PRIVATE CAPITAL FLOWS TO LOW INCOME COUNTRIES:

Perception and Reality

Matthew Martin
with Cleo Rose-Innes

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Introduction

Low-income countries, particularly those in sub-Saharan Africa, have long been perceived as aid-dependent, receiving virtually no private foreign capital. The future for such alleged "basket cases" was judged bleak. Yet many low-income countries have long known the reality: private foreign capital (PFC) flows are significant. That reality was reflected in several studies in the mid-1990s.[1]

Low-income countries have very rudimentary systems for monitoring private capital, resulting in vastly underestimated and underreported data to international institutions. Reported data is usually based on estimates which bear little relationship to actual flows. Based on surveys of suppliers of private foreign capital flows, the true data indicates that low-income countries with stable economies and open investment policies attract extremely large flows in relation to GDP or other economic variables.

As a result, these large flows have provoked currency crises and macro-economic instability in low-income countries. Although these have been comparable in magnitude to the major crises in emerging market economies (Argentina, Brazil, Russia, Turkey, and East Asia), they have remained largely unnoticed by the international community.

This chapter looks at the reality of large private foreign capital flows to low-income countries. It is based on projects executed by Development Finance International (DFI) in collaboration with 18 countries, funded by the participating governments themselves, and by the governments of Denmark, Sweden, Switzerland, and the United Kingdom. These research projects analyzed the contrast between the perception and reality of flows to low-income countries. Subsequent project stages have moved on to assisting countries improve their monitoring of foreign private capital, and conducting detailed surveys of foreign assets and liabilities (FAL) and of investor perceptions[2] in seven low-income countries. The project is designed to build sustainable government capacity to conduct their own such analyses.

BOX 1

The Foreign Private Capital Capacity-Building Project

The goal of the Foreign Private Capital-Capacity Building Project (FPC-CBP) is to develop independent and sustainable capacity within participating countries to monitor and analyze the effects of foreign private capital on their economies.

The project is run by Development Finance International (a UK non-profit) in partnership with regional organizations to ensure that capacity to assist countries is decentralized.

These partner organizations are :

- Banque Centrale des États de l'Afrique de l'Ouest (BCEAO) in Francophone Africa;
- Centro de Estudios Monetarios Latino-Americanos (CEMLA) in Latin America;
- Macro-Economic and Financial Management Institute of Eastern and Southern Africa (MEFMI) in Eastern and Southern Africa; and
- West African Institute for Financial and Economic Management (WAIFEM) in Anglophone West Africa.

The data used in this study is taken from seven low-income countries currently participating in the FPC-CBP.

The latest published survey data covers Tanzania (1999); The Gambia, Ghana, Malawi and Uganda (2000); and Guyana and Zambia (2001). Flows are for that year, and the stock data is the closing stock at the end of that year. Data for 2000 and 2001 has been surveyed and is currently being processed for publication.

For this study on low-income countries, in-country analytical teams provided DFI with their latest finalized survey data. This information is in the public domain, as survey countries disseminate their analytical reports in print, and where possible, posting their reports on Central Bank and Investment Promotion Agency websites at the end of each project cycle.

Participating countries have also committed themselves to reinforcing their legal and institutional structures, human resources, management and supervision procedures and working environments, to give greater political priority to the issues, to increase the transparency of analysis to civil society, and to increase their financial contributions over time to these exercises.

Each country project is structured in the following way:

- Participant countries request a DFI/CEMLA/MEFMI/WAIFEM Demand Assessment Mission where conditions are assessed, a coordination structure between government agencies and other stakeholders established, and a methodology and budget finalized.

This approach encourages cooperation and cohesion among government agencies, saves donor money, and reduces the number of questionnaires received by the private sector, again increasing responses. In Uganda, for example, government questionnaires in this area have been reduced from three to one by close cooperation between the Bank of Uganda, the Uganda Investment Authority, and the Uganda Bureau of Statistics.

- Prior to the survey launch, members of the private sector are invited to an opening conference where these and related macroeconomic issues are discussed, raising awareness of the survey process and improving public-private sector dialogue.

- A survey sample targeting key investors is identified and the final survey questionnaire is tailored to country need by the in-country team.

  The survey is (usually) divided into three sections:

  — Foreign Liabilities: equity (stocks and flows of both direct and portfolio investment); retained earnings of FDI; borrowing from non-residents (by debt type and maturity)

  — Foreign Assets: equity (stocks and flows of both direct and portfolio investment); profit data; lending to non-residents (by debt type and maturity)

  — Investor Perceptions: the detailed questionnaire includes questions on economic and financial factors; political and governance factors; the efficiency and cost of services; labour, health and environmental factors; pull factors of initial investment; intentions over the medium-term; the utility of information sources for investment decision-making, and desired aggregate information from government.

Data quality is assessed and when satisfactory (this may require follow-up with respondents), output tables are produced for analytical purposes. The in-country teams finalize a report on their findings, which is disseminated at a closing conference.

The integration of balance-of-payments and perceptions questionnaires encourages a much higher private sector response rate. Countries that have included both elements of the questionnaire have increased their response rates by 20-30 per cent, producing a 75-80 per cent average response rate among the seven countries. The data used here is drawn from a total of 2,196 processed returns: Ghana, 255; Guyana, 33; Malawi, 155; Tanzania, 900; The Gambia, 204; Uganda, 326; and Zambia, 323.

- Country teams receive additional training on interview techniques, non-survey methodology, and data enumeration. As returns are collected from respondents the data is checked and entered into a database.

The remainder of the chapter is based on the work of DFI and teams of government officials in seven developing countries: The Gambia, Ghana, Guyana, Malawi, Tanzania, Uganda, and Zambia.[3] It examines in turn the current reality; the significance of private foreign capital flows; implications for government policy in low-income countries; and the need for building low-income countries' capacity to monitor and analyze foreign private capital.

The current reality

The scale of stocks and flows

In the mid-1990s, international data sources were reporting that flows of private capital to low-income countries were insignificant. However, as some countries improved their monitoring, it became obvious that these flows were very important. While international organizations were still relying on outdated data on gross inflows, inflows tracked by the countries themselves were double or triple the levels of internationally published figures.[4] This alternate "reality" occurred because the exchange control or foreign investment monitoring systems in many low-income countries did not have the capacity to record such items as retained earnings, intracompany debt transactions, and "offshore" borrowing (borrowing occurring outside the recipient country) .[5]

However, countries are now using survey techniques which further improve the coverage of inflows and that stress reporting returns on foreign private capital inflows (profit remittances and loan repayments), and on the outflows related to outward investment from low-income countries. Especially in periods of negative economic development, outflows are now seen to be much higher and net inflows considerably lower than previously published (for example, Ghana in 2000), due to large outflows for one company and ripple effects on new investment by others. On the other hand, dramatic improvements in the recording of private sector debt have pushed up flows and stocks in this area dramatically.[6]

Figures 1 and 2 examine the scale of gross foreign private capital inflows and accumulated stocks in relation to GDP in the seven project countries.

