Chapter 5 U.S. Investment in Developing Countries

1. Theories and Strategies for Economic Development

Developing countries (low to middle income countries as defined by the World Bank or countries other than developed countries according to the IMF) had embarked on economic development after the World War II. Since then, they have achieved higher economic growth than high income countries (Table 5-1). Their economic development strategies have evolved from import-substitution industrialization led by governments in earlier stage to export-oriented industrialization with emphasis on the use of market mechanism in later stage.

Table 5-1 GDP Growth Rate by Income Category

	1965-73	1973-80	1980-89	1990-98	1997-2006
Low and middle income countries	**6.5%**	**4.7%**	**3.8%**	**3.5%**	**n.a.**
Low income countries	5.3%	4.5%	6.2%	7.4%	n.a.
excluding China and India				3.7%	n.a.
Middle income countries	7.0%	4.7%	2.9%	2.2%	n.a.
Heavily indebted countries	6.4%	5.2%	1.9%	n.a.	n.a.
Sub-Sahara Africa	4.8%	3.2%	2.1%	2.3%	4.1%
East Asia	8.1%	6.6%	7.9%	7.9%	6.7%
South Asia	3.6%	4.2%	5.1%	5.7%	n.a.
Europe, Middle East, North Africa*	7.7%	3.9%	2.9%	-2.9%	3.7%
Middle East, North Africa	n.a.	n.a.	n.a.	3.0%	5.0%
Latin America	6.5%	5.0%	1.6%	3.6%	2.8%
High income countries	**4.8%**	**3.1%**	**3.0%**	**2.3%**	**2.7%**
OECD member countries	4.7%	3.0%	3.0%	n.a.	n.a.
World total	5.0%	3.3%	3.1%	2.3%	n.a.

* Europe only in and after 1990 (Compiled from the data of WDR, WDI and WEO)

(1) Import-Substitution Industrialization

Economic development policy widely adopted initially by developing countries dependent heavily on primary commodities was import-substitution industrialization. The strategy was supported by "structurism." The structurism advocated providing developing countries with multilateral aid by the World Bank and other organizations and bilateral assistance by developed countries led by the U.S. It encouraged the governments of the developing countries with small domestic markets to play active role in allocating limited resources to targeted sectors for economic development. They adopted policies to substitute imported products with domestically manufactured products. They put great effort into improving infrastructure (electric power, transportation, communication, etc) while they provided domestic infant industries with protective measures such as import restrictions and high customs duties on industrial products. They also supported domestic industries with subsidies, preferential tax treatments and government-sponsored financing. They often found it necessary to borrow money from foreign sources due to limited domestic capital resources.

Excessive government intervention, however, resulted in inefficient state-owned enterprises, and rampant rent-seeking and corruption, which led to inefficiency of national economy as a whole. In many cases of import-substitution industrialization in heavy and chemical industries, needed know-how did not build up as had been expected. Protective measures often prolonged than they should have. Amid of the social and political instability due to impoverishment of rural communities, coupled with mass-migration to cities, it became more difficult for the government to continue industrialization policies, and fiscal deficit ballooned. As the Latin American countries financed their growing fiscal deficits with external borrowing, they faced the debt crisis in the 1980s. These countries also faced difficulties in repaying existing external debts which they had borrowed to promote import-substitution industrialization, as they failed to transform such import-substitution industries into export industries.

(2) Export-Oriented Industrialization

After experiencing failures of government-led industrial policies, new theory emerged in the late 1960s and early 1970s. It advocated developing countries should avoid government intervention as possible, put more emphasis on market mechanism, and pursue export-oriented industrialization instead of import-substitution industrialization. International organizations gave support to the theory. Developing countries lifted restrictions, liberalized transactions, rationalized and privatized government-owned enterprises, pursued export-oriented industrialization, and exposed domestic industries to international competition. As the World Bank pointed out in the *World Development Report 1982*, many developing countries that had been successful in achieving sustainable economic growth were those countries that effectively promoted high level of investment with sufficient domestic saving and active intake of foreign capital. These successful countries, as a result, became capable of producing export goods or import-substitution goods at internationally competitive price, and started earning foreign exchange, which further improved investment efficiency.

