Factors Influencing the Flow of Foreign Investment and the Relevance of a Multilateral Investment Guarantee Scheme

Ibrahim F. I. Shihata

Recommended Citation
https://scholar.smu.edu/til/vol21/iss3/4

This Symposium is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in International Lawyer by an authorized administrator of SMU Scholar. For more information, please visit http://digitalrepository.smu.edu.
Factors Influencing the Flow of Foreign Investment and the Relevance of a Multilateral Investment Guarantee Scheme

I. The Role of Foreign Investment

The major ideological differences over the real benefits of foreign investment, especially direct foreign investment, are widespread and deeply rooted. Experience shows, however, that such investment, operating under appropriate safeguards, can play an important role in accelerating economic growth and development. \(^2\) The recent decline of the overall...
volume of foreign investment in developing countries should therefore be viewed with concern. After reaching a peak of U.S. $17.24 billion in 1981, direct investment flows to developing countries have plummeted to U.S. $11.86 billion in 1982 and to U.S. $7.80 billion in 1983. Their slight increase in subsequent years has not yet brought them to the low level of 1982. They have also declined in importance relative to other external sources of funds from 22 percent of total flows in the early 1970s to less than 14 percent a decade later. A number of interrelated factors in the world economy and in host countries explain this phenomenon.

Worldwide economic problems resulting in decelerating growth rates and sluggish demand levels continue to prevail. Meanwhile, the total debt of developing countries exceeded U.S. $950 billion in 1985 and was estimated to reach one trillion U.S. dollars in 1986. Worse still, due to the excess of debt service payments over new loans and to large scale “capital flight,” international capital has begun to flow in a perverse direction, from the indebted developing countries to the developed countries. The


6. The most recent World Debt Tables reports that as a group, the 107 countries reporting their debt through the World Bank debt reporting system paid U.S. $14 billion more in long-term debt service than they received from disbursement of new long term lending in 1984. Id. at x. For 1985 it is estimated that the negative “net transfer” from long-term lending rose to U.S. $26.3 billion for these countries. As for capital flight, figures vary according to the definition used. Based on bank depositing data, outflows of private capital, defined as the change in deposits with foreign banks by nonbank residents, rose in developing countries by almost $80 billion during 1980-86 to reach $185 billion at mid-1986, amounting to 21 percent of these countries' total debt. Based on balance of payments data, cumulative private capital outflows from capital importing developing countries during 1980-85 totaled $135 billion, equivalent to 15 percent of their total external debt. Defined as a residual, by subtracting from the increase in external debt the accumulation of foreign assets by the domestic banking system and recorded current account deficits and adding to it net nondebt creating flows such as direct investment, outflows of private capital by residents of developing countries in 1980-1985 may have amounted to $150 billion, equivalent to 17 percent of total debt. While these estimates are not free from inaccuracies, they clearly show the seriousness of the problem. See International Monetary Fund, International Capital Markets—Developments and Prospects 69 (1986); see also Khan & Ul Hague, Capital Flight from Developing Countries, 24 Fin. & Dev. 2-5 (1987).
combined effects of these unfavorable external conditions and of generally unsuccessful domestic policies in many developing countries are devastating. In several cases, they have set back the development process a decade or more. Some of these countries are now experiencing declines in real per capita output and consumption. Average per capita real incomes in most of Latin America are no higher now than they were in the mid 1970s; in much of Africa, they are back to the level of 1970.7

The long-term solution to these problems clearly lies in stimulating growth and development, thereby enhancing the abilities of developing countries to service existing debt obligations, restore their creditworthiness, and eventually increase the domestic consumption and living standards of their people. Such solutions require basic changes in the economic conditions inside and outside the developing countries and a substantial increase in the financial flows they receive from abroad. There has been, however, a net decline in such external flows in recent years. After a rapid expansion during the 1970s, commercial bank lending to heavily indebted countries has been greatly reduced since 1981 and is projected to remain constrained in the near future.8 Furthermore, official development assistance (ODA) flows remain inadequate and are not expected to increase significantly. The ODA flows from the member countries of the Organization for Economic Cooperation and Development (OECD) are at best expected to grow at an annual rate in the order of two percent9 while similar flows from the members of the Organization of the Petroleum Exporting Countries (OPEC) have already declined sharply.10 Persisting internal economic problems and the need to use a significant proportion of domestic savings to service foreign debt have also left few domestic resources to finance the local cost of development projects. The capital required to inject momentum back into the development process is thus huge, but far from being readily available.

The economic problems of developing countries have been further exacerbated by a number of other factors. Slower rates of growth and demand in industrialized countries and their protectionist policies have

---

adversely affected prospects for export-oriented investments in developing countries.\textsuperscript{11} Depressed domestic economic conditions and stagnating demand in these latter countries have made investment for import-substitution less attractive. Interest rates on borrowed funds also reached record levels, at times causing parent companies in developed countries to borrow from their subsidiaries abroad, rather than to provide financing to them. And a marked drop in commodity prices has drastically reduced both the export earnings of many developing countries and the attractiveness of investment in their extractive sectors, which used to account for a large portion of overall foreign investment. In these circumstances, uncertainties, real or perceived, about the transfer of returns on investments and the stability of contractual arrangements of foreign investors with host governments have increased substantially. Meanwhile, longer term forces such as the decreasing share of labor in production cost in industrial countries and the increasing conservation and reliance on substitutes to primary commodities are gradually depriving developing countries of the comparative advantages of low-cost labor and abundant raw materials.

