeconomic policies. Therefore, it was argued that underlying changes in macroeconomic policies would stabilise the situation, thus giving rise to the name. The IMF was the sole provider of support for these programs, as the World Bank was largely engaged in lending support for development projects. Formally, these programs were generally "standby arrangements". Fund support generally lasted only for three years; the implicit theory was that the underlying causes of macroeconomic instability could be corrected within that length of time.

By 1980, however, it came to be recognized that balance of-payments crisis were occurring not only because of macroeconomic imbalances but also because of problems with the "underlying structure of the economy"[1]. On one hand, the Fund increasingly provided loans for more than three years in the form of the Extended Fund Facility (EFF) and Structural Adjustment Facility[2] (SAF). On the other hand, the World Bank began granting "structural adjustment loans" (SALs) in support of policy reform programs. In addition to SALs, which were intended to provide support for overall policy reform, the Bank also engaged in Sectoral Adjustment Loans (SECALs), supporting policy reforms in specific sectors. These loans, known as SECALs, were normally intended to support reforms in such sectors as agriculture or trade.

By the mid 1980s, the IMF and the World Bank were both engaged in supporting policy reform efforts, and the dividing line between "stabilization" of macroeconomic policy and structural adjustment was sufficiently blurred that it was no longer a useful distinction. The World Bank continues to provide SALs and SECALs, and the Fund continues its activities with standbys, EFFs and SAFs.

'Conditionality', which is an agreement between the IMF and a member country on a stabilization program, usually signifies in a letter of intent from the President or Prime Minister of the country to the Fund. In many instances, Fund staffs have reached the conclusion that certain policies have to be changed if there is to be any hope returning to a viable balance of payments situation. In these circumstances, those policy changes are stipulated in the letter of intent, and the Fund typically declines to support programs until conditions judged at least minimally capable of bringing about the desired turnaround are agreed to.

Most of the time, disagreement comes over three issues: (i) the necessary magnitude of reforms – the degree of exchange rate devaluation, import tariff reduction, restructuring of agricultural prices, deregulation of interest rates, cuts in public sector expenditures and revision in tax rates and so on; (ii) the range of reforms to be undertaken initially; and (iii) the speed at which reforms should be introduced.

When the national authorities are in any event intent upon reform and seek primarily financial support from the IMF, the World Bank, and donor agencies, some problems may arise at home. Problems, and criticisms, are greater: (i) when there is less domestic consensus as to the need for policy reform; (ii) where the primary motive of major decision makers appears to be their desperation for foreign exchange to finance imports; and (iii) when the short-run results of the program result in considerable economic hardship.

Most of the reforms were introduced after the debt-crisis of 1982 in Latin American Countries which were badly affected by the two consecutive oil crisis as will be evident from the following discussions.

Oil Crisis of 1970s, Debt Crisis of 1980s and Economic Reforms

The two world oil crises of the 1970s, the first in 1973 and the second in 1979, produced two conspicuous effects: the developed industrial countries went into a prolonged period of economic recession and most of the developing countries, specially the oil importing countries, were pushed off their development tracks. Growth rates of their economies declined sharply. In a large number of African countries, which had been experiencing high population growth, real per capita incomes declined, indicating a sort of reversal of development and a large number of those developing countries fell into balance of payments crises. Mexico's default on her repayment obligation in 1982 triggered the developing world's debt-crisis. The debt crisis of 1982 was precipitated by a sudden reduction in capital inflows at a time when highly indebted developing countries were facing a slowdown of the world economy, a large increase in international interest rates, and a sharp loss in terms of trade.

This was the period when the reforms began and by the end of 1980s, more than 60 developing countries had submitted to the IMF-World Bank, market-oriented economic reforms, euphemistically called 'structural adjustment programmes'. The economic reforms led to liberalization, privatization and globalisation of the economy of the developing world. Policy reforms were introduced for liberal imports against earlier policies of import substitution and foreign investment was allowed to lower the external debt burden and to supplement the gap between the savings and investment in the domestic economy. We shall discuss in detail about the impact of globalisation on international trade and investment in subsequent paragraphs.

Globalisation : Meaning and Its Impact on Trade and Investment

Globalization refers to the growing economic interdependence of countries worldwide through the increasing volume and variety of cross-border transactions in goods and services and of international capital flows, and also through the more rapid and widespread diffusion of technology. The term "globalization" has no common, widely agreed upon meaning[2a]. We define it quite simply as follows: globalization is the widening and deepening of international economic interactions (Milberg, 1998).

Economic integration among nations is not a new phenomenon. Indeed, the increasing integration of the world economy in recent decades can in many ways be seen as

a resumption of the intensive integration that began in the mid-1800s and ended with World War I when belligerents imposed a series of quantitative restrictions.

A renewed movement toward liberalization under the Gold Exchange Standard (1925-31) ended with the Great Depression. After World War II, the international community, along with the IMF, the World Bank, and other international organizations, created the General Agreement on Tariffs and Trade (GATT). The World Trade Organization (WTO), which succeeded GATT in 1994, is currently engaged in reducing non-tariff barriers and protection, including in areas not covered by the GATT[2b].

There are three dimensions of globalisation: international trade, international investment and international finance. It needs to be said that openness is not simply confined to trade flows, investment flows and financial flows. It also extends to flows of services, technology, information, ideas and persons across national boundaries. Multinational corporations (MNCs) play a pivotal role in the cross-national flow of goods, capital, and technology (Gilpin, 1987, 1975; Vernon, 1977, 1971, 1966)[3].

There can be no doubt, however, that trade, investment and finance constitute the cutting edge of globalisation as discussed briefly in subsequent paragraphs.

International Trade

The second half of the twentieth century has witnessed a phenomenal expansion in international trade flows. World exports increased from $ 61 billion in 1950 to $ 315 billion in 1970 and $ 3447 billion in 1990. At the end of the century in the year 2000 the World exports have touched a figure of $ 7409 billion, which is more than double of 1990 level. The rate of growth of World exports has declined from 9.2% in 1964-73 to 4.6% in 1973-80 and further down to 2.4% in 1980-85 but has increased to 6.7% in 1985-94 (See Table-I). The free trade regime and removal of quantitative restrictions after the formation of World Trade Organisation with effect from 01-01-95 have contributed towards higher level of international trade of goods and services. The share of world exports in world GDP rose from about 6 per cent in 1950 to 12 percent in 1973 and 16 per cent in 1992. Export sales of foreign affiliates of MNCs accounted for $ 2338 billion in 1998 an increase of 14.9 percent over $ 2035 billion in 1997. It is estimated that 30% of the World trade is intra-firm[4].

Table – I				
Indicators of growth of international economic activity, 1964-1994 (average annual % change)				
Period	World export volume	World FDI flows	International bank loans	World real GDP
1964-1973	9.2	—	34.0	4.6
1973-1980	4.6	14.8	26.7	3.6
1980-1985	2.4	4.9	12.0	2.6
1985-1994	6.7	14.3	12.0	3.2

Source : Crotty, Epstein and Kelly (1998); UNCTAD (1997a:Table24,p.71), "Global Instability, The Political economy of world economic governance," Pg.117.

International Investment

The stock of direct foreign investment in the world economy increased from $ 68 billion in 1960 to $ 502 billion in 1980 and $ 1761 billion in 1990. At the end of 1998, the stock of FDI, a broad measure of the capital component of international production, stood at $4 trillion. The flows of direct foreign investment in the world economy increased from less than $ 5 billion in 1960 to $ 52 billion in 1980 and $ 209 billion in 1990. In 1998, global inflows reached $644 billion, an increase of 38.7 percent over the previous year. The World FDI flow grew at an annual average rate of 14.8% in 1973-80 and with a decline in growth rate to 4.9% in 1980-85 rose again to 14.3% in 1985-94 (See Table-I) The ratio of FDI flows to World gross capital formation was 7.84 percent in 1997 (See Table-IV). FDI is thus playing a larger and more important role in the world economy.

International Finance

The past two decades namely 1980s and 1990s have witnessed an explosive growth in international finance. The movement of finance across national boundaries is enormous. So much so that, in terms of magnitudes, trade and investment are now dwarfed by finance. This internationalisation of financial markets has four dimensions: foreign exchange, bank lending, financial assets and government bonds. The daily foreign exchange turnover exceeds the official reserves of all IMF members combined (Eichengreen 1996).

In foreign exchange markets, trading was a modest $ 15 billion per day in 1973. It rose to $ 60 billion per day in 1983, and soared to $ 900 billion per day in 1992. Consequently, the ratio of world-wide transactions in foreign exchange to world trade rose from 9:1 in 1973 to 12:1 in 1983 and 90:1 in 1992. In 1992, world GDP was $ 64 billion per day while world exports were $ 10 billion per day, compared with global foreign exchange transactions of $ 900 billion per day[5]. The estimated daily global turnover of foreign exchange market has gone up from $820 billion per day in 1992 to $1190 billion in 1995. The daily turnover of forex market as a percentage of world exports of goods and services has gone up from 7.4% in 1986 to 19.1% in 1995[6].

Financial Liberalization and Shift in Financing from Debt to Equity in Developing Countries

Prior to financial liberalization, the developing countries were dependent for their financing requirements mainly on multilateral financial institutions like the IMF, the World Bank; the regional development banks such as the Asian Development Bank; bilateral donor country financing and external commercial borrowings. Developing countries had extremely no access to private banking and the capital markets of advanced industrial countries. The 1980s, and 1990s have witnessed the rapid globalization of production process and finance under the Structural Adjustment Programme of World Bank and the IMF.