(3) From Market-Mechanism-Oriented Approach to Market -Friendly Approach

In the 1980s, neo-classical approach became the theoretical backbone for the IMF and the World Bank in economic development. Neo-classical approach emphasized the role of market mechanism instead of that of government. This approach was adopted by the IMF and the World Bank in addressing the debt crisis in 1982, in particular asking debt ridden developing countries to implement adjustment policies including radical structural reforms. However, structural adjustment policy came into question in the late 1980s in respect of adverse effects particularly to poverty group. Since then, poverty alleviation, along with economic growth, became the objective of economic development, hence emerged a new approach--market-friendly approach. International aid organizations broadly endorsed the new approach in which the governments of developing countries were encouraged to pro-actively intervene in several selected areas such as basic infrastructures, educational systems, healthcare programs, environment and other institutional frameworks for which market alone could not be expected to play significant role. The World Bank concluded in the *World Development Report 1997* that the past experiences indicated that no successful economic developments had ever been achieved neither by government-led strategy nor absence of effective government.

Asian developing countries adopted export-oriented industrialization approach from relatively early stage. while their governments actively intervened in economies. In South Korea and Taiwan, for example, export-oriented industrialization was promoted in the 1960s with U.S. aid[18] and aggressive foreign capital import. Two countries successfully expanded their exports commensurate with changing structure of international market demand. Following such success, foreign direct investment in the region increased in the 1970s. In the 1980s, foreign direct investment played greater role in the ASEAN countries and China where the governments promoted export-oriented industrialization and foreign capital import. In the 1990s, the Asian NIES even started outward direct investment in neighboring countries, thus contributing mutually stimulating and overlapping economic development in the region.

In contrast to the Asian region, many Latin American countries adopted import-substitution industrialization together with protective measures. As such, they were slow in exporting industrial products. In the 1970s, they started to accept large amount of foreign capital, but some of the countries faced debt crisis in the 1980s. Their economies stagnated due to debt crisis and reduced investment induced by saturated domestic market. In the 1990s, however, Latin American countries started attracting more foreign direct investment with progressing structural reforms including privatization program following debt crisis and with the development of the MERCOSEUR and the NAFTA. Brazil, Mexico and Chile have been increasingly integrated themselves into the global economy.

With the accelerated development of the globalized economy in the 1990s and thereafter, developing countries (including transitional economies) became to have no other choice than integrating themselves into the global economy. Increasing number of developing countries have

[18] According to Cook (1991-1992), U.S. aid financed 70% of South Korea's imports and 85% of Taiwan's current account deficit.

been aggressively taking foreign capital to promote their economic development. However, the success of such approach hinges on whether or not they can carry out domestic policies conducive to foreign capital, particularly direct investment, and promote exports.

2. Capital Flows to Developing Countries

Major part of the capital flows to developing countries in the post-war period was official money provided by the DAC (the Development Assistance Committee of the OECD) member countries and the IBRD group. In the early 1960s, such official money accounted for 66% of net inflow to developing countries[19]. As for private sector, foreign direct investment accounted for 20% while bank lending and export credits accounted for 7% each. In the early 1980s, medium- to long-term private lending increased its share sharply. As of 1982, the share of debt owed to private sector as percent to the total medium- to long-term debt of developing countries was estimated to reach 60% (more than 70% if short-term debt was included[20]). The following factors are cited as the background to the above-mentioned sharp increase: (i) active borrowing by developing countries at relatively low interest rate due to recycled oil money in the 1970s; and (ii) foreign direct investments by multinational corporations were restricted or their foreign operations were nationalized by many developing countries for the reason that such investments represented exploitation by foreign countries, and their equity contributions were eventually switched to lending by multinational corporations. Dominant part of the private flows was attracted to middle income developing countries. Low income countries continued to rely mostly on official flows (mainly multinational aid). However, in the wake of the debt crisis in the 1980s in Latin American middle income countries triggered by the two oil shocks, bank lending to developing countries decreased substantially.

