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# Developing Countries Rethink their Approach to Foreign Investment

by Jürgen Kühn, Bonn\*

**Many observations made in recent years suggest that even the developing countries which were previously known to have a sceptical approach to direct foreign investment have begun to take a fresh look at the situation. Undoubtedly, experiences with domestic state-owned enterprises and general doubts concerning centralised economic control coupled with the evidence provided by other countries pursuing an open policy towards foreign investment have proved to be crucial factors in bringing many developing countries to see in a new light the contribution private-sector investment can make to economic growth.**

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**T**he Third World's approach to direct foreign investment is not in the least a unified one: a wide variety of differing attitudes currently exists. Positions adopted inevitably vary from one developing country to another, and are also the subject of internal dispute. Private foreign investment is often met by policies which are fraught with inconsistencies and contradictions: incentives and barriers to investment stand side by side, with one agency frequently encouraging foreign companies to settle in the country concerned while another seeks to impose stricter controls over the same area of economic activity. A further consideration is that developing countries' economic policy is in any case much more prone to sudden change than that of the industrialised countries and, as a result, any description of the current situation is inevitably limited in its prognostic value.

Thus an attempt to describe the developing countries' position on direct foreign investment can be no more than a cautious approximation to factual situations which are extremely complex and mutually contradictory. Looking back at recent history, three phases may be distinguished in the Third World's relationship with foreign investment.

Between 1945 and the early 1970s, there was only an irregular and – compared with industrialised countries – relatively modest flow of private foreign capital into the developing countries. An initial period of growth soon levelled out after the Korean War and subsequently diminished in the wake of the nationalisation policies

pursued by many developing countries. As countries gained their independence, they often also expropriated private commercial assets.

Since the mid-1970s there has been a discernible concentration of private foreign capital flows in favour of the newly industrialising countries (NICs). At the close of 1981, the aggregate of direct investments so far made by the OECD countries into the developing countries was estimated at \$ 137 billion, of which 41 % was attributable to the NICs, 16 % to the OPEC countries, 36 % to medium-income countries (including tax havens), and 7 % to low-income countries (see Table 1).

The main hallmark of the most recent phase, beginning with the current decade, has been the Third World debt crisis. As the situation developed, there was a pronounced shift in the supply of private-sector finance to developing countries, away from direct foreign investment and towards the provision of bank loans. The partial replacement of direct investment by bank credit facilities brought negative consequences for both debt management and the balance of payments in the Third World. At the same time, the share of public development aid in the overall flow of funds to developing countries was in decline in the period up to 1982 (see Table 2).

## Modern Forms of Cooperation

In the 1970s in particular, the role played by direct foreign investment in the development process was the subject of intensive international discussions. In the period following the first oil crisis, universal agreement was reached at the 1977 "Conference on International Economic Cooperation" that improvements were necessary in the flow of private investment; however, no

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solution was found to important problems such as compensation for the expropriation of private-sector assets, the transfer of profits and equity capital, or arbitration in cases of dispute. These discussions in turn led to public debate within the developing countries themselves on the pros and cons of foreign investment, a debate which persists to this day.

The discussions have frequently begun by seeking to establish the extent of direct foreign investment. The problems of definition which occur when such attempts are made are symptomatic of recent developments in general: whereas transnational companies traditionally always directly injected capital into their foreign operations, new forms of business cooperation now frequently take place which cannot be precisely quantified. Examples of the above are management contracts, licensing agreements, production sharing, supply contracts, technical support and training assistance. These new forms of cooperation are greeted with far less distrust in the developing countries than direct injections of capital, although the latter maintain their place alongside the more recent methods. Even so, participation by foreign investors which is not exclusively capital-oriented will attain increasing significance in the future and will have an

**Table 1**  
**Estimate of the Cumulative Direct Investment**  
**from DAC Countries in Developing Countries,**  
**as at end 1981**  
(In \$ billion)

<b>Low-income countries</b>	10.2
of which India	2.7
<b>Medium-income countries</b>	49.1
of which Bermuda	5.5
Panama	4.9
Bahamas	3.8
Dutch Antilles	3.7
Malaysia	3.5
Peru	3.0
Philippines	2.5
<b>Newly industrialising countries</b>	55.6
of which Brazil	17.2
Mexico	10.3
Spain	6.9
Argentina	5.6
Singapore	3.9
Hong Kong	3.8
Taiwan	2.3
<b>OPEC</b>	22.3
of which Indonesia	8.6
Venezuela	4.3
Nigeria	1.2
<b>Total</b>	137.2

Source: Table 5, OECD: Investing in Developing Countries, 5th Rev. Ed., Nov. 1982.