Consequently, the flow of foreign capital to developing countries in the form of foreign direct investment and foreign portfolio investment witnessed an increase from US $ 26.912 billion in 1990 to US $ 152.832 billion in 1997 as evident from Table II. Within the total, net FDI flows rose from $23.687 billion in 1990 to $120.382 billion dollar in 1997 while net portfolio investment flows increased from $ 3.225 billion to $ 32.450 billion over the same period. The loans and other did not increase so fast.

Till 1980 long term debt from World Bank and other official lending agencies used to be the major source of finance to the Developing Countries. It is evident from Table-II that all the developing countries together received $10.893 billion in the year 1970 of which $6.648 was from Long- term debts, $2.092 in the form of various grants

and $2.152 from FDI. There was practically no receipt from Foreign Portfolio Investment (FPI) till 1980. In all practical sense long- term debt was the major source of finance to meet the requirement of external capital to service the old debt and to meet the trade deficit. It is a bit surprising to note that profit remittances on the FDI amounted to $6.446 billion as against inflow of only $2.152 billion of FDI in 1970. Similarly in the year 1980 FDI inflow was $4.420 billion as against huge outflow of $23.689 billion on account of profit remittances of FDI. Thus there was net outflow till 1980 on account of Foreign Direct Investment from the developing countries, which was met out by inflow of long term debts with cumulative effect of heavy inflow of debt till 1980, which ultimately resulted into debt crisis in most of the developing countries in the 1980's. This necessitated a shift in the policy directions and most of the developing countries, started inviting Foreign Direct Investment (FDI) through open policies. The results are evident from data given in Table-II. Beginning with year 1990, we find that equity flows have multiplied by more than 5 times as compared to 1980. On the one hand there is increase in the aggregate amount of the FDI inflow from $4.420 billion in 1980 to $23.687 billion in 1990 and on the other hand there is decrease on the profit remittance of the FDI from $23.689 billion to $17.319 billion. With the increase in the equity flow, the net transfers[7] of long term funds also went up from $26.375 billion in 1990 to $187.935 billion in 1997.

Foreign Direct Investment flows towards the developing countries increased from $23.687 billion in 1990 to $120.382 billion in 1997. As against this Foreign Portfolio Investment has increased from $3.225 billion in 1990 to $32.450 billion in 1997. A comparative study of FDI and FPI flow in developing countries has been made (Please see Figure 1.1).

Table – II

Aggregate Net Resource Flows and Net Transfers (Long-Term) (All developing Countries)

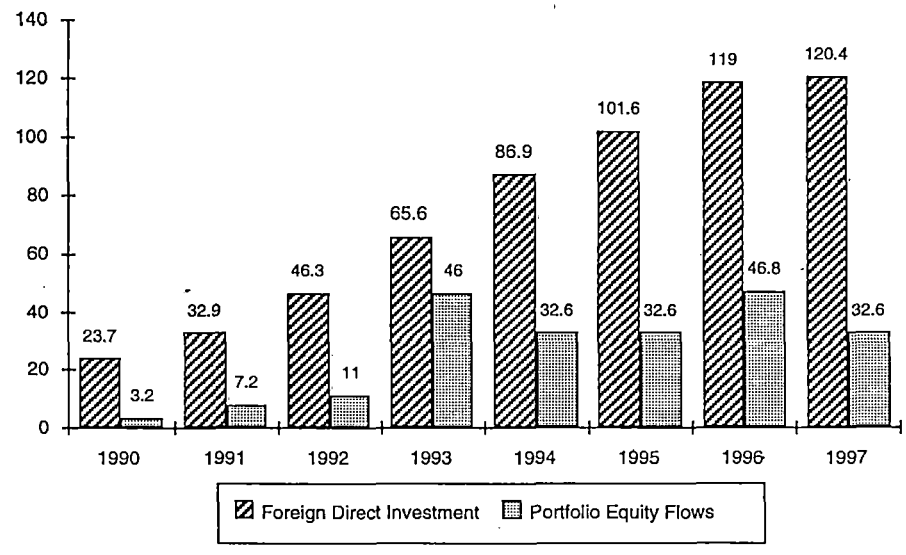
(US$ million, unless otherwise indicated)

	1970	1980	1990	1991	1992	1993	1994	1995	1996	1997
Net Resource Flows	**10,893**	**84,037**	**98,251**	**116,270**	**143,926**	**208,111**	**206,184**	**243,089**	**281,603**	**300,274**
Net Flow of long-term debt (excluding IMF)	6,648	66419	42,162	41,114	57,147	69,138	53,986	76,480	87,618	122,381
Foreign direct investment(net)	2,152	4,420	23,687	32,877	45,279	65,582	86,893	101,474	118,960	120,382
Portfolio equity flows	0	0	3,225	7,207	11,012	44,987	32,636	32,498	45,830	32,450
Grants (excluding technical coop).	2,092	13,198	29177	35,072	30,488	28,405	32,670	32,638	29,195	25,061
Memo:technical cpp[/ grants	1,729	6,296	14,162	15,768	17,927	18,578	17,447	20,594	19,274	18,272
Net Transfers	**2,147**	**27,994**	**26,375**	**44,007**	**70,244**	**134,233**	**122,810**	**142,465**	**174,175**	**187,935**
Interest on long-term debt	2,281	32,355	54,557	54,251	53,019	51,219	58,715	74,381	77,323	80,938
Profit remittances on FDI	6,466	23,689	17,319	18,012	20,663	22,660	24,660	26,243	30,105	31401

Source:-Global Economic Prospects 1998-99, World Bank.

Figure : 1.1

Comparative Study Between FDI and FPI in Developing Countries



Nature and Composition of Global Capital Flows to Developing Countries

The character of global capital flows to developing countries underwent significant changes on many counts during the nineties (Rao et.,al). By the time the East Asian financial crisis surfaced, the overall size of the flows more than tripled. It stood at US$100.8 bn. in 1990 and rose to US$308.1bn. by 1996. The increase was entirely due to the sharp rise in the flows under private account that rose from US$ 43.9bn. to 275.9 billion during the same period. In relative terms the percentage of private account capital flows increased from 43.55 to 89.55 per cent (See Table III). Simultaneously, the Official Development Assistance (ODA) declined both in relative and absolute terms. All the main components of the private account capital transfers, namely, (a) commercial loans, (b) foreign direct investments (FDI), and (c) foreign portfolio investments (equity and bonds) (FPI) recorded significant increases. Portfolio flows increased at a faster rate than direct investments on private account. As a result, starting with a low level of 11.16 per cent, the share of capital flows in the form of portfolio investments quadrupled to reach 37.22 percent in 1996 reflecting the enhanced emphasis on private capital flows with portfolio investments forming the second important constituent of the flows during the nineties. In this process multilateral bodies led by the International Finance Corporation (IFC) played a major role.

Following the East Asian financial crisis, initially there was a slow down followed, by a decline in private capital flows. While bonds and portfolio equity flows reacted quickly and declined in 1997 itself, loans from commercial banks dropped a year later in 1998. Decline in FDI was also delayed. But the fall in FDI was quite small compared to the other three major forms of private capital flows. While flows on official account increased, following the crisis, they continue to constitute only a small portion of the total flows. Thus, starting with the resolve by the developed countries to provide one per cent of their GNP as developmental aid, the industrialized world preferred to encourage private capital transfers through direct investments instead of official assistance[8]. The declining importance of official development finance is attributed to budgetary constraints in donor countries and the optimism of private investors in the viability of the developing countries[9].

Table – III
Aggregate Net Long-term Resource Flows to Developing Countries

(US$ bn.)

Type of flow	1990	1991	1992	1993	1994	1995	1996	1997	1998
A. Official Flows	56.9	62.6	54.0	53.3	45.5	53.4	32.2	39.1	47.9
B. Total Private Flows	43.9	60.5	98.3	167.0	178.1	201.5	275.9	299.0	227.1
of which.									
International Capital Markets	19.4	26.2	52.2	100.0	89.6	96.1	149.5	135.5	72.1
- Private Debt Flows	15.7	18.6	38.1	49.0	54.4	60.0	100.3	105.3	58.0
- Commercial Banks	3.2	4.8	16.3	3.3	13.9	32.4	43.7	60.1	25.1
- Bonds	1.2	10.8	11.1	37.0	36.7	26.6	53.5	42.6	30.2
- Others	11.4	3.0	10.7	8.6	3.7	1.0	3.0	2.6	2.7
- Portfolio Equity Flows	3.7	7.6	14.1	51.0	35.2	36.1	49.2	30.2	14.1
Foreign Direct Investment	24.5	34.4	46.1	67.0	88.5	105.4	126.4	163.4	155.0
C. Aggregate Net Resource Flows (A+B)	100.8	123.1	152.3	220.2	223.6	254.9	308.1	338.1	275.0
Share of Private flows in Total Flows (C)	43.55	49.15	64.54	75.8	79.65	79.05	89.55	88.44	82.58
Share of Portfolio Capital Flows (equity+bonds) in Private Flows (B)	11.16	30.41	25.64	52.7	40.37	31.12	37.22	24.35	19.51

Source : Based on World Bank, Global Development Finance, 1999.

The Determinants and Causes of Global Capital Flows

International capital flows have recently been marked by a sharp expansion in net and gross capital flows and a substantial increase in the participation of foreign investors and foreign financial institutions in the financial markets of developing countries (World Bank 1997)[10]. This expansion has been much greater than that of international trade flows (Goldstein, Matheieson, and Lane 1991 and Montiel 1993). It has been reinforced by the ongoing abolition of impediments and capital controls and the broader liberalization of financial markets in developing countries since the late 1980s. Feldstein and Horioka's (1980) finding of low international capital mobility based on the correlation between the shares of savings and investment in gross domestic product (GDP) still remains a puzzle (see Obstfeld 1995). However, studies based on interest rate differentials generally provide evidence that there is a high and increasing degree of international capital mobility among the major industrial countries and among international and developing countries (Montiel 1993).