With the development of financial deregulation and globalization, international capital movements have increased sharply since the 1980s. The globalization has been accelerated in the 1990s by the end of the Cold War regime and the emergence of China's market economy under socialism. In response to the expanding global economy, big corporations reviewed their organization structures and activated cross boarder businesses including establishing new distribution channels or production sites. While developed countries accounted for 80-90% of the total foreign direct investment, developing countries that had undergone debt crisis came to place more importance on foreign direct investment as stable source of capital flows, and pursued open policy to foreign capital, thus having attracted increased foreign direct investment. The share of direct investment as percent to total capital inflows to developing countries increased from 11% in 1978-81 to 20% in the 1990s. Foreign direct investment by multinational companies, etc. not only accelerates the world economic growth, but also promotes globalization through exports and imports. According to the recent IMF data, foreign direct investment accounted for 41% of total capital inflows to developing countries in 1994-1997. It reached 85% in 1998-2003 as lending to the developing countries was repaid after the Asian financial crisis.

While the sharp increase of foreign direct investment in the 1990s was due mainly to privatization deals in Latin American countries and transitional economies as well as M&A transactions of banks and companies in Asian countries in the wake of the currency crisis in the region, it should also be noted that, in contrast to the traditional type of industries such as oil and gas extraction and labor-intensive manufacturing, investment in new types industries in particular service industry segment has been increasing with the development of regional economic integration. In the early 1990s, Asian countries such as China accounted for more than 50% of total direct investment in developing countries while Latin American countries 30%. In the late 1990s after the Asian financial crisis, the region slightly reduced its share while Latin American countries and former Eastern European countries increased their shares. More recently, reflecting strengthening economic ties among Asian countries and the development of regional integrations such as MERCOSEUR, Asian NIES, Brazil and Chile have been increasing their presence as investors.

[19] World Bank, WDR (1982)
[20] World Bank, WDR (1983)

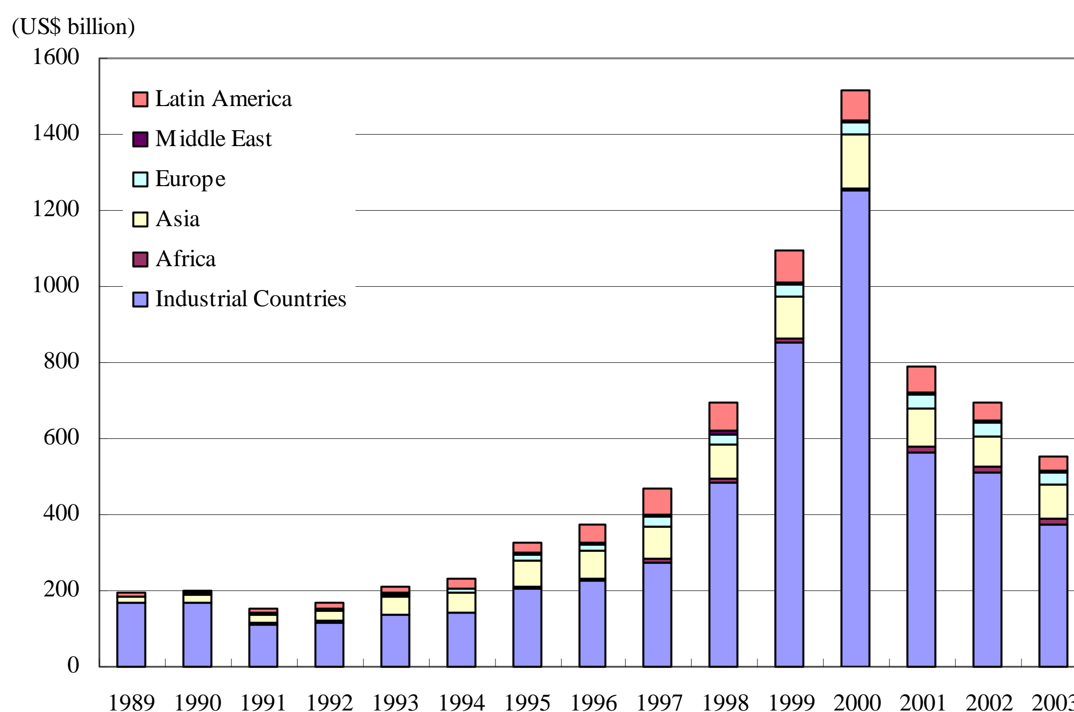
Table 5-2 Make-up of Capital Flows to Developing Countries