**Table 2**  
**Balance-of-Payments Deficit Financing in**  
**Capital-importing Developing Countries**  
(in \$ billion)

	1980	1981	1982	1983
Balance of payments	-61	-91	-94	-57
Net private sector payments	39	48	28	22
of which direct investment	10	14	12	9
Net public sector payments	39	40	42	42
Deferred payments	-	1	8	- 2
Withdrawals from reserves	-17	2	17	- 5

Source: UN World Economic Survey 1984.

ever greater influence on the public view of cooperation between private business interests and the Third World.

Figures on the stream of investment into developing countries, then, can only inform us of a limited proportion of the overall activities of foreign businesses in the Third World – as such, they are only a partial reflection of economic reality.

### Incentives and Barriers to Capital Investment

A recent survey of the flow of direct overseas investment from OECD to developing countries (Table 3) illustrates the differing magnitude of the capital streams going to individual classes of country. Approximately half of the private-sector investment in question flows to the NICs. From the survey data, Brazil, Mexico and Hong Kong proved to be among the countries in which private investors had the greatest confidence. Also noticeable are the sharp rise in foreign investment in the OPEC countries and the relatively high proportion of "tax havens" among the middle-income group of countries. All of the classes of country so far mentioned have been able to offer opportunities to direct foreign investors, whether they depended on the overall economic situation, the stability of the legal system, profit opportunities, or any special incentives provided.

Other developing countries, either for purely economic reasons or because of questions of political principle, were not in a position to offer such opportunities. Nevertheless many observations suggest that here too a process of reassessment is under way with regard to direct foreign investment. Experiences with domestic state-owned enterprises and general doubts concerning centralised economic control were crucial factors in bringing many developing countries to see in a new light the contribution private investment can make to economic growth. Evidently the example provided by countries with an open policy towards foreign investment is beginning to convince

**Table 3**  
**Selected Developing Countries' Net Receipts**  
**from Foreign Direct Investment originating**  
**in DAC Countries**  
(in \$ billion)

	1980	1981
<b>Low-income countries</b>	0.3	0.5
of which Egypt	0.0	0.1
India	0.1	0.1
Zaire	0.1	0.1
<b>Medium-income countries</b>	2.8	3.7
of which Colombia	0.1	0.2
Peru	0.1	0.2
Philippines	0.1	0.1
Thailand	0.2	0.2
Off-shore banking centres	1.8	2.0
<b>Newly industrialising countries</b>	5.1	6.0
of which Argentina	0.9	0.6
Brazil	0.8	1.3
Hong Kong	0.4	1.0
Korea	-0.2	0.3
Mexico	2.0	1.2
<b>OPEC</b>	1.0	3.3
of which Indonesia	0.3	2.6
Nigeria	0.1	0.4
Venezuela	0.1	0.3
<b>Total</b>	<b>9.2</b>	<b>13.5</b>

Source: Table 4, OECD: Investing in Developing Countries, 5th Rev. Ed., November 1982.

even those sceptics who, for ideological reasons, had previously tended to view foreign capital simply as a source of exploitation and a restriction imposed upon national sovereignty.

### Future Trends

The international debt crisis has accelerated this change of attitude. The lack of a sufficient capital base suffered by many developing countries means that stronger bids will be made for external private-sector financial resources. Even if foreign direct investment cannot provide a short-term solution to the debt problems of individual developing countries it nevertheless is an important precondition for longer-term economic growth. It would, however, be inappropriate to assume from the above that barriers to private-sector Third World investment will in future melt away of their own accord. There is virtually no other area of economic policy in which developing countries have been seen to experiment and institute drastic changes of course as much as they have in the field of foreign private investment. Nor can it be said that contradictions and uncertainties will not occur in the future. However, if all the relevant trends are considered recent signs are that a cautious opening towards the outside economic

world is occurring, rather than a policy of erecting more barriers.

### Investment Protection Agreements

A key indicator of the openness of foreign countries towards direct foreign investment is their willingness to conclude bilateral agreements on investment protection. According to a statistical report by the Berne Union, the International Union of Credit and Investment Insurers, 13 of the union's member countries have drawn up a total of 110 investment protection agreements with 66 other countries (see Table 4). Even though this list does not cover contracts not involving any of the union's members (e.g. between developing countries), it still gives a good impression of the global interest in this method of underpinning private sector overseas investments. West Germany, with its 43 contracts and 1 exchange of notes already in effect and 9 more contracts awaiting ratification, has concluded more investment protection agreements than any other country.