Another main feature of recent capital flows to developing countries is that private (bond and equity) flows, as opposed to official flows, have become a crucial source of financing large current account imbalances: "This surge of portfolio investment

combined with the large amounts of foreign direct investment has meant that in the early 1990s, close to half of all aggregate external financing of developing economies comes from private sources and goes to private destinations" (Bruno 1993,).

Net capital flows arise when saving and investing are unbalanced across countries, resulting in a transfer of real resources through a trade or current account imbalance.

The processes of deregulation, globalization, and innovation have increased both the efficiency of and volatility in financial markets. Volatility adds another source of risk, not only making the pricing of financial assets more difficult but also generating portfolio flows that are potentially more unstable (Corrigan 1989; Claessens, Dooley, and Warner 1995; Grabel 1995; and Clarke 1996). Also some evidence suggests that volatility is not correlated with any measure of financial integration and that it does not rise because of financial liberalization (see, for example, Tesar and Werner 1995 and Bekaert 1995).

The recent literature usually distinguishes between two sets of factors affecting capital movements.

The first are country-specific-pull-factors reflecting domestic opportunity and risk. As developing countries' creditworthiness is restored, capital (bond and equity) flows are likely to become an increasingly prominent source of external finance. For example, equity related capital flows could be very large and come in the form of either foreign direct investment (FDI) or portfolio investment in equities. FDI may be attracted by the opportunity to use local raw material or employ a local labor force. Although portfolio equity flows to developing countries have increased sharply in recent years, they are expected to be extremely sensitive to a country's openness, particularly to rules concerning the repatriation of capital and income (Williamson 1993). The right to repatriate dividends and capital may be the most important factor in attracting significant foreign equity flows (Goldstein, Matheieson, and Lane 1991).

Rates of return – obviously a crucial determinant of capital flows – are often very high in the financial markets of developing countries relative to many major markets in industrial countries, reflecting the high risk generated by their typically high volatility.

Credit ratings and secondary-market prices of sovereign debt, reflecting the opportunities and risks of investing in the country, are likely to be important in determining capital flows as well (Bekaert 1995). Those indicators also rose in the late 1980s (Mathieson and Rojas-Suarez 1992 and Chuhan, Claessens, and Mamingi 1993).

The second set of determinants of capital flows to developing countries is global-push-factors. For example, the sharp increase in U.S. capital flows, which represent a significant share of the portfolio flows received by emerging markets, may have been induced to some extent by the fast and market fall of U.S. interest rates (short, medium, and long term) in the late 1980s. Moreover, the slowdown of the U.S. economy in the late 1980s may also have attracted U.S. capital flows, especially because during that period macroeconomic policies, labor market conditions, and exchange rate policies in many developing countries were becoming noticeably more stable (Calvo, Leiderman, and Reinhart 1993 and 1996). One would expect that as the governments of developing countries make macroeconomic and institutional reforms, international investors will gain confidence and be more willing to direct capital flows toward the new markets (Papaioannu and Duke 1993).

In other words the causes of capital inflows can be grouped into three major categories: autonomous increases in the domestic money demand function; increases in the domestic productivity of capital; and external factors, such as falling international interest rates. The first two are usually interest rates and referred to as "pull" factors, the third as "push" factors.

While the composition of capital inflows can provide information about their causes, it is often difficult to distinguish between foreign direct investment flows and portfolio investment flows, especially in the short term. In general, an increase in money demand is likely to attract short-term portfolio investment, whereas other changes, such as an increase in the domestic rate of return on capital, will tend to attract longer term foreign direct investment. In these cases, also, there may be long delays between the stimulus and the inflow of capital, depending, among other things, on the regulatory environment and absorptive capacity of the recipient country. Thus, an increase in the domestic productivity of capital may initially lead to larger portfolio inflows and only later attract greater amounts of foreign direct investment.

Global Flow of Foreign Direct Investment and International Production

The growth of international production is an important part of the process of globalization. "International production" refers to that part of the production of goods and services of countries that is controlled and managed by firms headquartered in other countries. Firms that engage in international production (TNCs) establish, under the common governance of their headquarters, international production systems in which factors of production move, to a greater or lesser extent, among units located in different countries[11]. According to World Investment Report 2000, global inflows reached $865 billion in 1999, an increase of 27 percent over the previous year. At the end of 1999, the stock of FDI, a broad measure of the capital component of international production, stood at $5 trillion[12]. Sales by foreign affiliates, a broad measure of the revenues generated by international production, reached an estimated $14 trillion in 1999, while their gross product (value added) stood at an estimated $3 trillion. The gross product of all TNC systems together – that is, including parent firms – was an estimated $8 trillion in 1997, comprising roughly a quarter of the world's gross domestic product[13]. Developed countries attracted $636 billion in FDI inflows in 1999, $156 billion more than in 1998, accounting for nearly three quarters of the world's total. The United States and the United Kingdom continued to lead in both inward and outward FDI. FDI flows to developing countries, after stagnating in 1998, seemed set to resume their earlier growth trend. Their value reached $208 billion, an increase of 16 per cent over 1998. However, given the rise in flows to developed countries in 1999, their share in world FDI inflows continued to decline, falling in 1999 to 24 percent from 38 per cent in 1997. Total flows to developing countries amounted to $208 billion; some $106 billion went to developing Asia (including Central Asia and West Asia), $40 billion of it to China alone[14].

An analysis of the FDI flows during 1986-1998 (Table-IV) reflects the growing influence of FDI in the global economy. The annual growth of FDI inflow in 1998 was 38.7 percent over 1997. Though the average annual growth in FDI inflow in the second half of 1980s was 24.3% (1986-90), the annual growth in FDI inflow in the first half of 1990s was a comparatively low at 19.6% (1991-1995). However the growth rates in the second half have been better. The growth was 29.4% in 1997 as against 9.1% in 1996, which can be said to be the lowest rate of growth in the past ten years. The FDI inflow has grown from $209 billion in 1990 to $464 billion in 1997, indicating a growth of 122 percent over seven years or an average annual growth of 17.43 percent. As against this the growth in one single year in 1998 over 1997 is 38.79

percent. The recent years have experienced increase in cross-border mergers and acquisitions which have phenomenally been manifested by an increase in FDI flow under this mechanism from $ 163 billion in 1996 to $ 236 billion 1997 and $ 411 billion in 1998. The annual sales of all the foreign affiliates together have gone up to $ 11.43 trillion in 1998 over $ 9.38 trillion in 1996 and $ 9.73 trillion in 1997. The total assets of MNCs and their affiliates during this period grown to $ 14.62 trillion in 1998 as compared to $ 11.25 trillion in 1996 and $ 12.21 trillion in 1997. The increase in sales of MNCs and their affiliates have grown by 17.5% in 1998 as compared to a low of 3.8% in 1997. This is however close to average annual rate of growth of 16.6% in 1986-90. The growth in gross product of MNCs and their foreign affiliates have been much higher at 12.8% in 1997 and 17.1% in 1998 as against a negligible 2.5% in World GDP in 1996 and 1.2% in 1997. The World GDP growth has come down substantially from average annual growth of 12% in 1986-90 to 6.4% in 1991-95 and a law of 1.2% in 1997. Though the GDP growth of MNCs was also very low at 7.3% average annual during 1991-95 as compared to 16.8 during 1986-90, it has picked up very well in the recent past at 12.8% in 1997 and 17.1% in 1998 and specially, if we compare it with World GDP growth. This is mainly because of growth of FDI influence in the developing countries where the growth rate is comparatively higher than that of the developed countries.

The gamut of Foreign Direct Investment has expanded far and wide the globe through its huge network of TNCs, now numbering 63000 parent firms with around 690,000 foreign affiliates and a plethora of inter firm arrangements. The foreign affiliates of the top 100 TNCs, employ over 6 million persons and their foreign sales are of the order of $ 2 trillion. They are concentrated mainly in electronics and electrical equipment, automobiles, petroleum, chemicals and pharmaceuticals[15].

While there are several reasons behind the expansion and deepening of international production, the ongoing liberalization of FDI (and related) regimes and the recognition that FDI can contribute to firm competitiveness stand out as the principal pull and push factors.

The expansion of TNCs has been facilitated by favourable legal framework created by host countries. Over the period 1991-1999, 94 per cent of the 1035 changes worldwide in the laws governing foreign direct investment (FDI) has gone in favour of TNCs. Sales of foreign affiliates worldwide ($14 trillion in 1999 as against $ 3 trillion in 1980) are now nearly twice as high as global exports[16].

- Between 1986 and 1990, the total inward stock of FDI increased at an annual rate of 17.9%—"inward stock" being the cumulative total reported by recipient or "host" nations—but between 1991 and 1995 this rate fell to a still substantial 9.6%. By contrast, total world exports of goods and non-factor services grew at a rate of 15% between 1986 and 1990, but slowed to 9.3% between 1991 and 1995. World GDP grew at an annual rate of 12% between 1986 and 1990, and slowed to 6.4% between 1991 and 1995. (For details, see table IV)

It is apparent that all three aggregates (FDI inward stock, world exports, and world GDP) grew faster during the last half of the 1980s than during the first half of the 1990s. The slowdown was most evident during the early 1990s, a period of economic recession in the advanced nations. Interestingly, the latest available figures show recovery in the growth of FDI inward stocks, which grew 11.4% in 1997 over 10.6% in 1996 but neither world GDP, which grew 1.2%, nor world exports, which grew only 2.9% during the same year, demonstrated the same level of growth.

Table – IV

Selected indicators of FDI and international production, 1986-1998.