(US$ billion per year)

	1978-81	1982-89	1990-95	1994-97	1998-2003	2003
Direct investment	11%	16%	20%	41%	85%	52%
Portfolio investment	9%	2%	44%	30%	27%	29%
Bank lending, etc.	80%	55%	36%	29%	-6%	25%
Flows to LDC (A)	n.a.	n.a.	n.a.	348	256	339
Flows to all areas (B)	n.a.	n.a.	n.a.	1,798	2,858	3,217
A/B	n.a.	n.a.	n.a.	19%	9%	11%

(Compiled from the data of Bosworth & Collins and IMF Balance of Payments)

Figure 5-1 U.S. Direct Investment Destination



(Compiled from the IMF Balance of Payments Yearbook)

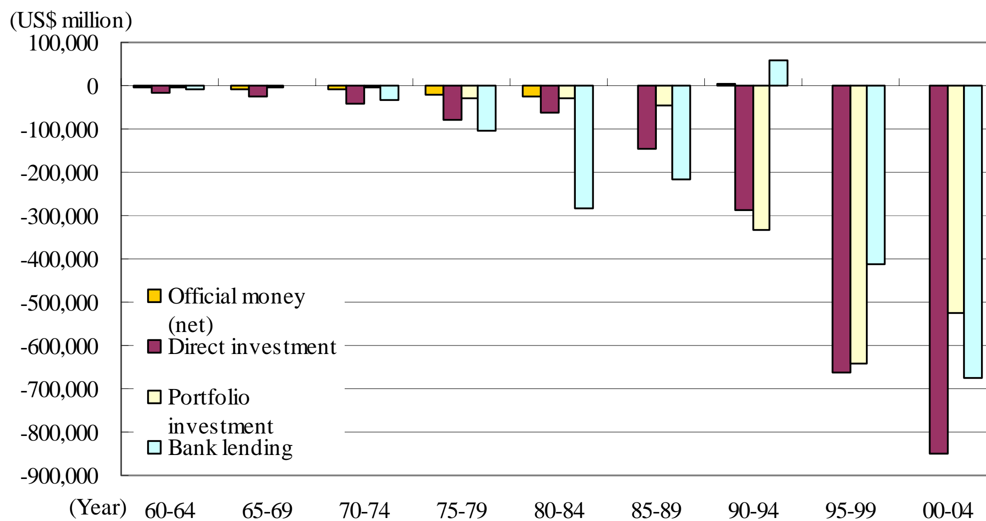
3. U.S. Investment in Developing Countries

Up until the 1970s, the U.S. capital outflows centered on direct investment, majority of which was destined to European countries. Asia and Africa were the major borrower of U.S. official money while Europe was repaying the debt. For the period from the late 1970s to the late 1980s, U.S. bank lending increased sharply. The background to this sharp increase was the need for international banks particularly U.S. banks to recycle the accumulated huge oil money of oil producing countries in the wake of the first and second oil shocks to non-oil-producing developing countries and communist countries that were in need of foreign currency for oil import and economic development. The Euro dollar market accelerated such trend. The dominant borrowers from U.S. banks were Latin American countries for the period from 1972 to 1983 with net amount of lending to the region for US$200 billion, representing twice the amount to Europe (including developed countries), 100 times the amount to East European countries or five times the amount to Asia and Africa. However, U.S. bank lending dropped sharply in the 1980s due to Latin American debt crisis. U.S. bank lending to Latin America recovered slightly towards the end of the 1980s before dropping again in the beginning of the 1990s. In the late 1990s, bank lending to Latin America showed relatively strong increase, but dominant borrower was Europe. Direct investment increased strongly in the 1990s, in particular for the period from the late 1990s to 2004 with growing number of M&A deals in Europe. U.S. has accounted for 20-30% of the world total direct investment since the 1990s.

The destinations of U.S. direct investment center on developed countries with a share of 70% of total balance. Developing countries' share is only 30%. As for U.S. direct investment outflows into developing countries, Latin America has accounted for more than 50% for most of the period because of the geographical proximity. It is of note, however, that investment in Asia has increased markedly since the late 1980s. In terms of investment balance, the share of Latin America dropped from 69% in the mid-1960s to 50% in 2003 while that of Asia increased from 9% to 34% for the same period. In the 1960s, Venezuela ranked top for the destination among developing countries. In the 1970s, Brazil and Mexico were preferred to Venezuela for destination. After NAFTA was formed in 1994, investment in Mexico increased sharply.