Figure 3 shows that there are also large outflows of profits, dividends, and debt service. These have averaged 59 per cent of the inflows (39 per cent excluding Ghana). These outflows demonstrate the high rate of return which can be achieved on foreign private capital in low-income countries.

On the other hand, outflows also demonstrate the vulnerability of low-income economies to net-flow reversals in the event of changes in the economic environment. Ghana experienced this vulnerability in 2000, when its outflows were almost twice as high as inflows that year. This reversal, precipitated by a crisis faced by the large investment company

Ashanti Goldfields—which was widely reported in the international press—caused a collapse in the currency and national foreign exchange reserves.

As a result, net flows average only 3.5 per cent of GDP a year across the project countries. The high level of inflows and outflows related to the low-income countries' economies shows the potential major impact on economic stability and the need for low-income country governments to pay close attention to policies which can stabilize these flows or swiftly adjust to changes.

On the other hand, there is little outward investment from most of these economies. The stocks of such assets are less than 2 per cent of GDP, and less than 7 per cent of the stocks of liabilities. Nearly all (70-80 per cent) are bank loans rather than equity. As most countries have no restrictions on outward flows, this is surprising—it may reflect the lack of knowledge in their private sectors of alternative investment opportunities to diversify their portfolios. The lack of assets to offset liabilities makes these countries more vulnerable to crises caused by PFC.

Composition of stocks and flows

Another problem with previous systems for monitoring private foreign capital flows is that they have tended to assume that almost all flows are Foreign Direct Equity Investment (FDEI). This is because they have been based on asking Investment Promotion Agencies (IPAs) how much "invest-

Figure 1
Private foreign capital inflows (% GDP)

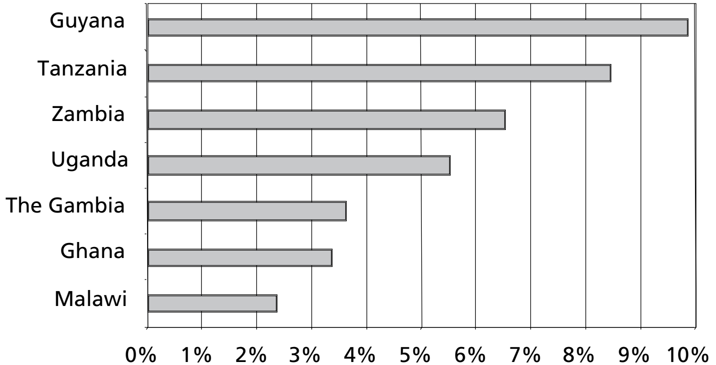


Figure 2
Private foreign capital stock (% GDP)

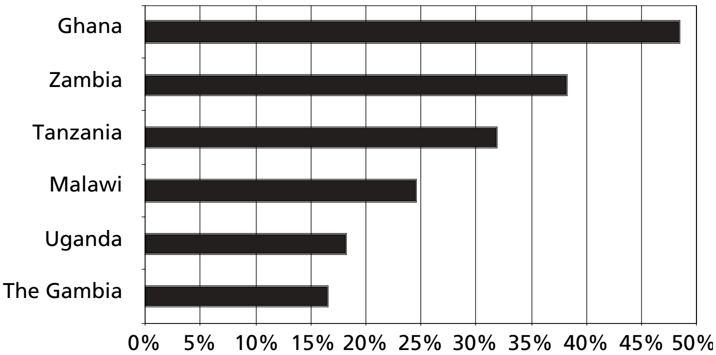
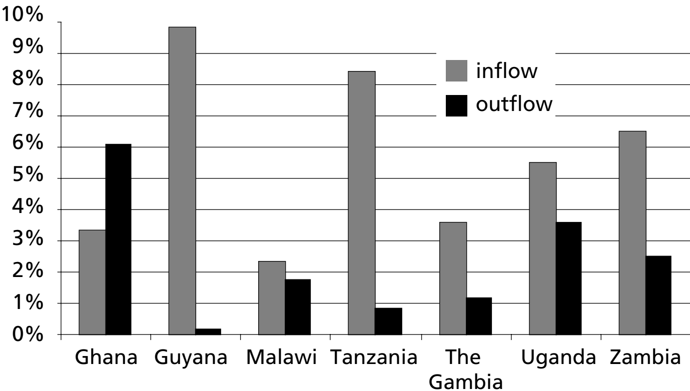


Figure 3
Inflows and outflows (% of GDP)



ment" they have approved, and then estimating that a certain percentage might have turned into actual investment. Yet virtually no IPAs ask investors how they are going to fund their investment, even though different funding methods have dramatically varying implications for the sustainability of private flows.

Foreign private capital can be divided into four main types of flows:

- Foreign Direct Equity Investment—divided in turn into new direct equity and earnings from existing equity which are reinvested in the company rather than expatriated
- Foreign Portfolio Equity Investment—new equity (or reinvested earnings on existing equity) which is less than 10 per cent of the equity value of a company
- Foreign Direct Non-Equity Investment—loans provided by related (parent or affiliated) companies to a recipient country company
- Other Investment—represents loans from unrelated companies and less formalized short-term credit to companies for trade and services payments

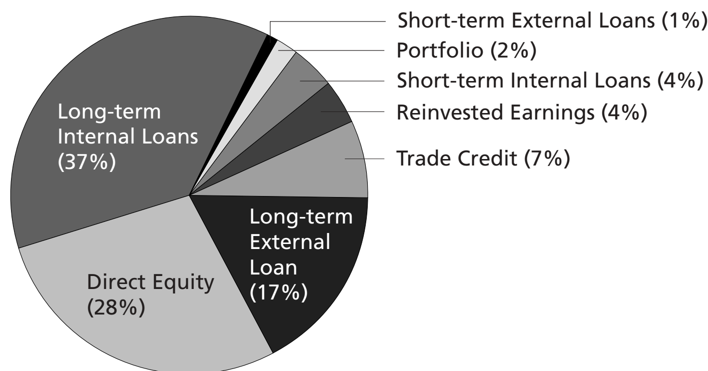
Recent country data has revealed some surprising new findings, shown in Figure 4, about the average composition of flows to the seven low-income countries studied:

- on average, new direct equity investment (including reinvested earnings, which were previously not recorded) represent 32 per cent of the total
- portfolio investment is very low, at only 2 per cent, but there continue to be large gaps in reporting these flows, especially by the many non-resident investors who put money into treasury bill or bond markets via nominee local companies
- intracompany loans are a crucial source of funding for equity investors, and are higher than total equity flows at 41 per cent
- debt to/credit from unrelated companies is also important at 25 per cent of flows
- total private sector debt flows are very high, averaging 66 per cent (though two-thirds come from related companies, and 82 per cent are long-term)

Figure 5, however, reveals wide differences among countries with equity representing only 19 per cent of total flows to Guyana, and 45 per cent for The Gambia. Even within debt

Figure 4

Composition of foreign private capital flows



flows, related debt is much more significant than unrelated debt for Malawi, Tanzania, and Zambia, and much less significant for The Gambia.

