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TRADE AND DEVELOPMENT BOARD Commission on Investment, Technology and Related Financial Issues

REPORT OF THE EXPERT MEETING ON PORTFOLIO INVESTMENT FLOWS AND FOREIGN DIRECT INVESTMENT

Held at the Palais des Nations, Geneva, from 28 to 30 June 1999

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I. AGREED CONCLUSIONS 1

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 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.

¹ As adopted at its closing plenary meeting on 30 June 1999.

D. Policy implications

- Experts agreed that policy measures should be taken at the national, regional and 5. 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.

II. CHAIRPERSON'S SUMMARY

7. The characteristics and developmental impact of foreign direct investment (FDI) and foreign portfolio investment (FPI) and the policy implications resulting therefrom were discussed in the course of the informal sessions. The main findings are incorporated in the agreed conclusions (see section I above).

A. Statistical recording

- 8. Although international standards for the recording of FDI have been established by the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD), a recent survey conducted by these two institutions has shown that the "10 per cent threshold" guideline to distinguish between FDI and portfolio equity investment has not been consistently followed by all countries. Nor have all countries reported transactions between affiliated companies as FDI.
- 9. The borderline cases of portfolio investors who have a lasting interest while holding less than 10 per cent of the equity capital and investors who hold more than 10 per cent while having no such interest are considered as being of marginal importance. An additional criterion could be based on the investor's direct influence on the management of the firm.
- 10. The discrepancies between assets and liabilities of foreign investment at the global level are larger for FPI than FDI. There are still many problems related to the statistical recording of portfolio investment. As countries also hold portfolio investments as official reserves, this information is often considered as confidential and is not reported. Details of pension fund assets are also not always disclosed. Not many countries are recording financial derivatives. Financial derivatives in the future will be recorded only as financial transactions (at present, interest swaps are recorded as interest income and included in the current account). The "third-party gap" is reflected in balance-of-payments data, as these indicate only the direct parties to investment transactions, not the beneficiary parties. This problem is made worse by the large volume of transactions which are channelled through international financial centres. Furthermore, offshore centres do not report on investment transactions.
- 11. In order to address these problems, the IMF Committee on Balance of Payments Statistics conducted the Coordinated Portfolio Investment Survey in respect of the year-end 1997. The objectives were twofold: to collect comprehensive information on the stock of cross-border equities and long-term debt securities for use in the compilation or improvement of international investment position statistics; and to allow the bilateral exchange of comparable data, in order to improve estimates of non-resident holdings of portfolio liabilities, as well as associated capital flows and investment income data.
- 12. Ways to improve the recording of debt statistics are also being considered by the Inter-Agency Task Force on Finance Statistics, in order to reflect more accurately the potential drain

on reserve assets. Two problems will be tackled: debt will be recorded according to the residual maturities and long-term bonds with put options will be recorded separately.