Developing countries are thus seemingly trapped in a vicious circle. The balance of payments difficulties of the heavily indebted countries have practically cut many of them off from borrowing "new money" on the international capital market or from attracting the large volume of foreign investment needed to expand their productive facilities. Many other developing countries that managed not to accumulate large debts are equally unable to attract greater external flows due to stagnation in ODA flows and the perceived negative aspects of their investment climate. The majority of these countries also suffer from a continuing decline of their earned foreign exchange.

In fact, this difficult and vicious circle can be broken. The IMF and the World Bank are intensifying their efforts to help the heavily indebted countries restore their creditworthiness and regain their attractiveness to commercial lenders. Major industrial countries are at long last taking initiatives to encourage both commercial banks and international financial institutions to increase their exposure in developing countries. It is also increasingly recognized that foreign direct investment could be an important component in an effective strategy to develop global solutions to the world debt crisis. Foreign direct investment has considerable potential for promoting sustained growth and employment and reducing vulnerability to future deterioration in economic conditions.\textsuperscript{12} It increases the

\textsuperscript{11} See Development Assistance Committee, Organization for Economic Cooperation and Development Press Communiqué (April 11, 1986).

\textsuperscript{12} OCCASIONAL PAPER No. 33, supra note 2, at 1-2.
flows of nondebt creating equity to developing countries, and compensates to some extent for the drying up of international bank lending.

This is not to suggest, however, that foreign direct investment does not have an economic and social cost. Nor does it suggest that it can be a substitute for other types of capital inflows. To represent net gains to host countries, investment must always operate within appropriate safeguards that would ensure their economic soundness, their contribution to development, and their compliance with the laws of the host country. Expansion of such investment does not negate the need for further expansion of other forms of financial inflows. Higher levels of commercial lending should still be reached with greater concern as to the end use of funds. And the highly concessional ODA flows are not easily substitutable, especially in low-income countries. Given the fact that foreign direct investment has been highly concentrated in higher income countries and that its growth cannot realistically take the same rate experienced by external commercial lending in the 1970s, it should always be conceived as a complementary source of finance for developing countries, which need to undergo substantial developments in size, geographic direction, and sectoral composition if such investment is to play a substantial role in the growth of developing countries as a whole.

It should be noted in this context that foreign direct investment has a considerable advantage over external borrowing due to a number of factors. First, direct investment does not simply provide funds, but an integrated package of financial resources, managerial skills, technical knowledge, and marketing connections. Second, it is not a debt creating instrument. The investor bears the risks of project failure, while a lender has the right to be repaid regardless of how effectively the borrowed funds were used. Third, other indirect but important attributes of this form of capital relate to benefits that ensue from the introduction of efficient and internationally competitive enterprises into the local economy. In the long run, direct foreign investment can foster a general improvement in production by stimulating the adoption of improved techniques and management in other sectors of the economy, and among local entrepreneurs. Fourth, foreign investment often works as a catalyst for associated lending for specific projects, thus increasing the overall availability of external resources for productive purposes. Also, foreign investors often act as lobbyists in their home countries for the benefit of their projects in developing countries.

Foreign portfolio investment in the securities markets of developing countries, although relatively limited to date, could also become an important complementary source of nondebt creating equity finance in several developing countries. The total investable funds of institutional investors in the industrialized countries is estimated at over U.S. $2 trillion, and
growing at about 15 percent annually in nominal terms. For the developing countries with emerging capital markets, this represents a vast potential source of capital inflow without the usual concerns about managerial control inherent in direct investment. Even a small shift of these funds towards these emerging markets could represent an important addition to the volume of capital flows to developing countries. Domestic financial systems may also be strengthened through portfolio investment, which can bolster the capital bases and alleviate the high corporate debt:equity ratios found in many developing countries. For the investor, portfolio investment in the emerging markets would allow risk diversification and the possibility of generally higher returns. The total annual return in U.S. dollars for such emerging markets (excluding Hong Kong and Singapore) in recent years has been estimated to average approximately 15 percent in comparison to 12 percent for the rest of the world's equity markets.

Many developing countries now recognize the advantages inherent in foreign investment, in both its direct and portfolio forms, and its vital role in their future development, particularly in view of the decline in other external sources of funds. This has necessitated a fundamental change of attitude from the previous two decades, which were characterized by increasingly restrictive investment environments reflecting nationalistic sentiments, the availability of alternative bank lending and negative perceptions about earlier experiences with foreign investment. Foreign investors were typically accused of adopting practices unfavorable to the economies of their host countries. The long list of accusations, which were often based on a mixture of hostile ideologies and actual experiences, included the adoption of inappropriate productive technologies and centralized management, the crowding out of potential domestic borrowers by raising a good part of capital requirements locally, and the use of transfer prices, royalty and interest payments, and other means to avoid host country limits on profit remittances and foreign exchange regulations, circumvent price controls, and escape taxes. Today, however, devel-


oping countries have come to realize that there is scope for a more balanced situation. They are gaining increased confidence in their ability to create a receptive and liberal investment environment that recognizes the legitimate interests of foreign investors while maintaining adequate policies and procedures to ensure the soundness of the investments involved. As a result, a great number of developing countries are now competing to promote foreign investment and to restore the confidence of foreign investors, which had been impaired by the wave of expropriations and other discriminatory actions in the 1960s and the early 1970s and by the growing difficulties in the convertibility and transfer of income.

In spite of this change of attitudes, developing countries are faced with the grim reality of declining foreign investment flows. Until 1981 the real value of annual investment flows hardly changed over fifteen years, while other sources, especially commercial loans, were increasing rapidly. Even the nominal value of investment flows, which was increasing until that year, has drastically dropped ever since. Of all foreign direct investment worldwide, developing countries receive only about one-fourth. Of this, the bulk has gone mainly to a few higher-income countries in Latin America and Asia, with Brazil and Mexico accounting for a large (almost 30 percent) though declining share.