For many countries the debt:equity ratio is around 1:5 and the leverage ratio (debt as a percentage of total liabilities) is around 60 per cent. This is relatively high and comparable to recent debt:equity ratios for the East Asian and Pacific countries,[7] and explains why companies are so vulnerable to market shocks.

In order to understand composition of flows, it is necessary to look at the individual sectors where investment is taking place and at key companies. In several countries, individual sectors have very high debt:equity ratios. In general, countries where resource extraction sectors and projects (especially mining and petroleum) are important have a much higher debt:equity ratio, and debt finance tends to be much more available to transnational corporations.

Overall, high debt:equity ratios also lead to a rapidly growing private sector debt burden, as Figure 6 shows. Though they represent on average only around 15 per cent of total national external debt, in countries such as Ghana and Mozambique, the numbers are closer to 30 per cent. With the reduction of public sector debt under the HIPC Initiative and the rapid accumulation of private sector debt (66 per cent of new inflows), this is set to become a key element of national debt burdens. HIPC Finance Ministers have demanded more attention be paid to this issue.[8]

Figure 5

Composition of private capital inflows

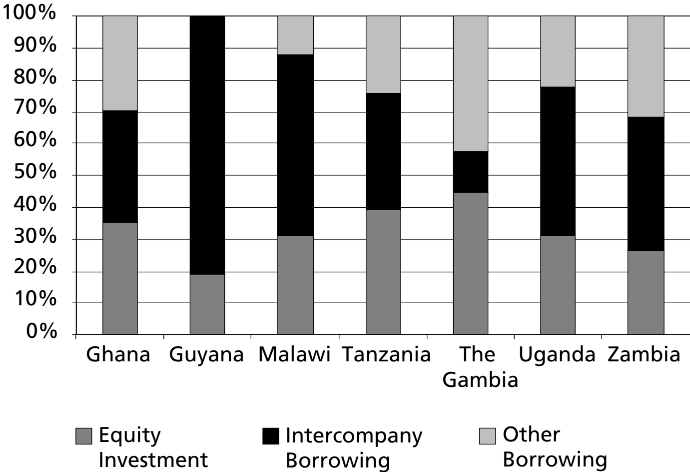
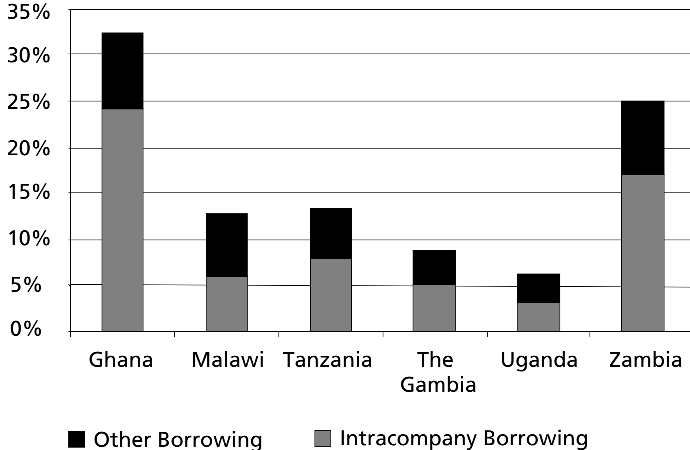


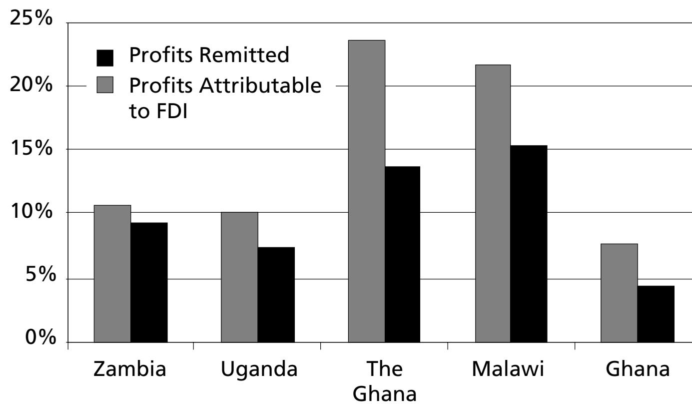
Figure 6

Private sector external debt (PSED) stocks by type (% of GDP)



The composition of flows is important because it determines the volatility of the flows and the rate of return. Typically, the international literature on private flows to developing countries has assumed a hierarchy of desirability of private capital flows, starting with the least volatile with

Figure 7
Profitability of equity capital



the lowest return, and descending to the most volatile demanding the highest return.[9]

The most desirable flows have, therefore, been assumed to be Foreign Direct Investment (FDI), which is believed to be less volatile and more long-term because it consists of fixed capital investment and is difficult to expatriate. However, detailed studies of low-income countries indicate that this is not true. As Figure 7 shows, such investment demands and achieves very high returns (much higher than those of debt discussed below), averaging 14.8 per cent but exceeding 20 per cent in The Gambia and Malawi. Of course, many of these companies are foreign-local joint ventures and generate large profits for local investors.

However, of this amount, around 75 per cent is repatriated as remittances, exceeding 10 per cent of capital each year. These figures far exceed previous International Monetary Fund (IMF) balance-of-payments estimates which averaged only 65 per cent of remittances (of much lower stock estimates). There is also strong evidence that in periods of crisis in a recipient economy, equity investors increase dividend repatriation and repayment of intracompany loans, implying that flows vary procyclically, exacerbating trends in the wider economy.

The profitability of equity varies enormously by sector in different countries, but construction often produces rates of 70 per cent or more. Both agriculture and finance have average profits around 20-25 per cent, and manufacturing averages rates of 15 per cent. The wholesale and retail trade, and accommodation and tourism appear to be the least profitable sectors at an average 5 per cent.

The next most desirable flows, according to international studies, have been long-term loans, followed by short-term loans and portfolio equity flows. However, the evidence from low-income countries argues for a much more nuanced analysis of the stability and return on such flows.