(Billions of dollars and percentage)

Item	Value at current prices (Billion dollars)				Annual growth rate (Per cent)				
	1990#	1996	1997	1998	1986-90	1991-1995	1996	1997	1998
FDI Inflows	209	359	464	644	24.3	19.6	9.1	29.4	38.7
FDI outflows	245	380	475	649	27.3	15.9	5.9	25.1	36.6
FDI inward stock	1 761	3 086	3 437	4 088	17.9	9.6	10.6	11.4	19
FDI outward stock	1 761	3 145	3 423	4 117	21.3	10.5	10.7	8.9	20.3
Cross-border M&As	151	163	236	411	21.0	30.2	15.5	45.2	73.9
Sales of foreign affiliates	5 503	9 372	9 728	11 427	16.6	10.7	11.7	3.8	17.5
Gross product of foreign affiliates	1 419	2 026	2 286	2 677	16.8	7.3	6.7	12.8	17.1
Total assets of foreign affiliates	5 706	11 246	12 211	14 620	18.5	13.8	8.8	8.6	19.7
Exports of foreign affiliates	1 165	1 841	2 035	2 338	13.5	13.1	-5.8	10.5	14.9
Employment of foreign affiliates(thousands)	23 605	30 941	31 630	35 074	5.9	5.6	4.9	2.2	10.9
Memorandum:									
GDP at factor cost	21 473	29 024	29 360	..	12.0	6.4	2.5	1.2	..
Gross fixed capital formation	4 686	6 072	5 917	..	12.1	6.5	2.5	-2.5	..
Royalties and fees receipts	27	57	60	..	22.4	14.0	8.6	3.8	..
Exports of goods and non-factor services	4 173	6 523	6 710	6 576	15.0	9.3	5.7	2.9	-2.0

Source : UNCTAD, based on FDI/TNC database and UNCTAD estimates.
(World Investment Report, 1999 Page 9)

Figures for 1990 taken from World Investment Report, 2000 Page 4

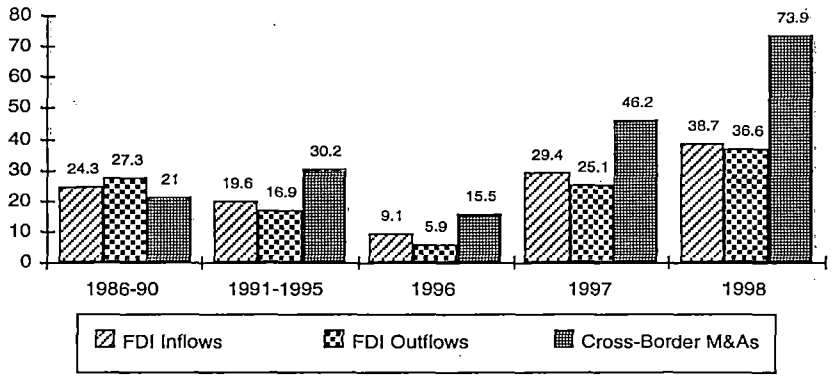
Note:- Not included in this table are the value of worldwide sales by foreign affiliates associated with their parent firms through non-equity relationships and the sales of the parent firms themselves. Worldwide sales, gross product, total assets, exports and employment of foreign affiliates are estimated by extrapolating the worldwide data of foreign affiliates of TNCs from France, Germany, Italy, Japan and United States (for sales and emloyment) and those from Japan and the United States (for exports), those from the United States(for gross product), those from Germany and the United States (for assets) on the basis of the shares of those countries in the worldwide outward FDI stock.

Figure 1.2 displays annual growth rates of FDI inflows, FDI outflows and cross border merger and acquisitions during 1986-1998. It is observed that the FDI flows through merger and acquisitions have grown over the period consistently from 21 percent during 1986-90 to 30 percent during 1991-95 and then after a shortfall in 1996 has jumped to 45.2 percent in 1997 and 73.9 percent in 1998. The FDI inflow and outflow, both have grown at a lower rate during the period 1991-95 as compared to the period 1986-90. However there is a spurt in FDI inflow and outflow during 1997 and 1998.

Figure 1.3 indicates that the growth rate of FDI inflow and FDI outflow is more or less similar in absolute value during the period from 1996 to 1998. However the share of cross-border merger and acquisition has grown over the period faster than other hands of FDI.

Figure : 1.2

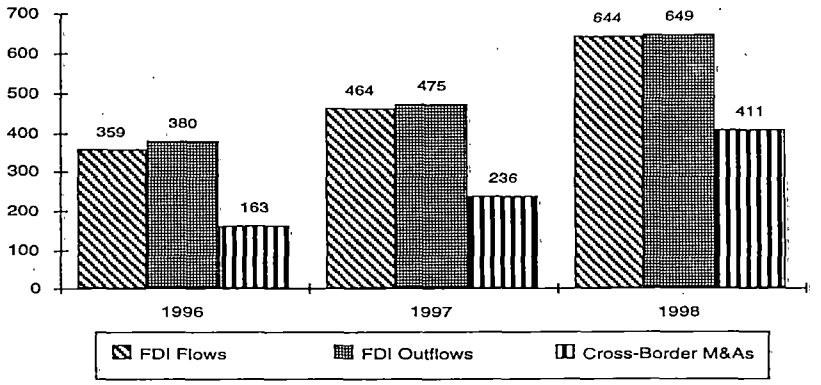
FDI Flows, Annual Growth Rates (Percent)



Source: Compiled from data given in table IV.

Figure : 1.3

FDI Flows, Values at Current Prices (Billion US Dollars)



Source: Compiled from data given in table IV.

Distribution Pattern of FDI in Developed and Developing Countries: A Comparative View

It is evident from table V that the value of FDI inflows has consistently increased from 1987 to 1998. The average annual flow between 1987-1992 was $173.530 billion and has consistently grown through 1993-1998. The distribution of FDI is more in favour of developed countries as compared to developing countries as will be evident from table VI and figure 1.4 and figure 1.5. The share of developed countries during 1987-1992 was 78.73 which came a little down around 60 percent during 1993-1997 but has against gone up to 71.51 in 1998. On the other hand the share of developing countries, which had gone up to 37.16 percent in 1997 from a low of 20.35 during 1987-1992, has again come down to 25.77 percent in 1998. The gap between developed and developing countries' share of global FDI has increased in 1998 due to cross border merger and acquisition which have taken place in large number in developed countries in 1998.

Amongst the developed countries, the major share has gone to Western Europe and North America. USA alone is the largest recipient of FDI inflow in the developed World. Its share in the global FDI flow has gone up from $46.211 billion annual average during 1987-1992 to $193.375 in 1998, which is 42 percent of the developed world and 30 percent of the World FDI inflow in that year.

Amongst the developing countries the share of Africa is very small and has gone down from annual average of 8.52 percent of the developing countries total during 1987-1992 to 4.78 percent in 1998. Latin American and the Caribbean accounted for 35.10 percent doing 1987-1992 and its share has gone up to 43.18 percent in 1998. Mexico is the prominent recipient of FDI and its share in Latin American country was 34.76 percent during 1987-1992 which has came down to 14.29 percent because of competition amongst other host countries in the region. However Mexico has regained its position as a favourable destination of FDI and it received $12.831 billion in 1997 which had earlier gone down after Peso crisis in 1994. The largest amount of FDI amongst various regions of developing countries came to Asia. It received $19.613 billion on annual average basis during 1987-1992, which was higher then Latin America and Caribbean, which received $12.400 billion on average during this period. Its share has constantly gone up through 1993-1997. In 1997, Asia received $95.505 billion as compared to $68.255 billion of Latin America. However the share of Asia has gone down to $84.880 billion in 1998 as compared to 1997, though the

share of Latin America has gone up to $71.652 in 1998 as compared to $68.255 in 1997.

It appears that due to increase in merger and acquisition in 1998, the shares of Latin America has gone up and secondly due to South East-Asian crisis in 1997, some adverse effect has come to FDI inflow in Asian Countries.

Amongst Asian Countries, the South, East and East Asian Countries have enjoyed the largest share. China has been the single largest recipient in this region. Its share has gone up from annual average of $4.652 billion during 1987-1992 to $45.460 billion in 1998. It is the single largest recipient amongst the developing countries. In 1993 it received $27.515 in 1993 and thereafter its share in global flow of FDI has been next only to USA till 1997.

Foreign direct investment in developing countries has a long history. It has fluctuated over time, as investors have responded to changes in the environment for investment, including government policies toward foreign direct investment and the broader economic policy framework. Hence, trends in FDI have reflected changes in policy stances by developing countries, from import substitution in the 1950s and 1960s through natural resource-led development in the 1970s, structural adjustment and transition to market economies in the 1980s, and an increased role for the private sector in the 1990s.

With $ 81 billion inflows to developing countries in 1996 South, East and South-East Asia received about two-thirds of the developing countries' total in the year. Next to China, Singapore was the second largest investment recipient with inflows worth $ 9 billion. Indonesia, Malaysia, Philippines and Thailand together recorded some $ 17 billion in 1996, an increase of 43 percent over 1995. A 34 percent increase in investment flows to India to $ 2.5 billion pushed total inflows to South Asia to $ 3.5 billion. Investment flows into Latin America and Caribbean increased by 52 percent in 1996, to a record level of $ 39 billion. Africa continues to receive small levels of Investment flows nearly $ 5 billion in 1996. The share of central and Eastern Europe was $ 12 billion.

Until 1998, which saw a reversal in the trend, the share of developing countries in world FDI inflows had increased, reaching 37 per cent in 1997. The share of

developing countries in world FDI inflows has exceeded their shares in world imports and exports between 1991-1997. This suggests that, as a group, developing countries play a more important role in world inward FDI flows than as participants in world trade. The least developed countries (LDCs), however, did not participate in the upward trend in FDI flows to developing countries: their share in world FDI flows remained less than one per cent during most of this period, similar to their share in world trade[17].