As mentioned earlier, the general decline in the flows of foreign investment to developing countries has resulted from both global economic conditions and changes in the investment climate, as well as from policies prevailing in the developing countries themselves. In particular, percep-


16. For the figures on foreign direct investment flows and bank loans to developing countries in constant 1982 prices and exchange rates from 1970 through 1983, see OECD 1984 REVIEW, supra note 3, at 65.

17. According to figures reported by the IMF, the share of Brazil and Mexico in total foreign direct investment flows to developing countries, which reached some 40 percent in earlier years, averaged about 29.2 percent during 1980-1983, and the share of Singapore in foreign direct investment flows to Asia averaged about 38.8 percent during 1980-1983. INTERNATIONAL MONETARY FUND, BALANCE OF PAYMENTS STATISTICS 1984, at 76-77 (1984) [hereinafter BALANCE OF PAYMENTS STATISTICS 1984]; see also World Development Report 1985, supra note 7, ch. 9; ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, INVESTING IN DEVELOPING COUNTRIES 19-24 (5th ed. 1983). Since OECD and IMF use different data bases, the figures reported by them are not completely consistent.

SUMMER 1987
tions of unfavorable climates and volatile economic policies have discouraged investors from seeking projects in developing countries. Investors' behavior shows a consistent preference for "safer" investments even when they are commercially less attractive. Their reluctance to invest larger volumes in developing countries in recent years is not simply a result of a dearth of investment opportunities.

It is generally recognized that, on average, capital invested in developing countries is likely to yield a higher economic, social and, at times, financial return than that invested in industrialized countries. This is in fact a logical result of a greater scarcity of capital in developing countries. It also indicates that the growth of foreign investment flows may be expected to resume in the future, particularly in the more rapidly growing economies such as those of South East Asia. However, recent experience suggests that this is far from being a foregone conclusion.

Untapped investment opportunities in developing countries could certainly attract external funds to exploit them. But fundamental changes in the economic policies of both the governments of capital-exporting and capital-importing countries would be required if drastic changes in the investment flows are to take place. In addition, perceptions of foreign investors about the noncommercial risks they are likely to face in developing countries have to be dramatically dissipated before substantial increases in the volume of foreign investment flowing to these countries can materialize.

II. The Investment Climate

An attractive investment opportunity and an acceptable investment climate represent the optimal mix of high financial returns and low non-commercial risks. Improving the investment climate, and, in particular, reducing perceptions of political risk in developing countries, are therefore important steps without which even the most profitable opportunities are likely to remain untapped.

18. During 1970-1982, the "incremental capital output ratio" (ICOR), measuring the amount of investment capital needed to produce one unit of extra Gross Domestic Product, was roughly 7:1 in developed countries and some 5:1 in developing countries. Even though a portion of the differential in return rates has to be discounted to offset the perception of risk that is attached to investments in developing countries, the risk-adjusted return is large enough to justify, in theory, preference for investment in developing countries. See World Development Report, supra note 7, table 9.2; A. VAN AGTMEI, supra note 14.

19. UNCTC REPORT, supra note 2, at 29. The report states that "since rates of return in Latin America may be slow in recovering, it is possible that the recent trend towards greater concentration of investment in the rapidly growing economies of South East Asia will continue in the near future."
The investment climate should be seen in this context from both a global and domestic perspective. Overall volumes of investment flows and host countries' efforts to increase such flows are constrained or stimulated by the degree of strength and stability of the world economy. A faster and sustainable growth in developing countries depends to a great extent on the policies and actions of industrial countries, especially the latter's own growth rates, the levels they adopt for interest and exchange rates, the degree of openness of their markets and the levels of their external aid flows. However, within this framework much can be done to improve current conditions on the domestic scene of developing countries as well.

The domestic investment climate is a multifaceted, dynamic concept. In its broad sense, it comprises many interrelated elements that can be presented in three categories: (a) institutional, including policy aspects; (b) infrastructural aspects; and (c) legal aspects.

A. Institutional and Policy Aspects

Institutional aspects of the investment climate particularly cover the political stability of the government of the host country, its economic policies (especially policies and behavior toward private investment, both domestic and foreign), the degree of sophistication of its financial and administrative institutions, as well as the administrative procedures for initiating and operating investments in the country.

The policy toward foreign investment will, to some degree, depend on the ideological orientation of the host government. However, this need not be a market philosophy. For example, centrally planned economies are increasingly encouraging foreign investment by providing stable and well-defined conditions. Governments which enjoy political and social stability, and have established institutions to ensure continuity and smooth transitions without the pains of abrupt or violent changes, greatly contribute to the evolution of an attractive investment environment. The prevailing cultural environment may also be important in shaping business customs and attitudes toward foreign investment.

Under a policy of encouraging foreign investment, pronouncements that emphasize the government commitment to a fair and stable treatment of such investment are important in reassuring investors that they are welcomed by the host country. Predictability and perseverance in the implementation of these policies are essential in establishing credibility and in dissipating negative perceptions. The applicable rules need to be established in advance in a nondiscriminatory and unambiguous way. Promotional efforts may also make an important contribution to the amount

---


SUMMER 1987
of investment received. In view of the fact that investment decisions are made on the basis of known alternatives, the greater the supply of information about investment opportunities, the more the likelihood of attracting potential investors and dispelling perceptions of risk that emanate from uncertainty and ignorance. Accurate and up-to-date information on investment opportunities, as well as data on general economic trends, trade flows, and domestic market and consumption patterns, are of great relevance to any prudent investor. Clearly defined development programs that elaborate priorities and identify sectoral opportunities are also useful. The more sophisticated promotional agencies may provide assistance with preinvestment studies and certain aspects of implementation and managing of projects.