The judgement made of these bilateral agreements in international discussions has not been entirely positive. The UN Centre on Transnational Corporations recently complained that the agreements do not contain express provisions on how investment is to be promoted. The Centre's criticism also makes the point that the agreements are inadequately balanced, setting out the obligations of the host countries but containing no corresponding obligations on the part of the foreign

**Table 4**  
**Investment Protection Agreements**

	Total	In force	Not yet ratified
W. Germany <sup>1</sup>	52	43	9
Switzerland	34	34	—
France <sup>2</sup>	28	20	8
United Kingdom	22	22	—
Netherlands <sup>3</sup>	17	6	11
Belgium	15	10	5
Sweden	6	6	—
USA	4	4	—
Italy	4	4	—
Japan	2	2	—
Austria	2	2	—
Finland	2	1	1
Norway	2	1	1
	190	155	35

<sup>1</sup> Does not include investment protection agreements with no prospect of being ratified.

<sup>2</sup> France has not so far concluded any agreements with the 13 countries in the French Franc Zone.

<sup>3</sup> Includes a number of cooperative agreements with investment protection clauses.

investors. Given this negative reception of bilateral investment protection agreements it is all the more surprising that the tendency for more of them to be concluded goes on unabated. Within the last three years West Germany has signed investment protection agreements with Bangladesh, Somalia, Lesotho, Mauretania, the People's Republic of China and Panama. Discussions over new agreements are currently under way with, among others, Bulgaria, Yugoslavia and Costa Rica. The USA recently abandoned its previously reticent approach to this policy instrument, and is now initiating negotiations with a number of prospective host countries. The trend suggests that contractual protection for foreign investment is as essential an element of the North-South dialogue as it ever was.

### **Multilateral Protection for Investments**

In parallel to bilateral moves aimed at protecting direct foreign investment, efforts have always been made to ensure investment protection multilaterally. An early example of this is provided by the 1948 Havana Charter which contained regulations on private investment. However, the Charter – precisely because its aims were so far-reaching and its rules for international business so all-embracing – never came into force. Nor have any of the less ambitious attempts made since that time achieved a much greater measure of success. The World Bank's latest efforts to establish a system of multilateral investment insurance do possibly represent a more realistic approach to the question, but they have reached no conclusion as yet. Clearly there are obstacles on both sides: Neither the industrialised nor the developing countries are prepared to accept a level of investment protection which is binding upon all countries according to the tenets of customary international law. For many of the industrialised countries, West Germany included, this level would be insufficient to meet their perception of a realistic guarantee for private-sector foreign investment, whereas that same level of protection is beyond what many developing countries are willing to concede. It will become clear in the next few months whether the World Bank proposal will be supported by enough countries to have the chance of coming into force.

Negotiations between European and Arab countries on an investment protection convention have achieved more substantial progress. The convention derives from a wish expressed by the Arab countries, during a dialogue begun in 1973, that their monetary and financial deposits in European countries should be protected, and their value guaranteed. Both sides were

agreed that mutual investment should be encouraged to strengthen economic cooperation between them, and in 1977 they set about negotiating the convention which, for the first time, is also intended to include financial deposits, i.e. portfolio investments, short-term investments and monetary claims. The fact that the two sides' interests are broadly in harmony naturally creates a different set of conditions for an eventual settlement than has existed in previous bilateral negotiations for investment protection agreements. No further discussion is needed of the desire on the Arab side for improved access to European capital markets, and for additional protection of their capital investments against inflationary or exchange-rate losses; on the other hand, negotiations are continuing over the demand for guarantees against any "freezing" of Arab assets in the event of a major conflict. Though many questions are still wide open, it has nevertheless been possible to reach agreement on a lot of rules for the mutual protection of investments.