Among developing countries, though, the distribution of world FDI inflows is uneven. In 1997, for example, developing Asia received 22 percent; Latin America and the Caribbean, 14 percent; and Africa, 1 percent. In relative terms, however, the picture looks different: expressed as a ratio of gross fixed capital formation, FDI inflows to Africa were 7 percent in 1996, compared with 13 percent for Latin America and the Caribbean and 7 percent for developing Asia. In other words, inflows to Africa have a greater impact on the countries of that continent in relative terms than the absolute figures suggest.

Malaysia, Singapore, Thailand and Indonesia are other major recipient in South-East Asia. There has been reversal in the growth trend in 1998 particularly after the South-East-Asian currency crisis in 1997 in these countries. Indonesia is the worst affected, where there is a negative flow of $356 million in 1998 from $4.673 billion inflow in 1997. India is also an important recipient of FDI in South-Asia. Its share has gone up from a low of $58 million annual average during 1987-1992 to $3.351 billion in 1997 and $2.258 billion in 1998. A detailed comparative study has been done amongst Mexico, China and India in Chapter VIII.

The recent surge in FDI flows to developing countries was largely caused by the developing countries' commitment to market-oriented structural reforms, which vastly improved the trade and investment climate and raised the expected rate of return on capital in those countries. As trade theory suggests, foreign investment occurs because the South (the developing countries) is well endowed with labour but is relatively short of capital (both physical and human), and the North (the industrial countries) possesses the opposite mix of factor endowments. Thus, capital moves from the North to the South until the risk-adjusted returns to capital are equalized[18].

Table – V

FDI inflows, by host region and economy, 1987-1998.

(Millions of dollars)

Host region/economy	1987-1992 (Annual average)	1993	1994	1995	1996	1997	1998
World	173 530	219 421	253 506	328 862	358 869	464 341	643 879
Developed countries	136 628	133 850	146 379	208 372	211 120	273 276	460 431
Western Europe	75 507	78 684	84 345	121 522	115 346	134 915	237 425
North America	52 110	48 283	53 299	68 031	85 864	120 729	209 875
Canada	5 899	4 749	8 204	9 259	9 411	11 465	16 500
United States	46 211	43 534	45 095	58 722	76 453	109 264	193 375
Other developed countries	9 011	6 884	8 735	18 819	9 910	17 632	13 130
Developing countries	35 326	78 813	101 196	106 224	135 343	172 533	165 936
Africa	3 010	3 469	5 313	4 145	5 907	7 657	7 931
Latin America and the Caribbean	12 400	20 009	31 451	32 921	46 162	68 255	71 652
Mexico	4 310	6 715	12 362	9 526	9 186	12 831	10 238
Developing Europe	82	274	417	470	1 060	970	1 297
Asia	19 613	54 835	63 844	68 126	82 035	95 505	84 880
West Asia	1 019	3 710	1 562	-418	621	4 638	4 579
Central Asia	25	1 327	897	1 479	2 017	3 032	3 023
South, East and South-East Asia	18 569	49 798	61 386	67 065	79 397	87 835	77 277
China	4 652	27 515	33 787	35 849	40 180	44 236	45 460
India	58	550	973	2 144	2 426	3 351	2 258
Indonesia	999	2 004	2 109	4 346	6 194	4 673	-356
Malayasia	2 387	5 006	4 342	4 178	5 078	5 106	3 727
Singapore	3 674	4 686	8 550	7 206	7 884	9 710	7 218
Thailand	1 656	1 805	1 364	2 068	2 336	3 733	6 969
Central and Eastern Europe	1 576	6 757	5 932	14 266	12 406	18 532	17 513

Source : UNCTAD, FDI/TNC database, Annex Tbable B.1 Complied from World Investment Report 1999; Pg.477-481.

Table – VI

FDI Flows in Developed and Developing Countries – A Comparision 1987-1998

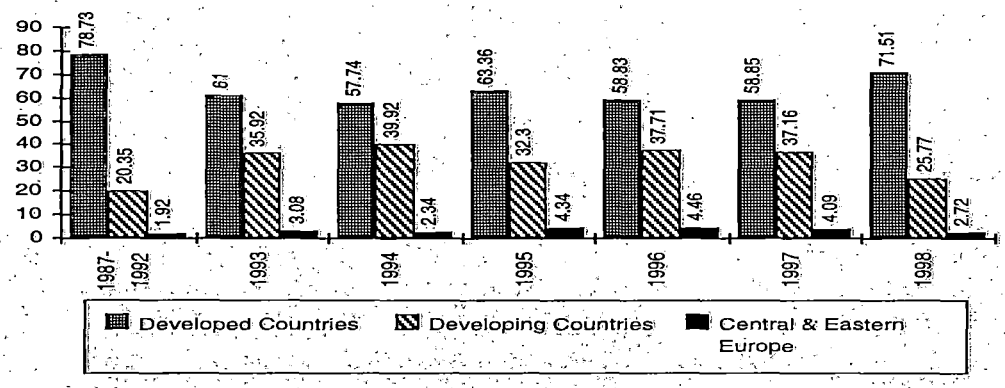
(In Percentage)

Host region/economy	1987-1992	1993	1994	1995	1996	1997	1998
Developed Countries							
% of World	78.73	61.00	57.74	63.36	58.83	58.85	71.51
Developing Countries							
% of World	20.35	35.92	39.92	32.30	37.71	37.16	25.77
Central & Eastern Europe	1.92	3.08	2.34	4.34	4.46	4.09	2.72

Source : Adopted from data given in table V.

Figure : 1.4

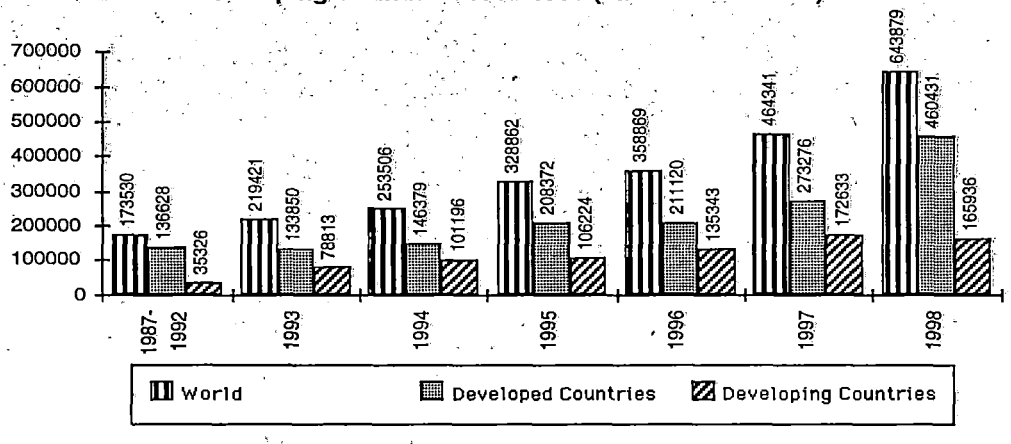
Comparative Study of FDI Flow between Developed, Developing Economies and Economies in Transition, 1987-1998 (in percentage)



Source : Adopted from data given in table IV

Figure : 1.5

Comparative study of FDI flow between Developed and Developing Countries. 1987-1998 (millions of dollars)



Source : Adopted from data given in table IV

Regional Distribution of FDI

There is concentration of world FDI flows in a handful of few home and host countries. The 10 largest home countries (in terms of outward FDI stock) accounted for four-fifths of the world's outward FDI flows in 1998; in total, some 34 countries had FDI outflows of $1 billion or more (compared to 13 countries in 1985). On the host country side the 10 largest (in terms of inward FDI stock) accounted for 71 per cent of world FDI inflows in 1998. At the same time, 111 countries in 1998 recorded inflows of over $100 million, compared to 45 countries in 1985. If only developing countries are considered, the degree of concentration seems to have risen recently: the five largest host countries over the past decade or so (China, Brazil, Mexico,

Singapore and Indonesia, in that order on the basis of inward FDI stock) accounted for 55 per cent of FDI inflows to all developing countries in 1998, compared to 41 per cent in 1990. The global distribution of FDI is not symmetrical. Ten countries received 74 percent of the global FDI flows which was $ 865 billion in 1999. Just 10 developing countries received 80 per cent of total FDI flows to the developing world[19].

The regional distribution of FDI inflow and outflow for the period from 1995 to 1998 is given in table VII. It is evident from the table that the developed countries are the abode of both the FDI inflow as well as FDI outflow. Between the two, FDI outflow in developed countries is proportionately more than the FDI inflow. Developing countries are gradually sharing more FDI inflow mainly because of adverse debt-service ratio at home and also because of sharing the advantages attached with foreign direct investments more fully described and discussed in chapter I. Some developing countries in Latin America and Asia are also participating in FDI outflows but their share is very low as compared to developed countries. USA alone is the biggest participant in both the inflow and the outflow.

The above patterns reflect several recent and ongoing trends. First, rising FDI has signified the increasing importance of inter-firm trade – that is, transactions among the subsidiaries of the same multinational corporations (MNCs) in world commerce. It has tended to displace arm's-length transactions, and thus to create comparative advantages due to domestic sourcing, economies of scale, transfer pricing, and 'captive' markets. Disparities in such advantages can in turn alter international trade balance and national industrial competitiveness (Encarnation, 1992). These considerations augment the traditional incentives for FDI that stem from the desire to prolong product cycle and to protect market share (Knickerbocker, 1973; Vernon, 1977).