A favorable economic condition in the host country is one of the most important variables influencing the flow of foreign investment. Governments can significantly improve their investment climate by the adoption of macroeconomic policies to ensure proper economic planning and efficient utilization of resources. The stage of economic development of the host country, as well as good economic performance, are the major determinants of business opportunities, and explain resultant investment flows and their concentrations at present in relatively few developing countries. For example, countries with large domestic markets and demand can be attractive for import-substitution investments. While countries with low levels of income and small domestic markets receive little investment of this kind, they may still be attractive to foreign investors as locations for export-oriented production.

The pursuit of appropriate financial and exchange rate policies are of great importance. The current foreign exchange constraints of many indebted developing countries may impair confidence in the long-term viability of investments in their territories and the possible risk regarding future repatriations of profits. The currency transfer risk is of particular concern for investments that do not generate foreign exchange directly through payments for exports. Liberal trade policies of both home and host countries are also critical in determining export-oriented investments. Other elements of the institutional aspects of a good investment environment that have to be considered include: appropriate market-determined pricing; labor policies and laws to reduce distortions and rigidities in the labor market; reasonable taxation levels to encourage investment; and the development of financial markets.

21. The foregoing discussion on general economic aspects of the investment climate is largely based on an internal study prepared in 1985 by the World Bank. See Industry Department, World Bank, Bank Group Role in Fostering Enterprise Development (1985) [hereinafter Bank Group Role].
Within the framework of general economic policies conducive to overall greater volumes of foreign investment, specific policies designed to enhance revenues or reduce the costs to foreign investors may be adopted, and can be used to channel flows into priority sectors or to influence the choice of location. However, the importance of such incentives should not be overstated. In the absence of an overall attractive climate, such incentives are not likely to be effective; where such climate is adequately attractive, they may in fact represent an unjustified sacrifice by the host country. Furthermore, it has been found that "in many cases, the incentives offered by a country, when taken together, are inconsistent, contradictory or redundant."22 A recent study by the International Finance Corporation (IFC) on the effects of incentives and regulations concluded that the investor's choice of country could sometimes be influenced by the host country's incentive policy.23 Other research on the subject seems to suggest that the impact of incentives is probably marginal.24 Incentives are more likely to influence intraregional location decisions, or decisions regarding the location within a specific country, its timing, size, and form, more than overall volumes of investment that are determined by the broader investment climate of the host country.25 However, it has been noted that "incentives matter in the sense that an individual country might stand to lose much direct investment were it to abolish all of its incentives unilaterally."26

The effectiveness of incentives policies is often reduced by the confusion created by their great variety and the existence of restrictions that may minimize the net benefits. The greater the complexity, and the more

23. S. GUISINGER, A COMPARATIVE ANALYSIS OF COUNTRY FOREIGN INVESTMENT STRATEGIES (1983). In two-thirds of seventy-four cases surveyed in four industries (petrochemical, automobile, computer, and food processing), the study found that the choice of country was influenced by host government incentives policies. Effectiveness of the incentives was "determined by comparing a country's attractiveness to investors under current incentive (and disincentive) policies with hypothetical conditions that would prevail if a country removed all incentives and disincentives while all other competitor countries maintained incentives policies as before. Id. at v. See also Guisinger, Host Country Policies to Attract and Control Foreign Investment, in INVESTING IN DEVELOPMENT: NEW ROLES FOR PRIVATE CAPITAL 157-72 (Moran ed. 1986).
24. See generally ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, INTERNATIONAL INVESTMENT AND MULTINATIONAL ENTERPRISES (1983); STAFF WORKING PAPERS No. 669, supra note 22; OCCASIONAL PAPER No. 33, supra note 2, at 16-17; WORLD DEVELOPMENT REPORT 1985, supra note 7, at 130.
26. OCCASIONAL PAPER No. 33, supra note 2, at 17.
often such policies change, the greater the degree of uncertainty introduced into the investment decision. Moreover, the stringent requirements and cumbersome and lengthy administrative procedures for obtaining the incentives can be a major deterrent for foreign investment. Such policies also result in an administrative burden for the host country, which has to use additional skilled manpower for the approval, implementation, and monitoring of the policies, but without which benefits to the economy might further be reduced. This problem is exacerbated where there is no central and efficient agency to carry out and coordinate all investment-related policies and the investor has to battle with various agencies with conflicting competencies and interests.

A government may also introduce regulations restricting foreign investment in certain sectors to ensure its conformity with developmental priorities. Entry into politically sensitive industries, like public utilities, the media, banking, and insurance, has been restricted in most developing countries. Industries with relatively simple technology or financial requirements have also been reserved for local enterprises. Other restrictions may relate to the degree of foreign ownership and control in enterprises, access to local capital markets, and remittances of profits. Specific performance requirements on foreign investors are common. Many of these regulations may prove in the long run to be very costly to the economy of the host country although some of them are no doubt justified, for example, on account of industrial security and protection of the environment. The extent of the limitations imposed is likely, therefore, to be the determining factor. The abovementioned IFC study found, with respect to restrictions, that companies tended to take such requirements into consideration in their investment decisions. The present trend toward a more liberal regulatory framework in developing countries should therefore help their efforts to attract foreign investment.

An excessive system of incentives and regulations may reduce the benefit derived from the investment for the host country without significantly increasing flow. Fiscal incentives are not a substitute for the fundamental prerequisite of a good stable economic and political climate and appropriate financial and exchange rate policies. A good example is that of several African countries where, despite the existence of elaborate investment codes offering substantial incentives, limited success in attracting significant increases in foreign investment has been achieved, not only due to small markets and limited natural resources but especially due to unstable political and economic environments.