In particular, it is vital to distinguish between loans from institutions linked to investors, and those from unrelated institutions as they have fundamentally different purposes and rates of return. Related parent companies of multinational investors often provide large intracompany loans to support working capital or imports of capital goods. Typically, these loans have low or zero interest rates and short (one year) or undefined repayment dates. Subsidiaries prefer these funds, largely because they cannot access international bank loans at such low interest

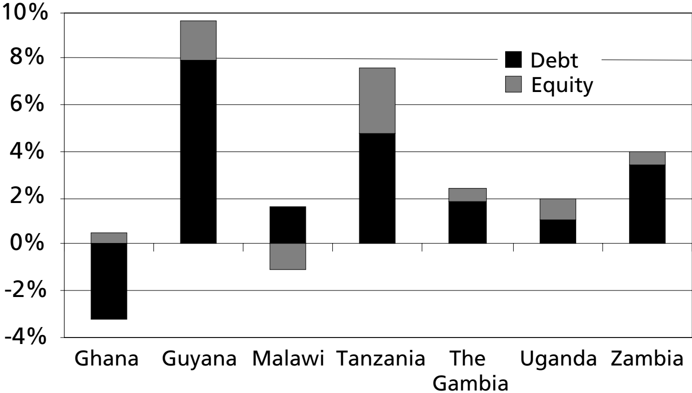
rates, and because intracompany loans provide flexible repayment schedules. Often, these parent companies are the sole source of "cheap" loans for subsidiaries; their large "float" can be withdrawn quickly if there is any sign of economic, political, or commodity price instability in the recipient country. Indeed, these flows represent a large proportion (20-40 per cent) of total foreign capital flows to low-income countries.

Loans from unrelated institutions are a different matter. They may help to finance trade credit or working capital but are more often used to finance capital goods for major investment projects with a longer repayment horizon. They usually have clearly defined repayment dates and higher interest rates, related closely to commercial lending rates in their home countries. Nevertheless, multinationals with access to such international finance appear to be efficient at mobilizing such capital at low interest rates, around international commercial rates for the borrowing currency, plus a spread of about 2 per cent. For those companies borrowing in US dollars, this meant rates of around 6 per cent in 2000. This fell to 3-4 per cent in 2001-02. Companies borrowing in South African rand were less fortunate, as rates were 15 per cent on a currency which was appreciating at the time.

Overall, these results somewhat contradict the traditional hierarchy of desirability of flows. FDI can be an extremely expensive (and therefore implicitly volatile) form of foreign capital but, while intracompany and unrelated debt can also be procyclically volatile, their costs in normal years are much lower than those of equity.[10]

Figure 8

Net equity and debt flows as a % of GDP



The results for balance-of-payments and economic stability are shown in Figure 8. Most net inflows are accounted for by debt in the bulk of countries but, in difficult years, both debt (Ghana) and equity (Malawi) can lead to net outflows.

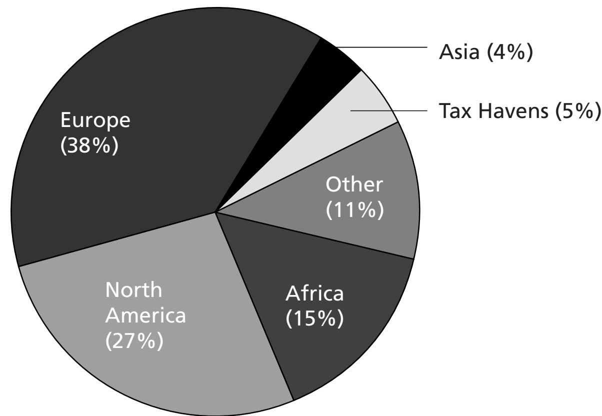
Direction of stocks and flows

Source countries

Most low-income countries' IPAs have until recently focused the bulk of their investment promotion efforts on Europe and North America. Yet evidence from the countries we have studied reveals this focus is rapidly becoming less appropriate. At the end of 2001, accumulated historical investment stocks stood at 65 per cent from Europe and North America. However, 35 per cent of stocks were from other regions of the world, including intra-African and intra-

Figure 9

Sources of foreign direct investment



Caribbean flows, and flows from Asia and Australasia. Of these, a surprisingly high 5 per cent came from offshore tax havens such as Bermuda, the British Virgin Islands, the Isle of Man, Panama, and the Turks and Caicos.

Three further data elements reinforce this conclusion:

- Investments by such companies as South African Breweries or Anglo American and Old Mutual are identified by their place of registration (i.e., the Netherlands and the UK) rather than their place of operation. When adjustments are made to reflect the true country where investment promotion efforts might influence decisions, the percentage of intra-African investment stock is estimated to rise to 25.5 per cent.

- There is strong evidence that investment from offshore havens represents investors based in African countries deciding to park funds in these havens in order to minimize risk, until they are ready to bring them in as FDI.[11] This would push the percentage of intra-African investment to over 30 per cent.

- Flow data indicates that in recent years diversification has been accelerating.

Individual countries show sharp variations. While 87 per cent of investment stock in Ghana is from Europe and North America, it falls to around 60 per cent for Guyana and Malawi, and around 40 per cent for Tanzania, Uganda, and Zambia. Intra-African investment is high in Zambia (40 per cent), Malawi, Tanzania, and Uganda (all at 30 per cent), but much lower in Ghana (5 per cent). Investment from Asia and the Caribbean accounts for 30 per cent of investment in Guyana. Offshore haven investment is highest in Uganda (21 per cent).

Recipient sectors

In international investment forums, it is often suggested that most foreign investment in low-income countries goes into mining and petroleum. However, the evidence from the project countries belies this (see Figure 10). Only in Tanzania and Zambia is mining the largest sector, accounting for more than a quarter of the stock of foreign equity investment (though, for example, in Zambia, mining accounts for 51 per cent of total foreign private capital stock due to high debt levels). Manufacturing is the most important sector in Malawi, Uganda, and Ghana, reaching half of equity stock in the first two. Finance and tourism dominate The Gambia. Finance is also important in Zambia, as is tourism in Malawi. Even agricul-

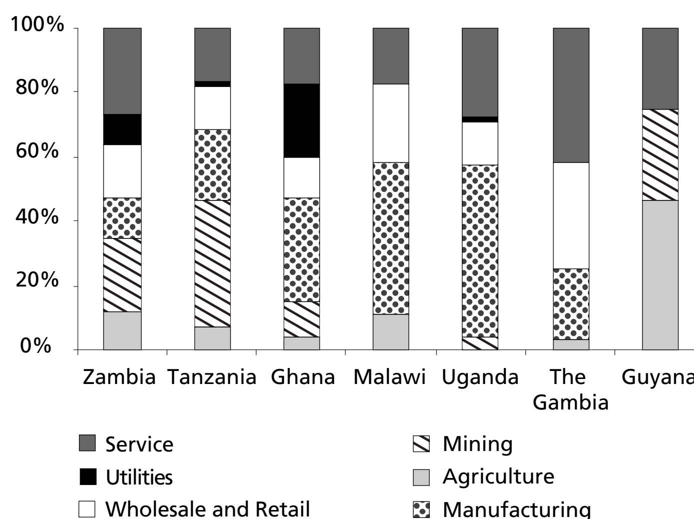
ture receives 5-10 per cent of investment in most countries, though it remains the poor relation and its share of investment is way below its share of GDP. Flows data also indicates that diversification is accelerating, with even higher proportions of recent flows than total stocks in manufacturing and services.