### **Code for Transnational Corporations**

Negotiations which, by way of contrast, have yet to achieve any tangible results are those being conducted within the UN on a Code of Conduct for Transnational Corporations. However, both the character and purpose of these discussions have fundamentally changed: whilst it was initially only the surveillance and treatment of the "multis" which came to the fore, in the course of time the question of how transnational corporations are treated by the developing countries has taken on an ever greater significance. Thus general questions surrounding direct foreign investment have become a central theme in negotiations over the Code. However, the intention of agreeing minimum standards in the UN – not legally binding – for developing countries' policies towards the multinationals has not yet led to any concrete result. The most serious disagreements concern customary international law which is not recognised, in particular, by the Latin American countries, whilst a number of industrialised nations are insisting on its express recognition. Even though intensive efforts have been made to reach pragmatic interim solutions there has been no recognisable convergence of the fundamental standpoints involved. Evidently the more flexible negotiating parties – the representatives from South-East Asia and Scandinavia are examples – have not been able to exert enough influence to shift the legalistic positions of the two confronting sides.

In view of the opposing economic interests and the differences in historical and political developments, it

may be that a worldwide project to establish effective rules for investment protection will forever be a utopia. But discussions on the legal framework for direct foreign investment are really only one indicator of developing countries' attitude to the question. A more important factor than official government positions taken up in intergovernmental negotiations is the actual investment climate: this more than any other element will determine the magnitude and intensity of investment participation from abroad.

### **Improved Investment Climate**

At the end of 1983 an extended essay appeared in the respected periodical "Institutional Investor" under the title "LDCs: Courting the private investor". Its author, Harvey D. Shapiro, cites a series of examples of developing countries following open economic policies, having increasingly recognised in recent years the significance of direct foreign investment for their economic growth. Typical cases mentioned are the changes of course undergone by Jamaica, Sri Lanka, Chile, Turkey and Costa Rica. The new trend is also said to have affected countries such as India, Mexico, China and even Cuba, after many years in which scepticism and refusal to admit private investment predominated there. The Ivory Coast, Hong Kong and Taiwan are shown to have welcomed investors from abroad for many years now, while Egypt and Indonesia have both just recently established a stronger basis for cooperation with foreign capital.

The main causes behind this new development are named in the survey as the need for more financial resources and the dismantling of ideological barriers. Many developing countries have attained a new self-confidence as far as foreign investors are concerned. They have lost their fear of the "multis" and are able to be more relaxed in the challenges posed by foreign capital. Global economic interdependence means that all countries, including the industrialised nations, have lost the possibility of maintaining sole control over their own economies. At the same time, though, the example of South Korea shows that keeping an open door to investment from abroad does not necessarily mean the chance of building an indigenous industry has to be forfeited. Shapiro draws a parallel between modern policies in the developing countries and the zoning arrangements which frequently apply to new urban development: in both cases state bodies are responsible for the overall plan, and "concessions" for new development are granted only a little at a time.

There are many developing countries in which adherence to control regulations in practice appears to

have become more flexible; the legendary Decision 24 of the Andean pact countries, for example, which stipulates that a majority shareholding should lie in national hands, is obviously not being followed in all cases. The latest information on this point is that the Presidents of Bolivia, Ecuador, Colombia and Venezuela, together with a representative from Peru, have agreed amongst themselves that Decision 24 should be modified, allowing each member country "to regain the sovereign right to decide how its own interests can best be served". At the same time, the variety of available incentives is growing throughout the developing world. Shapiro identifies 35 such incentives which, as he puts it, can be played on like an organ to suit the individual situation.

### **Limitations of Direct Investment**

However many positive aspects there are to private direct investment in developing countries, there can still be no pretending that foreign capital is a cure-all in itself. It cannot act as a substitute for bank loans, which will continue to be indispensable for the developing countries. Brazil, for example, has been attracting direct private investment at between \$1 billion and \$2 billion annually in recent times, but has also been taking out foreign loans averaging \$7 billion annually!

There is no doubt that private sector investment is not a panacea for generating across-the-board effects. In general, it brings benefits to a narrow sector of industrial activity, whilst neglecting the agricultural sector. For the foreseeable future, infrastructure projects and social programmes will remain dependent on the injection of public funds, and will not be privately financeable.

Despite the limited breadth of its effects, direct private-sector investment is one of the most important mediating links between the national economies and a competition-oriented world market. The productivity of a country's entire economic structure benefits from the challenges posed by harnessing foreign capital. The International Monetary Fund and the World Bank advocate with good reason that the developing countries should pursue as open a policy as possible towards foreign investment. The World Bank estimates that the flow of direct foreign investment into developing countries will reach \$24 billion in the year 1990. Should it be achieved, this would double the average flow which has occurred over the last few years. Increases of this magnitude can only be expected if the world economic situation continues to stabilise and hence present better growth opportunities to the Third World.