Second, the ongoing processes of globalization as well as regionalization of national economies tend to spur FDI. The diffusion of production techniques, the standardization of product designs, the easing of transport and communication barriers, and the conventions of subcontracting and local sourcing have facilitated this investment, especially of the export-oriented kind. At the same time, signs pointing to possible regional trading blocks in Western Europe and North America have raised the prospects of protectionism, and the consequent fears of being excluded from lucrative foreign markets have fueled defensive investment of the tariff-leaping kind.

Third, the diminishing amount of official development aid, the debt crisis of the early 1980s, and the examples of East Asia's export oriented economies have increased the relative acceptance of FDI in many developing countries. Concomitantly, a process toward privatization has been evident in a number of capitalist economies, developed or developing, whereby governments deregulate industries and abandon the less efficient public enterprises. These trends as well as a general turn away from the import-substitution approach to industrialization have opened up more opportunities for FDI.

Fourth, the developments just noted have been most dramatic in the economic reforms of the former socialist economies. In an ironic reversal of dependency theory, officials in Eastern Europe, China, and Vietnam have eagerly sought FDI in their attempts at market liberalization and export expansion. Although starting from rather low levels, FDI inflow has expanded rapidly for some. For example, from 1986 to 1990 its value rose from US$0 to US$16 million for Vietnam, from US$16 to US$89 million for Poland, and from US$1,875 to US$3,489 million for China (United Nations, 1992). The incorporation of these countries into the capitalist world economy appears to augur more competitive bidding for FDI. (Steve Chan)

That FDI largely takes place within the community of democratic nations. Foreign direct investors and MNCs seek countries that are prosperous and stable, and these overwhelmingly are democratic, industrialized states. In very recent years, however, there has been more direct investment in developing nations than has happened historically. Of the flows that did not go to advanced nations, over 70% went to just eight countries: Mexico, Brazil, Argentina, China, Indonesia, Malaysia, Singapore, and Poland.

The increased flows to this diverse set of countries demonstrate how multinational corporations also seek markets that are becoming prosperous and offer the prospect of a high return for their shareholders, even though the country may lack a long history of stable, democratic governance. This also seems to explain quite well why FDI flows to non-democratic China have been substantial in recent years whereas, say, those to democratic India have not.

China and a few other rapidly growing nations notwithstanding, the fact remains that FDI is mostly happening among the world's prosperous nations. And to the extent that

FDI actually is creating an integrated "global economy," it would thus appear to be one from which many, and perhaps even the majority of the world's nations are excluded.

China's success can be attributed mostly to it's large and growing domestic market, "Soft land" and macroeconomic reforms, as well as to measures to promote investment in provinces other than those in the coastal areas. Detail discussion on China has been made in chapter V.

Table – VII

Regional distribution of FDI inflows and outflows, 1995-1998

Regions as a share of totals (Percentage)

	Inflows				Outflows			
Region/Country	1995	1996	1997	1998	1995	1996	1997	1998
Developed Countres	63.4	58.8	58.9	71.5	85.3	84.2	85.6	91.6
Western Europe	37.0	32.1	29.1	36.9	48.9	53.7	50.6	62.6
European Union	35.1	30.4	27.2	35.7	44.7	47.9	46.0	59.5
Other Western Europe	1.8	1.8	1.9	1.2	4.2	5.8	4.6	3.1
United States	17.9	21.3	23.5	30.0	25.7	19.7	23.1	20.5
Japan	-	0.1	0.7	0.5	6.3	6.2	5.5	3.7
Other developed countries	8.5	5.3	5.6	4.1	4.4	4.6	6.4	4.9
Developing Countres	32.3	37.7	37.2	25.8	14.5	15.5	13.7	8.1
Africa	1.3	1.6	1.6	1.2	0.1	-	0.3	0.1
Latin America and the Caribbean	10.0	12.9	14.7	11.1	2.1	1.9	3.3	2.4
Developing Europe	0.1	0.3	0.2	0.2	-	-	0.1	-
Asia	20.7	22.9	20.6	13.2	12.3	13.6	10.0	5.6
West Asia	-0.1	0.2	1.0	0.7	-0.2	0.6	0.4	0.3
Central Asia	0.4	0.6	0.7	0.5	-	-	-	-
South, East and South-East Asia	20.4	22.1	18.9	12.0	12.5			
The Pacific	0.2	0.1	-	-	-	-	-	-
Central and Eastern Europe	4.3	3.5	4.0	2.7	0.1	0.3	0.7	0.3
World	100	100	100	100	100	100	100	100

Source:World Investment Report 1999, pp.18 to 20.

Comparative Study of Global FDI and FPI Flows of Capital

It is evident from Table VIII that the portfolio flows are more than the FDI flows in the whole world in all the years from 1988 to 1995. Secondly it is found that the FDI has grown over the period consistently while in case of FPI there is abrupt increase from $454.5 billion in 1992 to $733.6 billion in 1993 and again there is an abrupt fall to $337.4 billion in 1995.

Table – VIII

Structure and Composition of FDI and FPI Global Flow of Capital

(*in billions of US dollars and as a percentage of world flows)

	1988-89a		1990-91a		1992		1993		1994		1995
	US$	%	US$	%	US$	%	US$	%	US$	%	US$
Foreign direct Investment (net)	175.7	100.0	177.6	100.0	162.1	100.0	200.7	100.0	212.5	100.0	316.4
Industrialized countries	149.1	84.9	141.2	79.5	113.2	69.8	127.6	63.6	128.3	60.4	193.2
Developing countries	26.6	15.1	36.4	20.5	48.9	30.2	73.0	36.4	84.2	39.6	107.5
Asia	13.4	7.6	19.5	11.0	25.6	15.8	44.8	22.3	50.2	23.6	63.2
Africa	2.1	1.2	1.7	0.9	2.2	1.4	2.3	1.2	3.2	1.5	3.9
Latin America	8.7	5.0	9.7	5.4	13.8	8.5	14.1	7.0	17.6	8.3	14.9
Mercosur	4.2	2.4	3.8	2.1	6.9	4.3	8.6	4.3	5.2	2.5	7.9
Mexico	3.0	1.7	3.7	2.1	4.4	2.7	4.4	2.2	8.0	3.8	7.0
Portfolio flows(net)	299.0	100.0	356.6	100.0	454.5	100.0	733.6	100.0	337.4	100.0	593.2
International organisations	7.2	2.4	15.9	4.4	14.0	3.1	16.5	2.3	7.0	2.1	9.5
Industrial countries	283.6	94.9	313.6	88.0	397.7	87.5	621.7	84.7	277.3	82.2	472.5
Developing countries	8.1	2.7	27.1	7.6	42.8	9.4	95.4	13.0	53.2	15.8	42.2
Asia	1.2	0.4	2.0	0.6	7.1	1.6	25.1	3.4	18.8	5.6	26.6
Africa	ns	ns	-0.1	0.0	3.4	0.8	0.3	ns	1.5	0.4	2.1
Latin America	3.1	1.0	23.6	6.6	28.3	6.2	56.0	7.6	18.2	5.4	16.7
Mercosur	1.2	0.4	6.4	1.8	9.4	2.1	26.3	3.6	8.8	2.6	13.5
Mexico	2.0	0.7	8.1	2.3	18.0	4.0	28.9	3.9	8.2	2.4	-10.1

a. Annual Average.
ns: Not significant
Source: Figures calculated from IMF, Balance of Payments Statistics Yearbook 1995 (Part 2)
Stephany Griffith-Jones, Institute of Development Studies University of Sussex, "Global Capital Flows". Pg-29.

Table – IX

A Comparative Study of FDI and FPI Flow in the World

(* In billions of US Dollars and as a percentage of World Flows)

	1988-89a		1990-91a		1992		1993		1994		1995	
	US$	%	US$	%	US$	%	US$	%	US$	%	US$	%
Glow Flow (FDI and FPI together)	474.7	100.0	534.2	100.0	616.6	100.0	934.3	100.0	549.9	100.0	909.6	100.0
Foreign direct Investment (net)	175.7	37.0	177.6	33.25	162.1	26.29	200.7	21.48	212.5	38.64	316.4	34.78
Portfolio flows(net)	299.0	63.0	356.6	66.75	454.5	73.71	733.6	78.52	337.4	61.36	593.2	65.22

Adopted from Table-VIII
a. Annual Average.
ns: Not significant
Source: Figures calculated from IMF, Balance of Payments Statistics Yearbook 1995 (Part 2)
Stephany Griffith-Jones, Institute of Development Studies University of Sussex, "Global Capital Flows". Pg-29.

Foreign Portfolio Investment in Emerging Markets

Liberalization and globalization have stimulated the development of closer financial (as well as trade) relations between developed countries and emerging markets[27]. Foreign direct investment (FDI) has become an important source of capital inflows for emerging markets since the late 1980s. Another is foreign portfolio equity investment (FPI), which has spread to emerging markets as regulatory barriers to capital movements have fallen. By contributing or participating in the equity capital of firms, both FDI and FPI can enhance the development of the enterprise sector in host countries. Foreign Portfolio Investment (FPI) are mainly of two types: Bonds and Equity.

With the opening of the developing countries' economies, portfolio investment has grown very fast since 1985. During 1989-93, total portfolio investment increased by 700% from just $7.5 billion to $55.8 billion. Among developing countries, Mexico was the main beneficiary of equity flows, having received 25% of its entire external 1991-92 financing in this form (Todaro: 1997; 544). Portfolio flows have increased considerably from $5.5bn. in 1990 to $91.8bn. in 1996. In 1993 there was an abrupt increase in portfolio flows from $20.9bn. in 1992 to $80.9bn. in 1993. However the flow reduced in 1994 to $62bn. but again increased to $91.8bn. in 1996 (See Table X). East Asia and latin America received the highest amount of portfolio investment (See Table XI).