Recipient regions

Investment remains concentrated in one or two regions in most countries— generally those with strong infrastructure (e.g., where government and business centres are located), human capital, and natural resources. Poorer regions tend to lag behind— which is of major concern for policymakers trying to foster more regionally balanced development under their national poverty reduction strategies. Even when poorer regions receive massive investment, this may consist of one or two massive enclave projects, making these regions highly dependent on the project's success.

Figure 10

Foreign direct equity investment (FDEI) stocks by sector



The significance of private capital flows

One reason for private foreign capital's major significance in the project countries is profitability. The 2,200 international and domestic investors surveyed indicated a high level of confidence in the future prospects of their enterprises: 60 per cent said they had plans for further expansion (only 10 per cent planned reductions) and more than 65 per cent anticipated increased turnover and profitability in the next three to four years, despite the fact that a number of the economies surveyed had recently experienced significant macroeconomic shocks. This suggests that investors in these economies are resilient and have identified techniques to cope with shocks to the wider economy, notably relying on intracompany borrowing as a more flexible form of financing.

A second key reason is that these investors do not share (or even take notice of) the continuing negative perception of Africa as a "basket case" promising high risks and low returns, a perception which fuels the attitudes of many transnational corporate headquarters, the international media, and some rating agencies.[12]

Investors ignored these perceptions in determining risks, and based their decisions on their experience, using the actual information available. When asked which sources informed their investment decisions, they stressed the views of business associ-

Figure 11

Rating information sources for investment decision-making

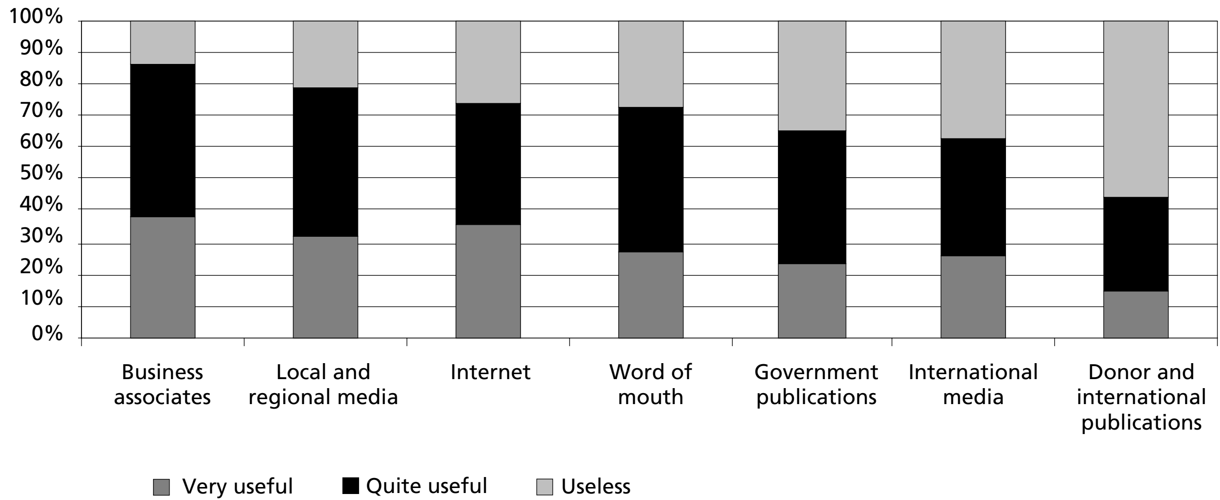
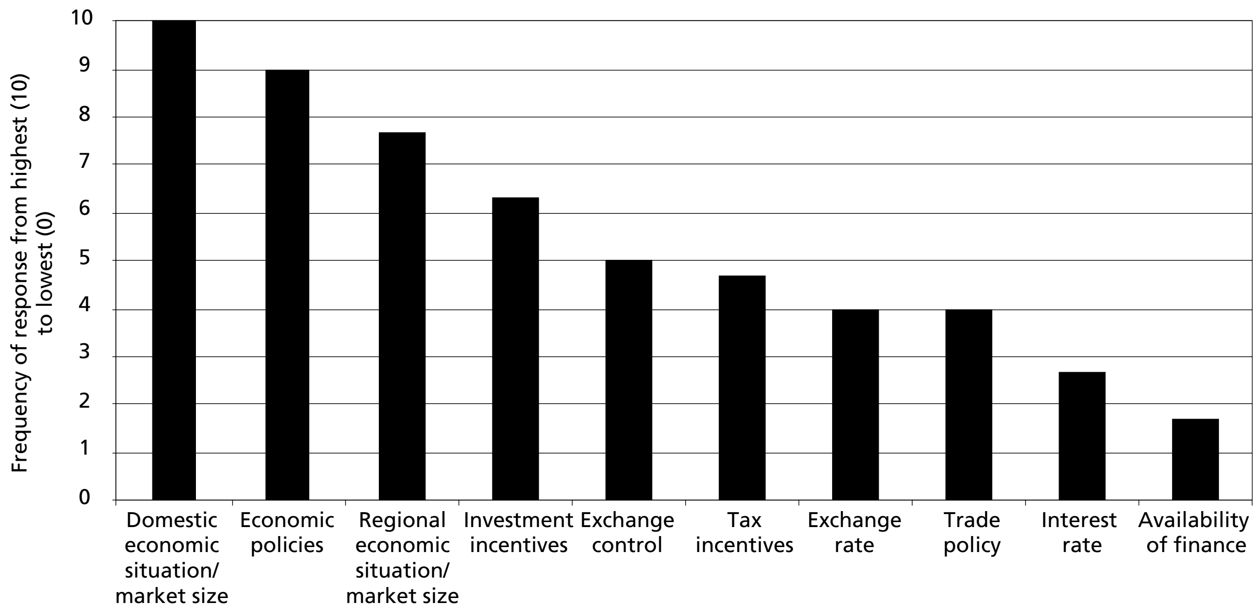


Figure 12

Pull factors motivating initial investment



ates and the local and regional media, and attached the lowest value to international media and donor and international publications.

A third reason for the high flows is the positive perception of the business environment by investors. Their initial decisions to invest were motivated by several positive pull factors.