27. Id.
28. Id. at 14.
29. GUISSINGER, supra note 23.
B. INFRASTRUCTURAL ASPECT

The infrastructural aspect of the investment climate affects the attraction of the host country as an investment location. In its broad sense the infrastructural aspect has many components, including in particular the availability and efficiency of physical facilities and human resources.

The physical component comprises the existence of a basic transportation network (rail, road, harbor, and airport facilities), power, water supply and sewerage systems, telecommunication systems, housing arrangements, and a natural resource base. Industrial estates and free trade zones can be an added attraction.

The availability of highly developed human resources may be a powerful incentive for investment, especially in the manufacturing and service sectors, which often require access to skilled labor and technical and managerial personnel. This presupposes a certain educational infrastructure and facilities for vocational training. If these resources are not available locally, the freedom to employ needed foreign nationals is necessary. The degree of discipline in the labor/management relationships in the host country may also prove to be an important factor, especially in industrial and labor-intensive investments.

Other elements of the infrastructural aspect of the investment climate include the availability of marketing arrangements (distribution, warehousing, trading channels), technological elements (standards, quality control and testing, laboratories, technology information system), and supporting services (accounting/auditing, consulting/engineering, maintenance),30 which will vary in degrees of sophistication depending upon the level of economic development of the host country. Foreign investors are bound to obtain such services through more costly means when they are not readily available.

The institutional framework required for foreign portfolio investment is particularly lacking in many developing countries. Restrictions on portfolio investment as well as complex administrative arrangements, inadequate reporting requirements, and the narrowness of securities markets, are the main problems.31 On the part of the investor, lack of knowledge

30. See Bank Group Role, supra note 21.
31. See Foreign Portfolio Investment, supra note 13, at 22. The IFC paper lists the following barriers that developing countries impose on portfolio investment:

• prohibition of foreigners/non-residents purchasing domestic securities except as direct investors;
• foreign exchange restrictions relating to foreign portfolio investment, particularly on terms for repatriations;
• unduly high withholding taxes on individual income and capital gains, relative to either or both international norms and treatment given domestic investors;
• minimum and discriminatory time periods during which foreign portfolio money must
about the securities markets of developing countries, and perceptions about risk have been deterrents. Given a change in the policies and the implementation of appropriate modifications to the institutional framework, as well as the perceptions of investors, portfolio investment can be significantly increased in some developing countries.

In short, it is obvious that an adequate infrastructure is indispensable for the implementation of an investment. In the absence of such an infrastructure, investors may be deterred altogether from undertaking investment because investment costs are increased and returns reduced. In the event that the investment is undertaken under such circumstances, it will be at an increased cost to the investor and, in turn, to the host country.

C. LEGAL ASPECTS

The third category of factors influencing the domestic investment climate is of a legal nature. There are basically two sets of legal factors: (1) the substantive rules governing foreign investment, whether these are domestic rules (e.g., investment codes, labor laws, tax regulations, etc.) or international agreements (bilateral or multilateral investment treaties); and (2) the procedure to be followed in the settlement of potential disputes between foreign investors and their host government. The latter may be limited to local remedies or may include resort to international mechanisms for conflict resolution on an ad hoc basis or through institutional conciliation or arbitration arrangements such as those available under the International Chamber of Commerce (ICC) Court of Arbitration or the International Centre for Settlement of Investment Disputes (ICSID).

Many developing countries have adopted codes favorable to foreign investors and concluded bilateral investment agreements with capital-exporting countries providing for the protection of investments. Although such codes and treaties may in many cases be unclear, and their application unpredictable, their mere existence is a relevant element in signaling the government’s desire for a stable investment environment

remain invested:
- restrictions on the types of shares which can be purchased or held by foreign portfolio investors either by class of share or by business sectors; and
- complex regulatory procedures concerning registration and transfer of securities, dividend payments, and the mechanics of fund transfers.

Id.; see also Occasional Paper No. 33, supra note 2, at 16.
32. For a collection of such laws, see I-X International Centre for Settlement of Investment Disputes, Investment Laws of the World (1973) (looseleaf service).
33. At present, some two hundred of such treaties are in force. For a collection of such treaties, see I-II International Centre for Settlement of Investment Disputes, Investment Treaties, (1984) (looseleaf service).
and enhances investor's confidence. More important, however, is the actual behavior of the legislative, executive, and judicial branches of the host country. Frequent changes in legislation, breaches of contractual arrangements, and the unavailability of a credible and independent judicial system represent important shortcomings in the legal aspects of the investment climate for local and foreign investors alike, which cannot be rectified merely by the issuance of a new favorable investment code. In fact, the countries that manage best to attract foreign investment do not offer any particular legal treatment to foreign investment, but simply treat investment as a whole, both domestic and foreign, in a reasonable way that encourages entrepreneurship and competition, assures stability, and avoids excessive regulation and taxation.

III. Political Risk Perceptions

It is clear, therefore, that if foreign direct investment is to play a key role in accelerating economic growth and development, policies have to be adopted at both the international and domestic levels to encourage larger volumes of such investment and to allow it to flow to regions of the world where it can effectively contribute to the development process.

There is no grand theory that neatly explains all the determinants of the decision to invest abroad. An investment decision is usually made on the basis of the complex interaction of several factors: economic, financial, commercial and noncommercial, including psychological factors, which are all of varying degrees of importance, depending, inter alia, upon the objectives of the investor, the host and home countries in question, and the sector and the project in which the investment will take place.