However, if any country relies heavily on portfolio investment to camouflage structural weaknesses of its economy, it may face difficulty, as happened in Mexico where grossly overvalued foreign exchange rates led to high current account deficits and dwindling foreign reserve.

The instruments through which portfolio investment takes place are broadly of two types: Equity instruments and Debt instruments. The Equity instruments include Country funds, American Depository Receipts (ADRs), Global Depository Receipts (GDRs), and direct purchases by the foreign institutional investors (FIIs). The Debt instruments include International Bonds, Commercial papers and Certificates of deposits.

TABLE – X							
Portfolio Flows to Developing Countries 1990-96							
							Billions of US $
Type of flow	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**
Portfolio flows	5.5	17.3	20.9	80.9	62.0	60.6	91.8
Bonds	2.3	10.1	9.9	35.9	29.3	28.5	46.1
Equity	3.2	7.2	11.0	45.0	32.7	32.1	45.7

Source : World Bank Debtor Reporting System

TABLE – XI							
Portfolio Equity Investment in Developing Countries							
							(Millions of dollars)
Region	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**
East Asia and the Pacific	2,623	2,268	1,049	5,102	18,107	12,613	12,230
Europe and Central Asia	71	235	0	65	191	1,934	1,590
Latin America and the Caribbean	434	1,099	6,228	8,229	25,149	13,159	6,220
Middle East and North Africa	—	—	—	—	—	106	85
South Asia	168	105	23	380	2,025	6,223	1,430
Sub-Saharan Africa	—	—	—	144	144	860	465
All developing countries	3,372	3,743	7,552	14,057	45,615	34,895	22,000

Source : World Bank, World Debt Tables 1996.

World stock markets are booming, and emerging markets compose a disproportionately large amount of this boom. Over the *past ten* years (1986-95), world stock market capitalization rose from $ 6.5 trillion in 1986 to $ 17.79 trillion in 1995, and emerging market capitalization jumped from less than 4 to close to 11 percent of total world capitalization. Between 1986 and 1995, emerging stock market capitalization grew more than tenfold-from $ 239 billion to $ 1.9 trillion-a much faster pace than that in developed markets. Trading in emerging markets also boosted the value of shares traded in such markets. In fact, it climbed from less than 3 percent (US $ 83 billion) of the $ 3.6 trillion world total in 1986 to close to 9 percent (US $1 trillion) of the $ 11.7 trillion worth of shares traded on all of the world's exchanges in 1995. (See Table XII)

TABLE – XII						
Expanding Stock Markets Developed and Developing Countries						
Item	Emerging Markets		Developed Markets		World	
	1986	1995	1986	1995	1986	1995
Market capitalization (billions of dollars)	239	1,896	6,276	15,892	6,515	17,788
Number of listed Domestic companies	9,618	19,397	18,555	19,467	28,173	38,864
Trading Volume (billion of dollars)	83	1,033	3,491	10,633	3,574	11,666
Trading volume as a Proportion of market Capitalization (percentage)	35	55	56	67	55	66

Source: International Finance Corporation.

The two major factors behind the increase in FPI flows to emerging markets are the liberalization and globalization of financial markets and the concentration of substantial financial resources in the hands of institutional investors.

Between 1988 and 1995, there was a significant increase in the number of emerging markets establishing liberal regimes towards foreign investment. In 1988, only three emerging stock markets were classified by the International Finance Corporation as "free" with respect to foreign investment in stocks listed locally; eleven markets were categorized as relatively free[20]. By 1995, 26 emerging markets were classified as free, 11 markets as relatively free, and only one market was closed to foreign investment.

The second major factor responsible for the surge in FPI flows to emerging markets is the institutionalization of savings and investments in developed countries. It has been estimated that insurance companies, pension funds and mutual funds in developed countries (and some emerging markets) had an identifiable pool of savings worth nearly $21 trillion in 1993. It is also estimated that the six largest developed countries are holding around $38 trillion in savings. These figures, although not strictly comparable provide a very rough indication of the heavy concentration of developed-country savings under the management of institutional investors. In comparison, global equity market capitalization in the same year was $14 trillion.

Investment by developed-country mutual funds in emerging markets has been particularly important[21]. However, by one estimate, the average share of emerging market securities in institutional investors' portfolios is only around 1 per cent[22].

It is estimated that, over the period 1992-1994, more than 35 per cent FPI flows to emerging markets originated in the United States, 15 per cent in Japan and 11 per cent in the United Kingdom (Howell et al., 1995)[23].

Growing Domination of Institutional Investors (FIIs) for Portfolio Investment (FPI)

The driving force behind the financial flows to developing countries and elsewhere are the institutional investors which have emerged largely in the late 1980s and early 1990s. With the growing trend towards the institutionalization of savings in industrial countries (from where the majority of funds originate), institutional investors now dominate the global financial world, especially the capital markets. In the U.S., for instance, institutional investors (FIIs) are not estimated to account for more than 49 percent of U.S. equities, compared with 16.5 percent three decades ago. With the U.S. based fund management companies dominating the business, the institutional investors manage and control assets worth billions of dollars. By the end of 1996, out of the world's top ten fund managers, three belonged to the U.S., three to Switzerland, two to Japan and one each to Britain and Finance. (See Table-XIII)

TABLE – XIII

World's Top Fund Managers (in $ billion)

Fund Managers	Country	Assets
United Bank of Switzerland[1]	Switzerland	920
Kampoo[2]	Japan	798
Fidelity	U.S.	516
Axa	France	496
Barclays	Britain	385
Merrill/Mercury Asset Mgmt.	U.S.	382
Credit Suisse[3]	Switzerland	378
Prudential Insurance	U.S.	333
Nippon	Japan	332
Zurich[4]	Switzerland	312

[1]*As of third quarter 1997.*
[2]*The Japanese Postal Insurance system.*
[3]*Including Winterthur.*
[4]*Includes Scudder, Kemper and Threadneadle Asset Management.*
Source: Institutional Investor, UBS, SBC, The Economist.

The Volatility of Foreign Portfolio Investment and FDI Flows into Developing Countries

There is cold war over 'Hot Money' (the term very often used for portfolio investment particularly after Mexican Peso Crisis) flows. Several episodes of financial turmoil have focused international attention on the problem of volatility of private foreign capital flows and the extent to which that volatility creates an unstable environment detrimental to economic development. An UNCTAD based study has made an analysis for 12 major developing economies during the period 1992-1997(See Table-XIV), which shows that commercial bank loans displayed the highest volatility (0.71), as measured by the coefficient of variation, followed by total portfolio investment (0.43) and FDI (0.35)[24].

Table – XIV
Volatility of Private Capital Flows for Developing Countries: 1992-97
Measured by Coefficient of Variation

Vollatility by Type of Investment For all Developing Countries		Country Specific Volatility		
			FDI	Portfolio
Foreign Direct Investment (FDI)	35%	Argentina	36%	51%
Portfolio Investment	43%	Brazil	96%	46%
Equity	38%	Chile	71%	68%
Bonds	51%	China	38%	71%
Commercial Bank Loans	71%	Hungary	57%	125%
		Indonesia	52%	63%
		Korea	57%	47%
		Mexico	40%	122%
		Philippines	41%	131%
		Singapore	46%	101%
		Thailand	19%	52%
		Uruguay	33%	65%

Source : World Investment Report, 1998, Pg. 15, Bulletin, Money & Finance – November 9, April – June 1999, Pg. 23.

For most countries, it has shown greater volatility than FDI. Mexico is a case in point: even when portfolio investment fell sharply in Mexico in 1994-1995 during the peso crisis, FDI was more or less sustained. For a few countries, including Brazil, Chile and the Republic of Korea, volatility coefficients were higher for FDI than for portfolio investment during the period under consideration[25].

The volatility of FPI flows tends to be higher in countries with high levels of macroeconomic instability.

The aftermath of the financial crisis that hit Mexico at the end of 1994 and spread for a short period to other emerging markets illustrates the resilience of emerging markets. Countries with a large domestic financial sector and a broad domestic savings base recovered especially quickly from the crisis. Thus, an analysis of the impact of the Mexican crisis on the performance of 26 emerging stock markets other than Mexico shows that it has been significant beyond December 1994 for only four countries (Atlan et al., 1996). Of these four countries, two are in the same region (Brazil and Columbia) and two have gone through domestic turbulence that has weakened their domestic financial sectors (Pakistan and Hungary). Detail discussion has been made on Mexican Peso Crisis and Stock Market turmoil in Chapter-VI.

Summary and Concluding Remarks

In view of the many constraints faced by least developed countries, the measures taken by them to attract foreign direct investment will have to be reinforced by complementary actions on the part of home countries.

There are some disincentives for outward investment in some countries in the form of requiring prior authorization, limits on the export of investment capital to countries outside certain regions, or the requirement of deposit of a portion of investment in non-interest bearing account. Where any form of restriction on outward investment exists, special relaxations should be granted for least developed countries. For instance, it can be provided that no prior authorization would be needed for investment of any size in a least developed country.

Fiscal incentives for outward investment should also be focused on least developed countries. In particular, home countries could unilaterally offer tax credit for taxes paid by their transnational corporations in least developed countries and grant higher tax concessions for dividends and profits remitted from least developed countries.

Financial assistance for investment is generally provided through public development finance corporations. A proportion of the resources of these organizations should be earmarked to support investment activities in least developed countries, including feasibility studies and co-financing of joint ventures.

Home countries should strengthen measures to increase the flow of information on viable projects in least developed countries that should be of potential interest to their

transnational corporations. Embassies of home countries can play a useful role in this regard.

With regard to preferential access for exports from least developed countries, home countries should widen product coverage, relax rules of origin and simplify documentation procedures under existing arrangements such as the Generalized System of Preferences, the Lome Convention and the Caribbean Basin Initiative of the United States. Such measures could ignite transnational corporations' interest in least developed countries as export bases.