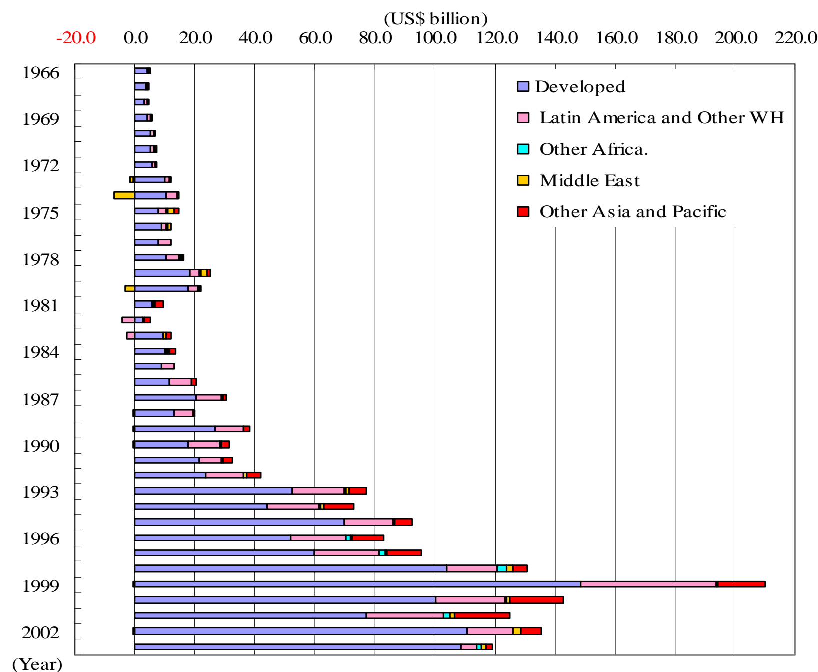
As for portfolio investment by the U.S. before the mid-1970s, majority part was investment in Japan, Canada and international organizations. However, Euro has accounted for more than 50% since the mid -1970s. In the 1990s and onward, Latin America has increased its share.

Figure 5-2 U.S. Capital Flows



(Compiled from the Department of Commerce data)

Figure 5-3 U.S. Direct Investment Abroad



(Compiled from the Department of Commerce data)

Figure 5-4 U.S. Direct Investment Abroad

(Flow by Area Excluding Developed Countries and Europe)