First come the motivations and the factors affecting the behavior of the investor who risks his time and capital. The investor's primary interest is in identifying an investment opportunity that presents an adequate rate of return relative to the perceived risk. Within this framework, other corporate considerations may also play a role in making an investment, such as the concern to secure or retain foreign markets, gain access to raw materials, take advantage of low production costs, or forestall or match a competitive move. The investor is highly selective and theoretically has a worldwide choice in searching for the ideal location. However, when choosing a location for investment, although many developing coun-

35. For example, Singapore accounted for 38.8 percent of total foreign investment in Asia in the period 1980-83. See Balance of Payments Statistics 1984, supra note 17; Oh, The Pacific Basin: The View from Singapore, Private Investors Abroad: Problems and Solutions in International Business ch. 5 (1986).
tries may offer comparative advantages provided by market size, location, and natural and human resources, a commercially less profitable investment in the home country or in another familiar industrialized or semi-industrialized country may be preferable, due to the cost attached to operating in alien environments, especially for smaller and less experienced investors.

Studies indicate that perceptions of political risk can discourage the flow of foreign investments. The political risk factor may be evaluated at different stages of the decision-making process. For example, investors may screen out some host countries as too risky at the preliminary stage of the decision-making process, thus preventing the identification of investment opportunities in these countries.

Aside from political and economic stability, a favorable government attitude toward foreign investment, in the context of a sound and seriously implemented national development program, is also considered to be an important variable. Investors are particularly affected by such questions as the terms for the transfer of profits and the repatriation of capital, nondiscrimination against foreign ownership and control, and freedom from burdensome regulations on ownership and management. When volatile conditions prevail, direct investments, which are long-term by nature and comprise assets susceptible to physical attack, become particularly vulnerable to the adverse effects of instability and may become the target of arbitrary and unpredictable behavior.

There are quantitative and qualitative costs attached to perceptions of instability in developing countries. Quantitatively, if the risk profile is perceived to be too high, the projected investment would not be made, thus decreasing the overall volume of capital inflows into the host country. In fact, there may even be capital flight, as local investors may prefer under the circumstances to invest in the industrialized economies even though they are aware of higher profits at home. In this situation the competitive market for foreign investment will be reduced, as much of the foreign investment will emanate primarily from larger


37. See H. Robinson, *The Motivation and Flow of Private Foreign Investment* (1961) (survey of two-hundred five companies covering three-hundred sixty-five investments made in sixty-seven countries carried out in 1961 to determine what foreign investors define as a desirable investment climate and the importance of specific factors influencing decisions to invest). The report also offers findings on the view of twenty governments that evaluated the incentives offered to foreign investors.

investors who, unlike most small- and medium-sized companies, have recourse to methods of self-insurance and have a greater capacity to diversify their risks and protect their investment by other means. Investments will also be carried out at a higher cost, to the detriment of the host country, for a premium will be charged for the added risks, and anticipated returns will have to be much higher to compensate for such risks. Qualitatively, the type of investment made may be affected because uncertainty about the medium and long-term horizon may encourage investors to go into ventures that yield high rates of return over a short period, whereas many important investment opportunities in these countries have longer gestation periods. Furthermore, by attracting only large investors, host countries would not be able to take advantage of the fact that smaller companies are often content with more balanced contractual arrangements and better able to offer appropriate technology suited to the needs of these countries.\textsuperscript{39}

It cannot be assumed, however, that large companies weather political uncertainties better than smaller ones in all cases. Certain industries tend to be more susceptible to noncommercial risks than others. For instance, large mining and energy companies in the extractive industries which by their nature require large capital investments, long gestation periods, and are physically tied to a given location, have proved to be particularly vulnerable to political risks. They have operated in developing countries only when the risk-adjusted returns were still high enough to justify the venture.

In the early 1970s, in the exercise of sovereignty over their natural resources, many developing countries sought to play a greater role in the exploitation and processing of their raw materials through nationalization of foreign assets and similar measures. These developments greatly heightened foreign investors' perceptions of political risks. Together with lower commodity prices, perceptions of such risks have adversely affected the propensity to operate in the developing world as a whole. For example, in the mining industry, despite the existence of rich and extensive mineral deposits in parts of Africa, the tendency has been to concentrate on deposits in "safe" industrialized countries like the United States, Canada, Australia, and South Africa.\textsuperscript{40} Similarly, in the energy industry, a recent study,\textsuperscript{41} which included interviews with one hundred ninety executives in forty energy companies in the U.S., Europe and Japan, found that concerns about political risks and past experiences with expropriation,

\textsuperscript{39} Id.
\textsuperscript{40} Id. at 693-95.
\textsuperscript{41} \textit{World Bank, Energy Protect Generation in Lesser Developed Countries} (report prepared by Booz, Allen and Hamilton, Inc. 1985).

\textbf{SUMMER 1987}
instability of contracts and politicization of energy development, have
greatly contributed to energy companies' caution about investing in de-
veloping countries. The study reveals, however, that energy companies
recognize that the developing countries remain an important element in
worldwide strategy, both as a critical resource base and as an essential
market in the long run. While the private sector is apparently willing to
invest on a significantly increased scale, the report concludes that it would
not do so unless there was a real change in both the perception and reality
of noncommercial risks faced in these countries. Most companies covered
in the study agreed that a globally operating investment guarantee scheme,
if combined with World Bank guarantees in certain cases, and perhaps
national and commercial political risk insurance, would greatly assist the
private sector in developed economies to invest in developing countries'
energy projects.