B. Contribution to development

- 13. Foreign investment in general brings additional financial resources. It can also make a contribution to enhancing the policy framework, improving economic management and transparency and developing the financial infrastructure. FDI can produce a positive impact on output, employment and tax revenues, and can provide externalities in the form of the transfer of technology, management know-how and marketing networks. It has been pointed out, however, that the impact on growth is sometimes difficult to measure, as the causal relationship between FDI and growth can work in both directions, and both can be influenced by common factors such as good economic fundamentals. Some participants noted that FDI externalities could not be important if the links with local business were weak. The net effect of FDI on the balance of payments depends on the outflows resulting from remittances of earnings, fees, royalties, imports of inputs and transfer of salaries by expatriate employees.
- 14. FPI can bring benefits in the form of a reduction in the cost of capital to local firms, the more efficient allocation of capital for investment, a strengthening of local capital markets through additional liquidity and through "imported" supervision and regulation from the source country, and the enhancement of corporate governance through better disclosure and risk-sharing. FPI can also play an important role in financing local infrastructure. The contribution of FPI to the financing of investment is higher if made through primary markets. FPI in emerging markets has been made mainly in bonds, which do not imply risk-sharing, rather than in equity. Large fluctuations in FPI flows can have a negative impact on the balance of payments and can induce exchange rate instability, as well as high volatility of asset prices. The long-term impact on development depends upon whether FPI flows finance a higher level of fixed capital formation that is sustainable. In the short term, FPI in the form of government bonds and purchases of securities on the secondary markets would foster consumption through a wealth effect and a credit boom. Resulting exchange rate appreciation and abrupt compensatory movements in fiscal and monetary policies that accentuate the cyclical movements of foreign capital can entail high development costs, especially if domestic financial systems are weak and not well regulated and supervised.
- 15. Trends in investment flows in Africa, Asia and Latin America were commented on. In Africa, there has been a very small volume of investment flows, which have mainly gone to South Africa and Mauritius. One third of FDI was driven by privatization. Very few African countries have access to international capital markets. There are 16 African stock exchanges, with a total market capitalization of US\$ 183 billion in 1998, with South Africa alone accounting for more than 90 per cent of this amount.
- 16. In Asia, it has been noted that FDI has contributed to an increase in exports from this region. For example, the ratio of exports to total sales of Japanese manufacturing affiliates in Asia is high. Until recently Japanese affiliates in Asia had relied on parent companies, regional headquarters or Japanese banks for funding. This source of funding has diminished as a result of

financial difficulties in Japan, and so Japanese affiliates will have to rely more on local capital markets.

17. In Latin America, the financial crisis which has recently affected emerging markets appears to be subsiding, with no long-term damage, but financial volatility will remain. Access to international capital markets has been renewed and spreads have come down, while stock markets have rebounded. Regional groupings like the Southern Common Market (MERCOSUR) may have played a role in attracting FDI. Smaller countries have also started to attract FDI.

C. Determinants and volatility

- 18. The factors affecting FDI flows are related to the size of markets, wage levels, political stability, macroeconomic stability and incentive systems. Proactive promotion policies can be effective in attracting FDI.
- 19. Factors which drive FPI flows are more complex and depend on the external environment as well as the internal economic fundamentals of host countries. The external factors include global liquidity and the macroeconomic policies of source countries, as well as international investors' strategies. There is general agreement that capital flows to developing countries are largely influenced by fluctuations in global liquidity. The changing demographic trends in OECD countries have resulted in strong growth in pension and mutual funds, which have contributed to increased liquidity in international capital markets. Some participants considered that global macroeconomic imbalances between major industrialized currency blocs were responsible for triggering the financial crisis in East Asia.
- 20. Investors' strategies and behaviour are behind the high speed of globalization of capital and channel the contagious effects of a crisis to other emerging markets. Problems of asymmetric information and principal agency may explain the herd behaviour of investors. Portfolio investors, who rarely have a local physical presence, may not possess accurate information on their borrowers and rely on common sources of information, which are often provided by credit-rating agencies. This increases the chance of the investment risk being incorrectly priced. The principal agency problem is reflected in the fact that portfolio investors, unlike transnational corporations involved in FDI, very often do not exercise direct control over the assets they acquire. These problems might explain why portfolio investors are prepared to sell their assets at the first sign of difficulties. In addition, margin calls and leveraged trading put pressure on investors to unwind their positions in risky markets in times of crisis.
- 21. There is general agreement that bank lending is the most volatile type of capital flow, followed by FPI and FDI. While portfolio investors can disinvest by selling securities, emerging capital markets are often not liquid enough to absorb these sales. For this reason, the scale of net portfolio outflows during the recent crisis was not that high, contrary to general assumptions. FDI as a financial flow can also be volatile, as investors hedge their exchange rate risks by matching their assets with liabilities in different currencies through bank loans and portfolio investment.

Thus although the physical assets remain in the country, transnational corporations can move out their financial investment, and sometimes do so, more easily than portfolio investors.