The most important factors were domestic economic and political stability, access to domestic markets, regional economic and political stability, access to regional markets, and economic policy. Investment incentives (i.e., liberalization and one-stop facilitation) ranked fourth, and tax incentives sixth. Privatization did not feature at all, except for the few investors who had acquired privatized companies.

Asked what supported their positive outlook, investors emphasized national economic stability and market access through regional integration and trade policy. Those who benefited from investment and tax incentives valued these elements highly. A major new factor is growing labour skills and productivity. Trade policy is also surfacing because it guarantees regional market access. High ratings for political stability in Malawi and Zambia were offset by negative ratings for political instability in neighbouring Zimbabwe.

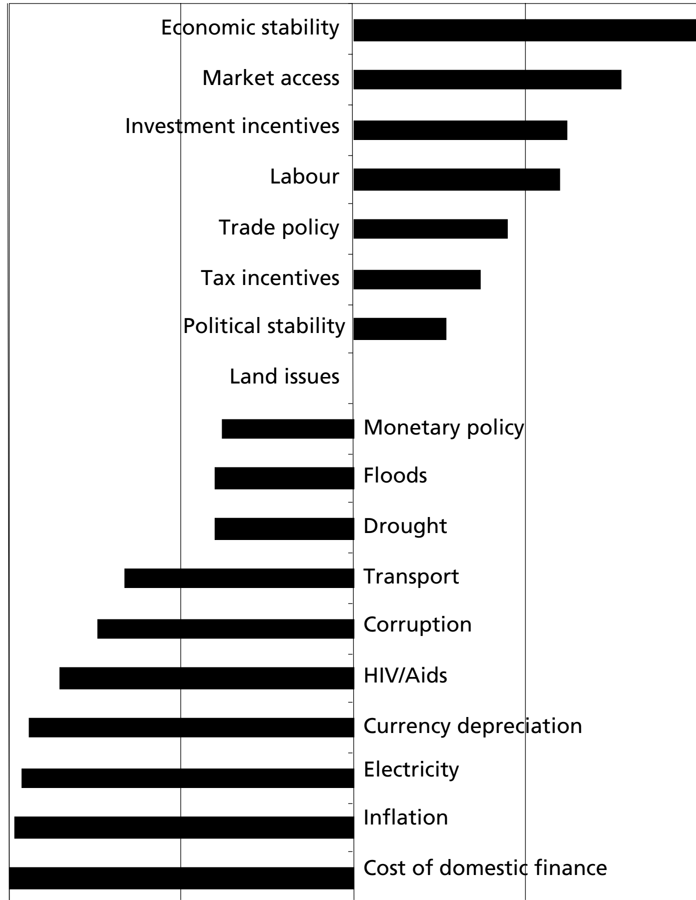
Negative factors affecting investment are rooted in investors' real experiences, especially the constraints placed on their business activities. Principal among these is the cost of domestic finance (through both interest rates and the cost of banking services), which contrasts with pre-investment perceptions of low costs and easy access, and has been the biggest shock for investors. This partly explains why they have turned so much to external debt financing.

Other key factors are economic volatility—notably inflation and currency depreciation—the high cost and inefficiency of utilities (especially electricity) and weak infrastructure (especially transport). Investors are also increasingly concerned about the effect of HIV/AIDS on their ability to maintain a stable and skilled work-force, and corruption.

Country-level analysis revealed interesting results. For example, the most negative scores are for HIV/AIDs in Malawi and Zambia, demonstrating how in touch investors are with the key problems facing their societies. In addition, there is a marked variation in

Figure 13

Current investment influences

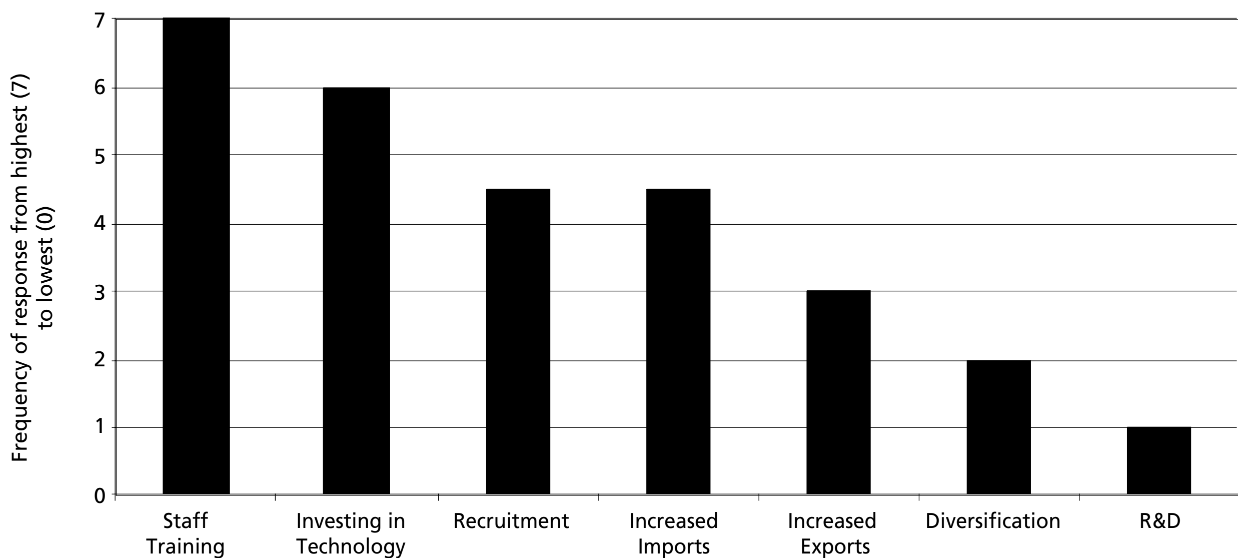


country scores, with Tanzania and The Gambia only marginally negative overall across the range, and Malawi and Zambia much more negative. This is broadly in line with investor future intentions, where the percentage intending to expand investment in Tanzania and The Gambia is much higher. It is also obvious from the country scores that investors' perceptions are not always in accord with those of international or donor institutions: for example, what interests investors most is not the principle of a policy (e.g., liberalization), but the practical result (e.g., devaluation).

The surveys also included the perceptions of resident investors and touched on policy measures needed to promote domestic investment and savings. They differ on several issues from foreign investors. Whereas foreign investors (dependent on the relative balance between imports and export earnings) are happy with exchange rate depreciation, domestic investors (often import dependent) place a high premium on exchange rate stability. Similarly, foreign investors with access to offshore finance, are not as concerned as domestic investors by the high interest costs or lack of access to domestic finance. Thirdly, domestic investors are much less concerned with (or informed about) investment and tax incentives.

Investors' positive expectations for the future affect how they intend to spend their future investment. Priorities include developing the skills of their workforce, investing in technology, and recruiting more workers. In addition, investors also indicated their intentions to increase imports and exports in the medium term.