The current low rate of investment in the mining and energy sectors is
a trend that has to be viewed with particular concern. Although it is usually
justified by the present prices of the commodities concerned, it does not
seem to pay adequate attention to future scarcities that need to be ad-
dressed much earlier in these long gestation industries. Increased invest-
ment in these sectors is obviously required to ensure the future supply
needs of a growing world economy. At the same time, increased volumes
of investment would stimulate much needed economic growth in many
developing countries that, though rich in resources, are currently expe-
riencing severe economic problems. The mining and energy sectors pro-
vide good examples of how political risk can deter foreign investment and
why it is imperative to decrease the noncommercial risks involved and
thus provide investors with incentives for increasing capital flows into
the developing countries.

Political risk perceptions can, nevertheless, be diminished through con-
certed efforts at both the national and multilateral levels. As already
mentioned, interested host countries can certainly pursue policies that
are conducive to a more attractive investment climate. Investors' home
countries can also adopt policies to encourage their nationals to invest in
developing countries. They should at least remove existing barriers faced
by such investors in their home countries and otherwise treat the products
generated by these investments in their markets as they treat their national
products. Such domestic action on both sides of the investment flows
should, however, be complemented by international efforts to stimulate
appropriate policies, alleviate noncommercial losses, and more generally
contribute to restoring the confidence of investors and establishing stable
investment conditions.
IV. Relevance of a Global Agency for Investment Insurance and Promotion

At the multilateral level, the creation of a new global agency to improve the worldwide investment climate and in particular that of developing countries represents a significant and timely initiative, all the more so if it is to combine the offering of guarantees against noncommercial risks with broader service and advisory functions. Such an agency would not only be a symbol of the multilateral will of the world community to increase foreign investment flows; it would also be the world policy instrument to pursue this objective on a systematic and continuous basis. By providing guarantees against noncommercial risks in a more comprehensive and effective manner than is available at present, such an agency would reduce a major impediment to international investment. The agency's guarantee against such risks could improve the investors' perceptions of the risk profile of a potential project, and in turn, would inevitably lower the rate of return required by an investor to undertake the investment (the hurdle rate). If and to the extent that an investor associates noncommercial risk with an investment, he can therefore be expected to reduce his hurdle rate in return for a guarantee diminishing this risk. As this premium would reduce the return from the investment, additionality would ensue whenever the reduction in the hurdle rate exceeds the premium.

This is a significant contribution when one considers the options that are typically available to the investor when faced with uncertainty of a noncommercial nature. If the risk is very high, the investment will not normally be made by a prudent investor. There will thus be cases when, despite opportunities for a profitable investment, investors will be reluctant to proceed. On the other hand, if it is decided to go ahead, and no guarantee is available, in all likelihood the investor will attempt to reduce his vulnerability to risks through a variety of risk management techniques such as the shortening of payback periods, the withholding from the host country of key techniques, the exclusion of host country nationals from key positions in the management of the venture, and the sourcing of inputs to local operations and the disposition of the output of local operations elsewhere in the corporate system. Obviously, such practices are not


likely to be consistent with the best interests of the host country. Quite often, they create adverse reaction in the country, which increases the potential of political risks.

Available guarantees provided by national agencies and the private market have their inherent limitations. Coverage of national agencies, though substantial in amounts and effect, fluctuates markedly from year to year and is extended only to a small fraction of investment flows. This is not due to a lack of demand as much as to the limits of these agencies’ programs. Gaps in the existing systems result in particular from eligibility criteria related to their respective national mandates and objectives, consequent restrictive underwriting practices, and the limited financial resources of each agency. Many of these constraints are inherent in the national approach to investment insurance. Within this approach, the risk diversification potential is likely to be limited due to concentration on preferred countries and sectors. Emphasis on the nationality of the investor and on the specific interests of the country of the insurance agency in the particular project are also likely to be highlighted, and the appraisal capacity of the agency may be quite modest. By aggregating investments from many countries and by offering uniform protection regardless of nationality and providing cover to the multilaterally financed investments while pursuing only economic considerations in its decisions, a multilateral agency could certainly have a more diversified and depoliticized protection that would complement the work of the various national agencies operating at present. Its emphasis on the soundness of investments and their developmental impact and its long-term cover would also differentiate its role from that of private political risk insurance. In addition, a global guarantee agency can, through reinsurance of and coinsurance with existing agencies, both public and private, contribute to a broader and more effective coverage. It could enable existing facilities to better leverage their resources through the additional protection provided by such reinsurance and coinsurance.

The transfer of risk through guarantees of investment against noncommercial risks is of particular benefit to the developing world. It facilitates investments that may not have otherwise been made without the coverage, and helps in ensuring that they will be made on terms mutually beneficial to both the investor and the host country. The purpose of such guarantees is not to make an inherently bad project good. Rather, it is to reduce, if

44. The nineteen national agencies members of the Berne Union had at the end of 1984 investment under cover totalling about $15 billion, of which more than $2 billion were accepted for cover in 1984. Only three of these agencies, however, had a total accumulated cover exceeding $170 million. The few agencies not members of the Berne Union run very modest programs.
not neutralize, the uncertainty factor by providing protection against un-
anticipated risks that, if they occur, would seriously endanger the project
and the investor. After all, it is impossible to have zero risk in any dynamic
situation. By taking coverage, the investor is given the confidence to make
an investment decision based on business considerations, instead of for-
going profitable opportunities due to perceptions of political risk.

In addition to its effects on foreign investors, a multilateral investment
guarantee agency can also play an important role in reversing the capital
flight phenomenon that had badly damaged the economies of many de-
veloping countries in recent years. By extending its coverage to funds
brought from abroad by nationals of a developing member country, the
agency would enable such nationals to consider again introducing new
investments in their home country where they enjoy obvious advantages.
To the extent that such coverage takes place only with the approval of
the host government and after ascertaining consistency with its laws,
adequate safeguards would be in place to protect the system against pos-
sible abuses.