22. The steep declines in asset prices in emerging markets during the crisis reflect the fact that these markets are not liquid and do not act as shock absorbers. Moreover, as these markets are not deep enough to allow widespread sterilization of capital flows, these inflows have been monetized. Given the large amount of global liquidity and the small size of emerging capital markets, fluctuations in capital flows tend to destabilize borrowers' liquidity disproportionately. For these reasons, it is necessary that capital markets in emerging markets and developing countries should be developed in order to mobilize domestic savings, and also to allow more absorption of external shocks and to reduce panic selling. It was also suggested that corporations from emerging markets could raise capital on international markets and repatriate their capital only when needed.

D. Policy implications

- 23. As the macroeconomic impact of capital flows, and FPI in particular, can be at times destabilizing for the recipient economies, policy measures should be recommended to counterbalance any potential negative effect. At the country level, there is a set of institutional and legal arrangements which would assure the stability of the domestic financial system: under these arrangements, the central bank supplies liquidity and acts as a lender of last resort; a central body or commission is established to implement prudential regulations and supervision of financial service firms; many investors are able to act as leading market-makers; and a sound and transparent legal system governing financial transactions is put in place. At the international level, these institutional and legal arrangements are not replicated, although efforts have been made to establish and enforce international codes and standards for financial markets. However, developing countries have not always been involved in the definition of these standards. It was agreed that private creditors should be bailed in to share the burden of finding solutions to financial crises. The inclusion of a collective representation clause in bonds issued both by developed and developing countries should be encouraged.
- 24. There needs to be a deepening of domestic capital markets, within an appropriate regulatory and supervisory framework and with the development of a strong domestic institutional investor base. In addition, in the short term, emerging market countries might prefer to apply measures to control short-term capital rather than to have a system of freely floating exchange rates. In this respect, price-based measures, such as taxes at varying rates according to the maturity of investment, would be more effective in lengthening the maturity than quantity-based or regulatory measures, which could be circumvented by investors. Price-based measures do not erect administrative barriers to the free flows of capital. However, these controls should not be substitutes for the necessary long-term structural reforms of the financial system. To reinforce the effectiveness of these measures, an active monetary policy (in the form of open-market operations or reserve requirements to sterilize capital inflows) may be necessary. The international coordination of taxes, particularly of withholding taxes on portfolio assets, would strengthen tax-based measures by reducing tax evasion and avoiding costly tax competition.

- 25. Participants noted the emergence at the regional level of three major currency blocks. It was also noted that crises tended to spread quickly on a regional scale and therefore contagion could be contained by stronger regional monetary cooperation. Some participants suggested the creation of regional currency zones and monetary unions, like the European Monetary Union, but this would require true economic convergence, which could be achieved only in the very long term.
- 26. It was pointed out that the main concern of low-income countries was their lack of access to global capital. To address this problem, consideration should be given to the creation of regional stock markets and to encouraging multilateral financial institutions to act as intermediaries in order to enhance these countries' access to capital markets.
- 27. Finally, there was a brief discussion on whether or not FPI should be included in investment agreements. The question arose as to whether the use of control measures on FPI would be contradictory to the national treatment provision in investment agreements. Some participants pointed out that investment agreements could provide safeguards which would allow such controls. Other participants argued that if protection was extended to FPI, it would encourage more equity investment. It was also said that a distinction should be made between the liberalization of trade in financial services, which is regulated by the World Trade Organization, and the liberalization of trade in financial instruments which concern the IMF; the question is whether the two issues go together or can be separated.

III. ORGANIZATIONAL MATTERS

A. Convening of the Expert Meeting

28. In accordance with the recommendation made by the Commission on Investment, Technology and Related Financial Issues at the closing meeting of its third session, on 18 September 1999,² the Expert Meeting on Portfolio Investment Flows and Foreign Direct Investment was held at the Palais des Nations, Geneva, from 28 to 30 June 1999. The meeting was opened on 28 June 1999 by Ms. Anh-Nga Tran-Nguyen, Officer-in-Charge, Development Finance Branch, Division on Globalization and Development Strategies, UNCTAD.