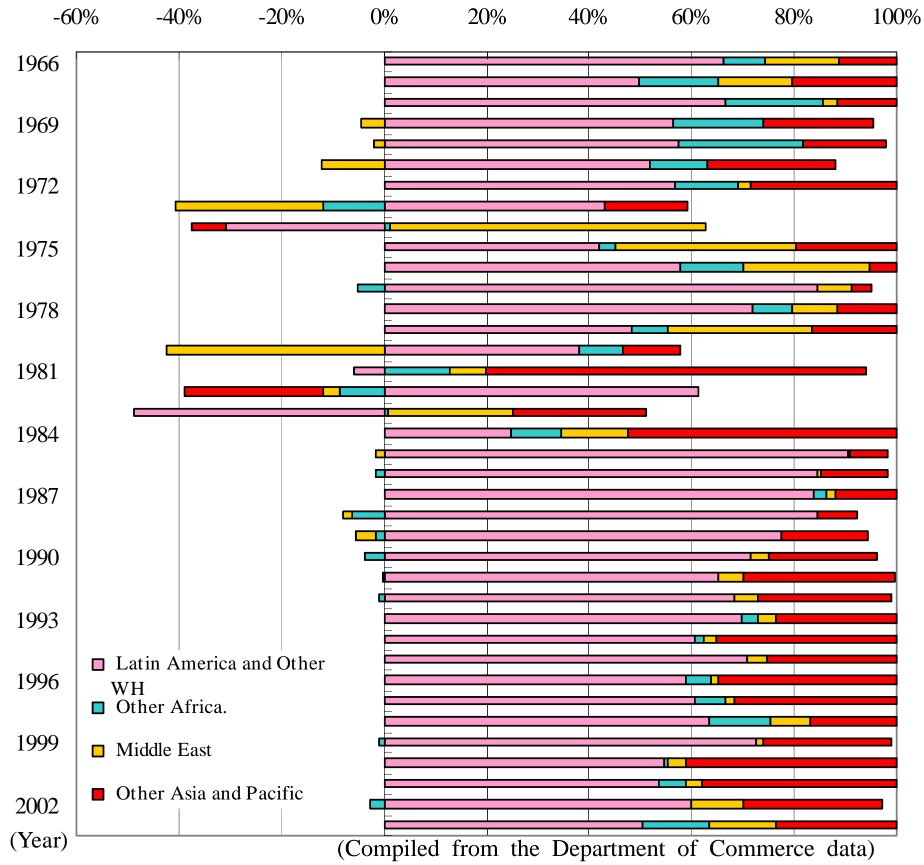
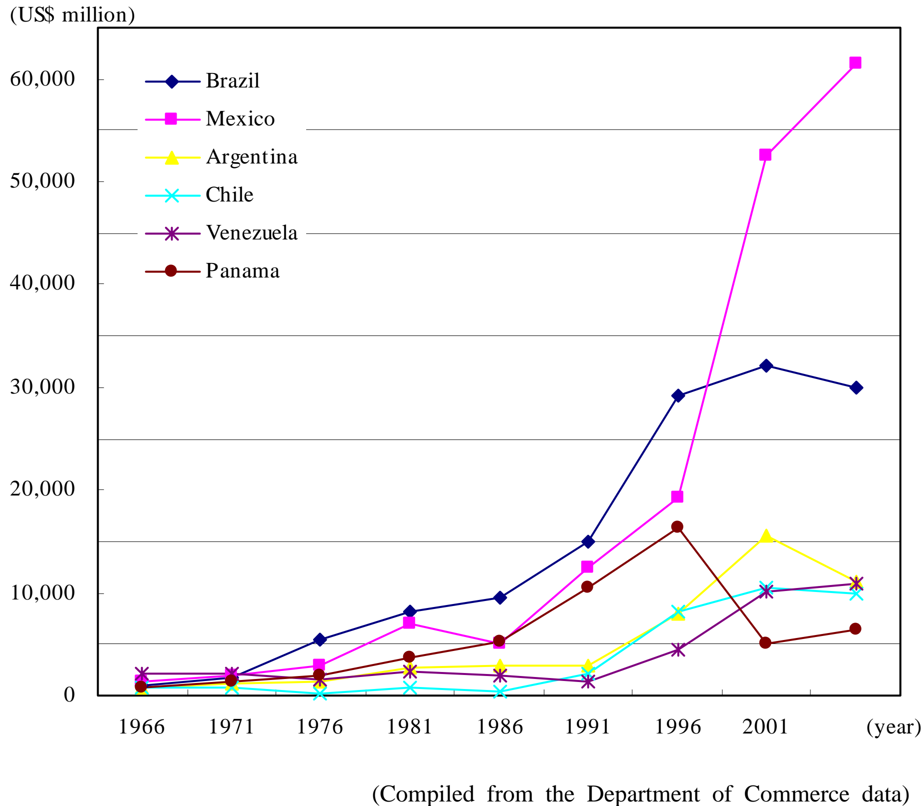


Figure 5-5 U.S. Direct Investment Position in Latin America



4. Contribution of U.S. Capital Flows

After the World War II, the U.S. provided unprecedented scale of financial support to the world, in particular to Europe with the Marshall Plan, which facilitated a great deal the growth of the world economy. The U.S. also initiated creating multinational framework of international monetary system, international trade, and financial aid for reconstruction and economic development. The U.S. became the largest equity contributor to the international organizations such as the IMF and the World Bank. In the 1960s, the U.S. actively involved in the international arrangements for developing countries, including President Kennedy's initiative in the "United Nations Decade of Development." Up until the 1970s, the U.S., as a guardian of the principle of liberal democracy, kept its market open to developing countries. The U.S. basically adhered to the principle of market mechanism, though some developed countries showed an increasing tendency to protectionism in the 1970s while developing countries intensified claims for economic sovereignty over natural resources or for nationalizing enterprises set up by foreign companies. The U.S. at the time was still unrivalled world leader, ready to listen to the voices of developing countries. In the 1980s, a series of protectionist trade bills were proposed amid of growing calls for correcting U.S. dollar appreciation and U.S. current account deficit. The Reagan's administration and its successors upheld the principle of fair trade instead of free trade, in pursuing a new order, and demanded Japan and Europe to open up their markets and accelerate structural reforms.