Figure 14
Key aims of future investment



On the other hand, investors awarded lower priority to diversifying their activities. This suggests both that they do not feel pressured by competitors, and that they lack access to capital which would enable them to diversify. Nor do they intend to devote resources to in-house research and development (as opposed to investing in technology supplied by others). These cautious strategies may limit national economic growth in that they make the economy less diversified and more dependent on imported technology, but are typical in low-income countries.

Implications for government policy

Macroeconomic effects

Until this new data emerged, countries had little idea of the state of their balance-of-payments, let alone the impact of foreign private capital on the wider economy. While the new data series is not yet long enough to allow reliable econometric analysis, the findings of the country studies confirm and deepen those of earlier work on the same economies:[13]

- Flows appear to be increasingly correlating with higher private sector investment, indicating the development of greater linkages between foreign and domestic investors. The causality of this relationship is unclear—it may be that country circumstances favour all types of investment. However, the growing number of joint ventures and knowledge of supplier-client relationships between foreign and local investors indicates that the relationship between foreign and domestic investment can be mutually reinforcing.
- There is also positive evidence of sectoral diversification, technology improvement, skills transfer, value-added from commodity processing, and increased employment from projects and sectors in some countries.
- However, too many large projects remain virtual enclaves, conducting most of their business and financing offshore, and paying virtually no tax due to incentives, as a result dramatically reducing any positive contribution to the economy.
- In addition, the high rate of dividends remitted by some sectors indicates a worrying short-term attitude, with companies looking for a quick return rather than opportunities for long-term reinvestment. Similarly, many companies are too dependent on finance linked to commodity production. The resulting volatility of flows in conditions of commodity price or wider macroeconomic instability renders flows highly procyclical, exacerbating the effects of economic booms or slumps, and an unreliable financing source for long-term sustainable development.
- Many low-income countries have suffered as a result of foreign private capital crises caused by the withdrawal of key investors or the general reaction of investors to wider national or international factors. Some (fewer) countries have also faced problems caused by excesses of foreign private capital.

Such crises, which can have much more dramatic negative impacts in undiversified low-income countries, underline the vital role of counter-cyclical, rapidly mobilized official flows in preserving economic stability and avoiding private capital crises. It is a role they are failing to play.

Potential policy responses

Low-income countries have limited tools to respond to these effects:

- Macroeconomic and policy stability appear to be the most reliable tools—though investors are anxious that stability not target low inflation levels at the expense of growth.

- Foreign exchange intervention has—in the last few years—become a relatively frequently used tool in some countries. But it is effective only in smoothing minor currency fluctuations and when not perceived by the markets (which will speculate against it). Given the low foreign exchange reserves in most low-income countries, it can provide only a first line of defence.

- Many low-income countries rapidly liberalized their financial flows in the 1990s, partly under pressure from the IMF and partly because they realized that capital controls had little effect on the massive amounts of private capital entering (and more usually leaving as capital flight) the country. Research has always indicated that capital (now known as financial) account liberalization should be gradual and carefully sequenced, and that countries should retain means of monitoring and analyzing flows after liberalization. Yet, even after several crises, and its acceptance among the G-8, very few countries benefit from this general consensus for gradualism.

- Trying to control booms and busts of foreign private capital through monetary measures does not work very well in OECD economies and succeeds even less in low-income countries with their underdeveloped monetary markets and poorly performing transmission mechanisms. Measures which have worked better in low-income countries—and which have been used more often in recent years—have included non-market mechanisms such as shifting government deposits from commercial to central banks, and varying reserve requirements on different types of foreign private capital.

- Most low-income countries have had to rely on fiscal policy to adjust to foreign private capital crises, with disastrous results. Boom and bust procyclical fiscal policy (i.e., increasing expenditures during booms and reducing them during busts) is highly undesirable and ruins long-term fiscal and poverty reduction expenditure plans. Instead, a contracyclical fiscal policy would be preferable, whether this means using tight fiscal policy to reduce booms caused by too much PFC, or increasing expenditures to make up for shortfalls in private investment.

- The low level of portfolio flows in almost all countries is not expected to be reversed in the short-term. In most small low-income economies there are few assets which can be privatized with sufficient profit to be floated on the stock exchange, and international investment funds are (with a few pioneering exceptions) relatively uninterested. Given the instability of portfolio flows in other regions, countries should focus most of their efforts on encouraging greenfield direct investment.

National policy measures can achieve little: if the international community is serious about low-income countries reaching the Millennium Development Goals, it must pay more attention to the effects of foreign private capital on their economies, and provide much greater amounts of official capital to promote economic stability, in order to allow poverty reduction expenditure and growth plans to proceed on schedule.

Policy implications of investor perceptions

Data on investor perception should not be used in a knee-jerk reaction to influence policy. Data must be disaggregated and compared with economic reality. For example, if domestic investors are complaining about exchange rate depreciation, but government analyses determine such depreciation necessary for an export-led development strategy, then policy-makers must better explain and discuss such measures with the investment community, and perhaps consider compensatory measures such as import duty/VAT drawbacks, rather than change the exchange rate policy. Similarly, government needs to counter investors' low regard for the health of their labour force as a key issue, illustrating why it is a key constraint to success and growth.

However, sound surveys which capture the opinions of 70-80 per cent of investors provide a much better basis for action than many of the public-private forums of recent years, where analysis is sometimes replaced by grandstanding or lobbying on behalf of special interests. They are also more reliable (and more positive) than many internationally-based media and ratings agency analyses of investment climates, because they represent the experiences of actual investors rather than the fears of potential investors. It is vital for governments to transmit these results to the international media and donor organizations, and to use them as part of their investment promotion drives.

The principal lessons from the investor perceptions survey are:

- Investors intend to increase their investment. Future surveys will provide more detail on the scale of such increases, as well as verifying if investors met their (probably) optimistic projections. However, the evidence is strong enough so that countries can forecast increases in foreign private capital in their macroeconomic projections.
- The most important positive factors in investment decisions are domestic economic growth and political stability, access to regional markets, and debt reduction. This implies that efforts to maintain high growth,

low inflation, and stable exchange rates, and to accelerate regional integration and cancel debt for the poorest countries, are top priorities for investment promotion.