B. Election of officers

(Agenda item 1)

29. At its opening meeting, the Expert Meeting elected the following officers to serve on its Bureau:

Chairperson: Mr. Franz Nauschnigg (Austria)

Vice-Chairperson-cum-Rapporteur: Mr. Bambang S. Wahyudi (Indonesia)

C. Adoption of the agenda

(Agenda item 2)

- 30. At the same meeting, the Expert Meeting adopted the provisional agenda circulated in TD/B/COM.2/EM.6/1. Accordingly, the agenda for the Meeting was as follows:
 - 1. Election of officers
 - 2. Adoption of the agenda
 - 3. Foreign portfolio investment and foreign direct investment: characteristics, similarities, complementarities and differences, policy implications and development impact
 - 4. Adoption of the outcome of the Meeting

 $^{^2}$ See Report of the Commission on Investment, Technology and Related Financial Issues on its third session (TD/B/45/9-TD/B/COM.2/15), para. 78 and annex I.

D. Documentation

31. For its consideration of the substantive agenda item (item 3), the Expert Meeting had before it a note by the UNCTAD secretariat entitled "Foreign portfolio investment and foreign direct investment: characteristics, similarities, complementarities and differences, policy implications and development impact" (TD/B/COM.2/EM.6/2).

E. Adoption of the report

(Agenda item 4)

32. At its closing meeting, on 30 June 1999, the Expert Meeting adopted the agreed conclusions reproduced in section I above, and authorized the Chairperson to prepare a summary of the Meeting (see section II above).

Annex

ATTENDANCE *

1. Experts from the following States members of UNCTAD attended the Meeting:

Argentina Lebanon

Austria Libyan Arab Jamahiriya

Belarus Madagascar Benin Malaysia **Bolivia** Mauritius **Brazil** Mexico Bulgaria Mongolia Burkina Faso Morocco Cameroon Nepal Canada Netherlands Chile Nicaragua China Norway Colombia Pakistan Costa Rica Peru **Philippines**

Cuba Philippine
Czech Republic Poland
Democratic People's Portugal

Republic of Korea Republic of Korea

Egypt Romania

El Salvador Russian Federation

EthiopiaRwandaFranceSaudi ArabiaGambiaSpainGermanySudanGuatemalaSweden

Guatemala Sweden
Honduras Switzerland
Hungary Thailand
India Tunisia
Indonesia Turkey

Iran (Islamic Republic of)
United Kingdom of Great
Israel
Britain and Northern Ireland

ItalyViet NamJapanZambiaJordanZimbabwe

^{*} For the list of participants, see TD/COM.2/EM.6/INF.1.

2. The following intergovernmental organizations were represented at the Meeting:

European Free Trade Association Inter-American Development Bank European Community

3. The following specialized agency and related organization were represented at the Meeting:

World Bank World Trade Organization

- 4. The United Nations Environment Programme was represented at the Meeting.
- 5. The following non-governmental organizations were represented at the Meeting:

General Category

World Federation of United Nations Associations Third World Network

6. The following panellists took part in the Meeting:

Mr. Arnab Banerji, Foreign and Colonial Management Ltd, London, United Kingdom Mr. Edmund Fitzgerald, Reader in International Economics and Finance, Oxford

University, United Kingdom

Mr. Michael Howell, Cross-Border Capital, London, United Kingdom

Mr. Sam Mensah, African Capital Market Forum, Accra, Ghana

Mr. John Motala, International Monetary Fund

Mr. Yung Chul Park, Professor of Economics, Korea University, Republic of Korea

Mr. Shigeki Tejima, Professor of International Economics, Nishogakusya University, Japan

Mr. Antonio Vives, Inter-American Development Bank