U.S. capital flows to developing countries accounted for 0.7% of GDP for the period from the 1960s through the 1990s, though they dropped temporarily to 0.5% in the 1980s. The level, however, has declined to 0.23-0.38% in 2000-2004. Nonetheless, the U.S. has been the largest contributor of capital flows to developing countries, with a 21% share in the world total.

Figure 5-3 U.S. Capital Flows to Developing Countries

(US$ million)

	1960-69	1970-79	1980-89	1990-97	2000-04
Total capital flows	**51,298**	**108,738**	**189,762**	**361,021**	**158,423**
ODA	34,637	40,103	83,814	78,038	70,969
of which Asia	-59%	-56%	-33%	-28%	n.a.
Private	15,070	54,040	86,143	258,320	58,315
of which Latin America	n.a.	-73%	-67%	-58%	n.a.
Direct investment	9,811	32,864	45,385	150,783	n.a.
Portfolio, lending	5,259	18,806	31,174	98,259	n.a.

(Compiled from the data of Survey of Current Business and DAC)

In the 1960s, U.S. official flows (e.g. ODA) accounted for more than 70% of the total. Private flows gradually increased their share[21] to reach more than 90% in 1997. The destination of the U.S. capital flows was strongly influenced by U.S. foreign policies and world economic developments. ODA flows went primarily to Asia in the 1960s and 1970s for strategic purposes[22]. ODA flows to Latin America depressed in the 1970s, but rebounded in the 1980s and 1990s with the new U.S. initiatives to developing countries of the Western Hemisphere. In the 1980s and 1990s, Israel and Egypt were among the major recipients of U.S. ODA. For private flows, Latin America accounted for major portion, but Asia increased its share recently. One predominant feature of geographical distribution of foreign affiliates of U.S. multinational corporations is that U.S. foreign affiliates are located in diversified areas around the word compared with the counterpart of France, Germany or Japan[23].

In addition to capital flows, the U.S. has been the leader in respect of transfer of technology. The U.S. led the world after the World War II in innovating technologies. U.S companies, with their active R&D in many advanced industrial sectors such as computers, plastics, pharmaceuticals,

[21] Policy initiatives under the Nixon administration: from bilateralism to multi-nationalism and initiative by private sector

[22] Bureau of Economics Analysis, Survey of Current Business (2000)

[23] UNCTAD (2005)

semi-conductors and aero space products, were successful in inventing new products and manufacturing processes and transforming them into businesses. Such new technologies also had great impact on industrial and trade structures of host countries through U.S. direct investment abroad.

The U.S., as we have reviewed in the preceding sections, had in the past taken initiative in liberalizing international trade and investment, and had played a central role in providing capital to developing countries. However, after the U.S. started running the world largest current account deficit and became a country of the world largest net foreign liabilities, the U.S. strategy has been changed. As stated in the external economic policy by the U.S. State Department (2000), it puts higher priority on increasing U.S. export opportunities by opening up foreign markets and liberalizing flows of goods, services and capital, thus facilitating to promote economic growth around the world including developing countries and transitional economies and to stabilize the global situation.

5. Implications of International Investment for Developing Countries

The U.S. used to play a central role in providing capitals and promoting free flow of trades and capitals. Free flow of capital is considered to have merits in reducing investors' risks through diversified investments, disseminating globally best practices such as corporate governance, accounting standards and legal systems, and checking inappropriate policy measures by governments. In addition, foreign direct investment has further merits for host countries in creating job opportunities, transferring technologies through procurement of parts, disseminating management know-how and factory administration skills through M&A, accelerating competition through new entries to markets, and increasing corporate tax receipts by host countries (unless preferential tax rate is applicable)[24].

