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COMMISSION ON INVESTMENT, TECHNOLOGY
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Expert Meeting on Portfolio Investment Flows
and Foreign Direct Investment
Geneva, 28-30 June 1999
Agenda item 3

FOREIGN PORTFOLIO INVESTMENT AND FOREIGN DIRECT INVESTMENT: CHARACTERISTICS, SIMILARITIES, COMPLEMENTARITIES AND DIFFERENCES, POLICY IMPLICATIONS AND DEVELOPMENT IMPACT

Agreed conclusions *

1. The Expert Meeting examined how different types of investment flows could contribute to development and discussed in that regard the relationship between foreign direct investment (FDI) and foreign portfolio investment (FPI) flows. It noted the respective roles of FDI and FPI. It had a fruitful discussion helped by the contribution of prominent international experts and high-quality documentation.

A. Statistical recording

2. Improvements in recording foreign investment flows have been achieved, but the discrepancies between assets and liabilities at the global level are even larger for FPI than for FDI. Given the importance of FPI, countries should increase their efforts to ensure the accurate statistical reporting of such flows for analytical and policy-making purposes. Experts noted the importance of adhering to

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* As adopted at the closing plenary meeting, on 30 June 1999.

existing international statistical standards. They also noted the importance of improved statistical methodology to quantify FDI and FPI in order to make it compatible between different countries.

B. Contribution to development

3. Foreign investment can contribute to development by increasing resources for investment as well as by improving the policy framework (for example, bringing discipline in economic management and improving corporate governance and transparency), but developing countries should not rely on foreign investment alone for their development. FDI can bring externalities in the form of the transfer of technology and management know-how. FPI can help in increasing efficiency in domestic capital markets, by deepening these markets and raising disclosure standards. At the same time, host countries should be aware of the potentially destabilizing effects of volatile investment flows.

C. Determinants and volatility

4. Experts observed that, alongside domestic factors, portfolio investment is influenced by global liquidity fluctuations. Problems of asymmetric information and principal agency can explain the herd behaviour of investors. Portfolio investment is mainly made in bonds, which do not imply much risk-sharing, rather than in equities. Sound macroeconomic fundamentals and robust domestic financial systems are preconditions for attracting foreign investment and ensuring that it supports productive investment and a competitive economy. In general, FDI is the least volatile of investment flows, while short-term bank lending is the most volatile. The volatility of FPI lies between the two, but does not often result in net outflows. For low-income developing countries, access to both FDI and FPI is a more important concern than volatility, whereas potential volatility is more of a concern for emerging markets.

D. Policy implications

5. Experts agreed that policy measures should be taken at the national, regional and international levels, and that all such measures should be mutually supportive. Effective integration into international capital markets requires a deepening of domestic capital markets by increasing domestic savings and developing a strong domestic institutional investor base on the one hand, and by strengthening the prudential supervision of financial markets, together with sound and efficient banking systems, on the other. At the national level, it is important to avoid monetary and fiscal policies which accentuate the cyclical movements of foreign capital. Alternative policies might include open market sterilization operations, the management of reserves and other public sector assets, and market-based instruments

such as taxes and reserve requirements on capital inflows. In the long term, however, controls may be less

effective and in any case cannot be a substitute for sound economic management. At the regional level, increased monetary cooperation could help to reduce financial instability. For small low-income countries, it is very difficult to establish a viable capital market or to gain access to international capital markets. As a consequence, regional capital markets should be supported and multilateral financial institutions should consider support for the issuance of equities and bonds on these markets. At the international level, considerable progress has been made in setting international codes and standards for financial markets; it was suggested that developing countries should be more involved in the design of such standards. Experts considered that close coordination between national tax authorities would help to avoid harmful tax competition and reduce the resulting distortion of capital movements. Efforts should also be made to bail-in the private sector in crisis management.

6. Experts expressed the hope that UNCTAD would continue to examine measures that would help developing countries, especially the least developed countries, to design adequate policies and bodies to attract stable investment flows. Furthermore, UNCTAD should support continuing expert discussions on these issues, including participants from the private sector and international and regional financial institutions.