The climate for foreign direct investment depends on many factors beyond the control of national policies of least developed countries. In order to overcome the many structural bottlenecks, measures adopted by host least developed countries and home countries have to be complemented by multilateral actions.

Least developed countries have initiated a number of reforms to attract transnational corporations. However, there is a need for a simultaneous change of perceptions on the part of transnational corporations which have not traditionally viewed least developed countries as attractive investment sites. Multilateral institutions should play a vigorous role in changing these perceptions by organizing round tables between Government officials of least developed countries, their private enterprises and executives of transnational corporations.

A number of least developed countries are actively pursuing efforts to privatize their state-owned enterprises. International organizations should assist least developed countries in securing participation of transnational corporations within the framework of such privatization programs and could provide co-financing for that purpose.

International financial institutions can facilitate the participation of transnational corporations in least developed countries by designing innovative investment packages, as has been done in some African countries by such institutions as the International Finance Corporation, the Commonwealth Development Corporation and the European Investment Bank.

The search for transnational corporations interested in investment in least developed countries is a time consuming process and may turn out to be quite expensive.

International organizations could effectively reduce the cost of searches by acting as intermediaries between least developed countries and transnational corporations.

International organizations could assist least developed countries to set up data banks, which could serve multiple purposes such as the provision of macroeconomic and sectoral information of interest to transnational corporations and collection of data on variables required by national authorities for screening and approval of investment proposals. Regional cooperation can help promote foreign direct investment in least developed countries by enlarging market size. International organizations could assist in strengthening existing regional arrangements or formation of new ones, which are considered appropriate.

Some serious thought should be given to the establishment of regional investment centers — perhaps one in Asia and the Pacific and one in Africa. These regional centers could act as vehicles for dissemination of the information on investment opportunities in least developed countries, establish contacts with interested transnational corporations, assist least developed countries in conducting negotiations with transnational corporations, as well as for providing training to least developed countries' Government officials and private sector executives in basic business skills such as accounting, management and financial administration.

Recognizing that the benefits of foreign direct investment to host countries are significantly determined by the terms of specific agreements and that many of the least developed countries do not possess strong negotiating skills to secure best possible terms, multilateral organizations could assist least developed countries in structuring foreign direct investment agreements, joint ventures and non-equity arrangements in various sectors. A number of international organizations already have programs in these areas. But the programs should be focused on least developing countries.

The growing importance of foreign direct investment in the world economy, not only in its own right, but also because of its close linkages with trade, technology transfers and financial flows, is by now well established. With that perspective in mind, the international community may wish to give consideration to achieving a consensus on ways and means to attract a greater flow of foreign direct investment to developing countries and to improve its qualitative content. Since, the scope for actions by individual host countries has become rather limited, the need for coordinated

multilateral action by all concerned —host countries, home countries, international institutions and transnational corporations — is all the more important.

Such action needs to take into account the linkages between improving foreign direct investment flows to developing countries and improving flows of technology, trade and finance. In fact, given the nature of these interlinkages, foreign direct investment policies today can no longer be formulated and implemented separately from those concerning trade and technology transfer. Initiatives being taken in those areas should therefore be increasingly coordinated, with a view towards maximizing the effectiveness of actions, which seek to encourage the growth and development of developing countries.

However any kind of multilateral arrangement needs to be on a consensus of all developing nations and should not be in the form of a conditionality as happens to be in the efforts of developed nations for implementation of multilateral agreement on investments. The European Union (EU) and the US want to introduce the Multilateral Agreement on Investments (MAI)[26] that proposes to free investment flows bereft of any restrictions. In effect, the suggestion is to allow foreign investment in almost all the sectors of the economy, prohibit constraints of any form on foreign companies and practically leave nothing for the government to decide about foreign direct investment. This proposal suffers from infirmity as it may bring several harmful impacts on the developing countries. All governments whether developed or developing have their own rules of the game as regard to FDI. However the proposed MAI says that FDI flows should be unrestricted in any form or in any sector except in defence and MNCs should be treated on par with the indigenous industry for all practical purposes.

It is an irony that it is the EU and the US that have scuttled the WTO negotiations in reaching an agreement in the areas of financial services and telecommunications. The MAI, if fructifies, will deprive developing countries of their discretions on the control and regulations of movements of foreign investments.

Nevertheless global integration will continue to drive FDI flows, wherever the economic environment is open to it. Globalization will increasingly blur the distinction between foreign and domestically owned enterprises, and between developed and developing countries. Countries that are open to foreign investment stand to share in the rising global prosperity that globalization bring. Nevertheless, to create

an enabling environment for FDI, a large unfinished agenda of policy reform remains. Some of the countries that have made progress in reducing restrictions, including some already receiving large amounts of FDI, still have some way to go toward providing a fully open environment for FDI. Many more countries have only begun to reexamine their policies toward FDI or the impact of their general economic policies on FDI flows. Yet these countries have not missed their chance to participate in global FDI flows. The rapid increase in FDI volumes in recent years has shown that this is not a zero sum game. As more countries open up to FDI, global integration will increase, leading to an increase in overall FDI flows. The challenge for the future is therefore to open more economies and sectors to foreign direct investment, thereby bringing opportunities for economic development to a larger part of the developing world.

The period between the end of World War II and the end of the Cold War in 1989 was an extremely significant one in the economic history of both developing and developed countries. The contours of the world industrial economy underwent a fundamental change.

The decade of 1970s and 1980s were debt flow and 1990s a decade of equity flow. Developing world has always been in need of foreign capital flows in order to meet their trade deficit and service of old debts and they will continue to do so in future until there is a reversal in their trade imbalances. The policy errors of past or the weaknesses embedded in their economy for long colonial exploitation, will take some time to make them debt free by way of proper policy planning and improvement efficiency with the flow of equity and modern technology including knowledge based industry. However human resource development through wide ranging education system will bring the advantages of international integration and globalisation to the developing world in the long run.

Notes and References :

1. *See Ernest Stern, "World Bank Financing of Structural Adjustment", in John Williamson (ed.), IMF Conditionality, Institute for International Economics (Washington, DC), 1983.*

2. *The SAF was later renamed the enhanced structural adjustment loan, or ESAF.*

2a. *See, Hirst and Thompson (1996) and Baker, Epstein and Pollin (1998) for a discussion of various definitions of globalization.*

2b. *See, World Economic Outlook May 1997, Pg.45,113.*

3. *See Steve Chan and Cal Clark, "Do MNCs Matter for Natioal Development? Contrasting East Asia and Latin America": Foreign Direct Investment a changing global political economy, International Political Economy Series, Pg.166.*

4. *For a review of the literature on trade and direct investment, see Markusen (1995).*

5. *Deepak Nayar, "Globalisation": The Past in Our Present, Presidential Address, Seventy-Eighth Annual Conference Indian Economic Association, Chandigarh, 28-30 December, 1995 Pg.6.*

6. *See World Economic Outlook, IMF, May 1997.*

7. *Net Transfer of fund means the net resource flows from official development assistance plus other long term borrowings plus equity flow in the form of Foreign Direct Investments and Foreign Portfolio Investments reduced by the outflow fund for debt service and remittance of Profit on FDI.*

8. *Goyal, 1980, pp.843-50; Goyal, 1982.*

9. *World Bank 1998, p-5.*

10. *For a comprehensive review of some recent prospects and developments concerning capital flows to developing countries, see World Bank (1995, 1997), IMF (1994a, 1994b, 1995).*

11. *World Investment Report 1999, New York and Geneva, United Nations, Pg-1.*

12. *World Investment Report 2000, New York and Geneva, United Nations, Pg-4.*

13. *World Investment Report 2000, New York and Geneva, United Nations, Pg-3.*

14. *World Investment Report, 2000, New York and Geneva, United Nations, Pg-29.*

15. *World Investment Report 2000, New York and Geneva, United Nations, Pg-xv.*

16. *World Investment Report 2000, New York and Geneva, United Nations, Pg-xv*

17. *World Investment Report 1999, New York and Geneva, United Nations, Pg-18.*

18. *Business Today, New-Delhi, August 7-21, 1997*

19. *World Investment Report 1999, New York and Geneva, United Nations, Pg-18.*

20. *For details, see annex Table A .18, WIR 1997.*

21. *For details, see annex Table A.19, WIR 1997.*

22. *IMF, 1995, pg. 172.*

23. *World Investment Report 1997, New York and Geneva, United Nations, Pg.107-114.*

24. *See for details Box Table 1.1 World Investment Report 1998, United Nations, Pg-15.*

25. *World Investment Report 1998, New York and Geneva, United Nations, Pg-14.*

26. *The Multilateral Agreement on Investment (MAI) is a new investment treaty being negotiated between the World's industrialized countries in the OECD. The MAI is aimed at creating common legally binding rules to reduce government regulations and controls of foreign investors, promote greater legal security and protection for investment, and establish a dispute settlement mechanism. It is likely that the MAI will eventually serve as a model for global investment rules later drawn up by the World Trade Organisation. (Oxfam (1998) "Briefing on the OECD Multilateral Agreement on Investment" (Oxford, Oxfam).*

27. *The term "emerging markets" is used to denote developing countries and transition economies in Central and Eastern Europe. This chapter follows a methodology similar to that used by the International Finance Corporation in classifying as an emerging market any country with a 1994 GNP per capita level of $8,955 or less (this includes countries classified by the World Bank as low- and middle- income). The group of countries so defined includes several countries that in other chapters are considered as developed (such as Greece and Portugal) and excludes several economies that are considered as developing elsewhere in this volume (such as Hong Kong, China and Singapore). For a more complete listing of comprise emerging markets, see IFC, 1996.*
(WIR 1997, Pg. 119)