According to a study by Bosworth and Collins (1999) on the effect of capital inflows on domestic investment for 58 developing countries in Asia and Latin America during 1978-1995, they found that an increase of 1.0 in capital inflows was associated with an increase in domestic investment of about 0.5. If we look at the ratio by type of inflow, foreign direct investment is at about 0.8 (0.9 for 18 emerging markets) while bank loan at 0.4-0.5 and portfolio investment at 01. They concluded that the benefits of free capital flows for foreign direct investment would be sufficient to offset any adverse effects of free flow of capitals.

As discussed above, capital inflows into developing countries are generally considered to contribute to investment and economic growth. However, some argue that all capitals are not necessarily beneficial, citing that stable flows like foreign direct investment are deemed as "good cholesterol" whereas short-tem funds motivated by interest rate differential or exchange rate fluctuation are "bad cholesterol."[25] Other argue that, the extent to which capital flows into developing countries contribute to economic growth of such countries is variable, depending on the level of improvement of domestic policies, speed of deregulation of capital controls, types of capital inflows, etc.[26] Furthermore, the cause-and-effect relationship between direct investment and economic growth has not been confirmed. (Does direct investment cause economic growth, or does economic growth attract capital inflows?) It should also be noted that a recent study points out that many developing countries with higher foreign direct investment ratio as percent to total capital inflows tend to be higher risk countries with less developed domestic capital and financial markets, and that such countries should make every effort to improve investment environment and develop domestic markets[27]. Whatever the case, foreign direct investment is not panacea at all. On the contrary, there are observations that point to risks associated with foreign direct investment such as sudden reversal of hot money through inter-group financial transactions, misguided investment in improper industries, transfer of controlling right at fire sale price amid of financial crisis in host countries, and crowding-out of domestic investment.

In conclusion, in order for developing countries to promote economic growth, it is utmost

[24] Feldstein (2000)
[25] Hausmann and Fernandez-Arias (2000)
[26] World Bank, Global Development Finance (2001)
[27] Hausmann and Fernandez-Arias (2000)

important that they have to integrate their economies into the global market by adopting open-door polices in trade and investment. In the process of industrialization, it is also important for developing countries: (1) to strengthen export competitiveness and promote gradual transition to higher-value-added export structure; (2) to balance economic development in agricultural and non-agricultural sectors lest balance of payments constraint due to increased food imports should hinder industrial development; and (3) to improve investment environment, to avoid growing debt accumulation, and to mobilize domestic resources including fostering domestic savings.

6. Summary of Chapter 5

Developing countries initially adopted government-led import-substitution industrialization policy. It, however, bred such problems as inefficient government-owned enterprises, and rampant corruption and rent-seeking. It was subsequently replaced by a new approach in which developing countries were encouraged to avoid government intervention in economy as possible and give greater importance to market mechanism. More developing countries pursued policies to lift various restrictions, liberalize transactions, rationalize and privatize government-owned enterprises, and promoted export-oriented industrialization. In the late 1980s, however, market-friendly approach emerged. The approach emphasized the balance of the roles between government and market. A number of Latin American countries that had adopted import-substitution industrialization faced debt crisis in the 1980s while several Eastern Asian countries that had adopted export-oriented industrialization succeeded in performing high economic growth.

In the early 1960s, U.S. official money accounted for most of the part of the U.S. capital flows to developing countries. The official flows, however, decreased gradually while private flows increased. The majority part of private capital flow has been direct investment, though bank lending to Latin America sharply increased temporarily in the late 1970s and 1980s.

U.S. capital flows to developing countries, particularly direct investment played significant role to support export-oriented industrialization and economic development. Direct investment is generally considered to have potentially offered host countries such merits as creating job opportunities, transferring technologies through procurement of parts, disseminating management know-how and factory administration skills through M&A, accelerating competition through new entries to markets and increasing corporate tax receipts by host countries (unless preferential tax rate is applicable). A study indicates direct investment have induced more domestic investment in developing countries than other capital flows. It is important that developing countries pursue balanced economic development by making most of the above-mentioned potential merits of direct investment while at the same time they implement such policy measures as opening up their markets for trades and investments, improving investment environment, and mobilizing domestic resources including domestic savings.