- Incentives are also an important factor in investment decisions, just as bureaucracy is a strong negative factor. Efforts to streamline investment procedures should be reinforced wherever possible.
- Availability of skilled local staff is also vital. The current focus on primary education in national poverty reduction strategies is laudable, but also underlines the need for expanding priorities to include secondary and vocational education.
- Tax incentives are of little importance in investment decisions. This is consistent with other findings which indicate that tax incentives affect neither the overall amount of FDI to developing countries, nor its distribution among them (except as a marginal factor in choosing between two countries which are otherwise virtually comparable in their attractiveness to investors). High tax burdens can deter investors.[14] This implies that countries need to move away from blanket tax holidays for foreign investors, where major investors receive five-to-10-year tax holidays from corporate and profit taxes, and in some cases even from staff income and indirect taxes. Countries should move toward more targeted tax allowances or credits for capital investment or training, as part of creating a level playing field with a relatively low corporate tax rate for foreign and domestic companies.
- Investors' intended targets for future investment fit well with this more nuanced approach. Staff training and upgrading technology are their top priorities and could benefit from incentives (though they may not be necessary if companies are already motivated). On the other hand, encouraging diversification, research and development, and promoting linkages between domestic and foreign investors, looks to be more difficult and will require more analysis and carefully targeted incentives.
- It is also essential to combat those negative factors which discourage investors from expanding their businesses. Given that utilities, infrastructure, and health (especially malaria and HIV/AIDs) issues have been identified as important priorities, it is encouraging to note the steps outlined in the New Partnership for Africa's Development (NEPAD) and other national poverty reduction strategies to overcome these problems. NEPAD's governance peer review mechanisms should reduce corruption and political instability over time.
- The lack of domestic financing is the major constraint to business. Given that commercial banks are unable to supply loans to businesses effectively (even in the most developed countries' financial systems), diversification of the financial sector beyond commercial banks to investment banks, venture capital, leasing, and micro-credit must top the list of policy reforms.[15]

Box 2

Monitoring Foreign Private Capital in Africa and Latin America

Developing country governments in Africa and Latin America have requested assistance in improving strategies for monitoring foreign private capital. In particular, countries require assistance:

- to move rapidly forward to meet international data dissemination standards for balance-of-payments flows and International Investment Position stocks, such as the Global Data Dissemination Standard and the Special Data Dissemination System
- to collect not just balance-of-payments data, but also other elements such as source countries, recipient sectors and regions, and terms of the flows/stocks
- to collect data on investor perceptions and intentions which go beyond simple analysis of motivations to invest and analyze investor policies, especially corporate social responsibility issues
- to be trained in how to use such information to refine macroeconomic and investment promotion policies
- to conduct more detailed analysis of long-term sustainability and volatility of flows, and the returns demanded on investment, and to integrate such analysis with their analysis of public sector debt sustainability and financing prospects
- to analyze in more detail the actual macroeconomic effects of foreign private capital, and simulate potential future effects and necessary policy responses, through scenario and risk analysis
- to analyze for themselves (as opposed to consuming analysis conducted by donor agencies) the actual and potential contributions of foreign private capital to poverty reduction, including via corporate social responsibility policies[1]
- to collect and analyze all of this information through an integrated national program run by a task force composed of all relevant government and private sector agencies, to build their own capacity rather than relying on external consultants or international agencies.

1 See Bhindi, 2002.

Capacity-building needs

Though the current projects are unearthing an enormous amount of additional information about private foreign capital in developing countries, the perceptions and intentions of investors, and the policy implications for recipient countries, there is a demand on the part of countries for more intensive assistance in this field. Despite the progress they have made in data collection and basic analysis, there is still a need for further work on non-survey reporting methods and more advanced analysis.

In addition, there are at least 50 developing countries which are not conducting these types of exercises at all, relying instead on estimates from investment promotion agencies, or surveys of a few large companies. As a result, 63 developing country governments in Africa and Latin America have requested further assistance in this field (See Box 2 - Monitoring Foreign Private Capital in Africa and Latin America).

As a result, the governments of Denmark, Sweden, Switzerland, and the UK are jointly financing the extension of the one-year, eight-country pilot Foreign Private Capital Capacity-Building Project into a three-year program which will help 63 governments (12 targeted for intensive capacity-building, with the others sharing information on best practice at regional and inter-regional seminars) to reinforce their capacity on these key development issues.

Biographies

Matthew Martin is Director of the Development Finance International Group, a not-for-profit corporation which is based in London and funded by donor governments and international organizations. The DFI Group is currently building capacity in 42 developing countries to analyze how to finance their development and to change policy at a the national and international levels.

The DFI Group works closely with partner institutions run by the ministries of finance and central banks of developing country governments themselves, to which it is transferring its responsibility for execution of programmes.

The two main DFI Programmes are:

- Debt Relief International (DRI), which is assisting 34 countries to analyse the sustainability and contribution to poverty reduction of their debt (external and domestic) and their new official financing, to negotiate the best possible financing and debt relief terms, and to advocate changes to the international system for debt management.
- Development Finance International (DFI), which is assisting 18 countries to monitor and analyse the sustainability and contribution to poverty reduction of their international private capital flows (including foreign direct investment, portfolio investment and private sector debt).

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Footnotes

1 For example, Nils Bhinda, et al., *Private Capital Flows to Africa: Perception and Reality* (London: Development Finance International:1999).

2 Previous surveys of FAL and investor perceptions were often conducted separately, overburdening the private sector with repetitive surveys.

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4 See Nils Bhinda, et al., 1999 and Matthew Martin, "Financing Africa's Development in the 21st Century." The Gilman Rutihinda Memorial Lecture, June 1999.

5 IFC studies of India indicate flows 3-4 times as high as recorded amounts, due to the same factors.

6 See Balliram Baball, *Monitoring Private Sector External Debt: Key Issues and Challenges* (London: Debt Relief International: 2002).

7 World Bank, *Global Development Finance*, Washington, DC: 2003.

8 HIPC Ministerial Forum, *Declaration of 8th HIPC Ministerial Meeting*, Kigali, April 2003.

9 See also Matthew Martin, *Financing Poverty Reduction in HIPCs* (London: Debt Relief International: 2002a)

10 See also Matthew Martin, "Analysing the Sustainability of Private Capital Flows" (London: DFI, 2002b), mimeo.

11 It is not clear how much of this is investment from one African country to another and how much represents "round-tripping" (funds taken out of the host country and brought back in again via offshore havens) which should be excluded from FDI as it is investment by residents of the country.

12 For more details of this attitude see Bhinda et al.

13 See Bhinda *et al.*, *Private Capital Flows to Africa: Perception and Reality*, 1999.

14 See Joel Bergsman, *Advice on Taxation and Tax Incentives for Foreign Direct Investment* (Washington, DC: World Bank, May 1999); Matthew Martin, *Financing Africa's Development in the 21st Century*; and Louis Wells et al., *Using Tax Incentives to Compete for Foreign Investment: Are They Worth the Costs?* FIAS Occasional Paper 15 (Washington, DC: World Bank: September 2001).

15 See African Economic Research Consortium (AERC), "Financial Sector Reform in Africa." Special Edition, *African Development Review*, Abidjan, 1998.