The value of a multilateral investment guarantee agency goes far beyond
that of providing compensation for losses. The very existence of such an
agency can be seen as an act of goodwill and confidence-building, and in
this sense could contribute to improving the investment conditions. The
multilateral nature of the guarantees provided would be more acceptable
to host countries than national ones, which may often be politically ori-
ented, in reality or perception. As has been observed, "by de-emphasizing
the national origin of the investment and its guarantee, discriminatory
action on the part of the host country may be discouraged, and the set-
tlement of disputes facilitated." The involvement of the agency will ob-
viously reduce possibilities of arbitrary action on the part of the host
country, sometimes preventing the loss from occurring at all and, in the
event that it should occur, mitigating the extent of the loss.

The fact that insurance is available for a specific country from an in-
ternational agency of which this country is a member enhances the con-

dience of the investor and contributes to a positive impression about the
host country's receptiveness to foreign investment. In some cases, this
may lead to indirect additionality by encouraging other investors who may
choose to enter the market without a guarantee. Also, coverage of some
investment improves the overall risk portfolio of the investor, allowing
him to invest more capital in the developing countries (possibly other than
the hosts of the guaranteed investment). And a guaranteed investment
may attract additional investments of suppliers and customers.45

45. For a detailed analysis of political risk considerations in the investment decision-

SUMMER 1987
"Qualitative additionality" is also expected to ensue from the involvement of the guarantee agency. Improvements in the terms and conditions of investments can occur, for example, when investments are made for longer periods of time or with greater benefits to the host country with respect to such elements as employment and the transfer of technology. It may also ensue from the changes in the mix of foreign investors: if a guarantee plays a larger role for small and medium-sized investors than for large transnational corporations, host countries might be able to gain more technology adapted to their needs and more labor-intensive investments, since these are more likely to be associated with small and medium-sized investments.46

Finally, the other major function of that agency, its promotional and advisory services, can make a considerable contribution to the investment climate. Much of the uncertainty about the political and economic environment is due to lack of knowledge. A global specialized agency in this field will offer a badly needed service that provides detailed, up-to-date, and reliable information about the host country, its institutions, law, policy framework, and sectors, and will attempt to identify potentially suitable projects. Technical assistance may be provided to interested host countries as a means of enhancing the effectiveness of their investment promotion programs, including direct assistance to them in brokering particular investment opportunities. Above all, sound advise to interested governments on the ways and means of attracting investments needed for their development could best be offered by an international agency with a worldwide experience and no particular national strategic or commercial interest in mind.

As part of its complementary activities, the international agency, by virtue of its composition and broad mandate, could also encourage and facilitate the conclusion of agreement among its members on the promotion and protection of foreign investments. It may also serve as a multilateral forum for professional assessments and reports on the consequences of certain policies, programs, and regulations affecting foreign investments that have been adopted by industrialized or developing countries. Gradually, this agency should play a positive role in the establishment of widely respected standards for the treatment of foreign investment and more generally in the progressive development of international law.

in this important area of international relations where controversy abounds about the content of applicable rules.

V. Conclusion

In a world that consists of strikingly different, yet increasingly interdependent, political units, the movement of capital and technology across national boundaries is virtually inevitable. Such a movement is subject, however, to basic uncertainties that add to its vulnerability. Major among these are the vagaries of the world economy, which for the most part are outside the control of developing countries, and the politico-economic environments of the host countries, especially those in the developing world. These constraints hamper a more efficient global application of investment resources and complicate the resolution of both the impending debt crisis and the longer-term development problems of many countries. It would be most unfortunate, therefore, if such constraints continued to prevail. Concerted international efforts are needed in order to ensure greater continuity, to increase the volume, to improve the quality, and to reduce both the volatility and the social cost of foreign investment.

The recent decline in the overall volume of investment flows to developing countries and the large capital outflows from them have been the natural result of a combination of factors. Following the debt overhang of many such countries, recession arrested the growth of local markets and reduced demand for new investment for import substitution purposes. The sharp drop in the prices of primary commodities, including oil, has adversely affected investment in the extractive sector. Most export-oriented industries were also affected by increasing protectionism in industrial countries. In addition to such factors, more enduring forces have been at work to the detriment of the poorer countries. The continuing decline in the share of labor in the total cost of production resulting from increased shifts to automated and technology-based industries is reducing the comparative advantage of developing countries with lower labor costs. Increased cost of production in these countries resulting in particular from persistent high rates of inflation and a low level of technical education is also making them less attractive to investors seeking cheaper locations for their export-oriented products. For a while (1982-1985) the strength of the U.S. economy with its strong dollar, unprecedented high interest rates, and favorable outlook for output, profits, and inflation offered an attractive alternative to conservative investors. Last, but not least, perceptions of high and increasing political risks in developing countries, especially risks related to the convertibility and transfer of profits, have greatly discouraged investors from transferring new funds or even reinvesting the earnings of existing enterprises. In several Latin American
countries, flows became negative and some multinationals started to di-
vest out of the region.

New policy initiatives to arrest these trends are therefore required if
there is to be a reversal of the perverse direction in which funds now
flow, from poor to rich countries. Among the factors that could cause
larger flows of investment to developing nations, improvement of the
investment climate and reduction of perceptions related to political risks
are fundamental prerequisites. In this context, the creation of the Mul-
tilateral Investment Guarantee Agency (MIGA) comes as a major policy
initiative that has considerable potential to remove barriers to interna-
tional investment and give a new vigor to the development process.