

**PRIVATE CAPITAL FLOWS  
TO LOW-INCOME COUNTRIES:  
PERCEPTION AND REALITY**

Chapter 2 of Canadian Development Report 2004

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# I. INTRODUCTION

Until recently, low-income countries, particularly those in Sub-Saharan Africa, have been perceived as aid-dependent and as receiving virtually no private foreign capital. The future of such alleged “basket cases” has looked bleak. Yet many low-income countries have long known the reality: that private foreign capital flows are very significant, as shown by studies in the mid-1990s (eg Bhinda et al).

Low-income countries have very rudimentary systems for monitoring private capital, and therefore this has been vastly underestimated and underreported to international institutions. Reported data are usually based on estimates which bear little relationship to the true flows. Based on surveys of suppliers of flows, the true data indicate that those low-income countries with stable economies and open investment policies, have received extremely large flows in relation to GDP or other economic variables.

As a result, these large flows have caused currency crises and macroeconomic instability in low-income countries. These are comparable in magnitude to the major crises in emerging market economies (Argentina, Brazil, Russia, Turkey and East Asia), but have remained largely unnoticed by the international community.

This article presents the reality of large private capital flows to low-income countries. It is based on projects executed by Development Finance International 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 looked at the contrast between the perception of low flows and the reality of large flows. More recently, they have moved on to assisting countries to improve their monitoring of foreign private capital, conducting detailed surveys of foreign assets and liabilities and of investor perceptions<sup>1</sup> in 8 low-income countries, in a way which is designed to build sustainable government capacity to conduct such analysis.

The remainder of the chapter is therefore based on the work of my colleagues in DFI and teams of government officials in 7 developing countries.<sup>2</sup> It examines in turn what is happening with these flows (Section 2); why the flows are occurring (Section 3); the implications for government policy in low-income countries (Section 4); and the need and plans for building low-income countries’ capacity to monitor and analyse foreign private capital (Section 5).

## II. WHAT IS HAPPENING ?

### 2.1 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 have

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<sup>1</sup> Previously surveys of FAL and investor perceptions were often conducted separately, overburdening the private sector with repetitive surveys.

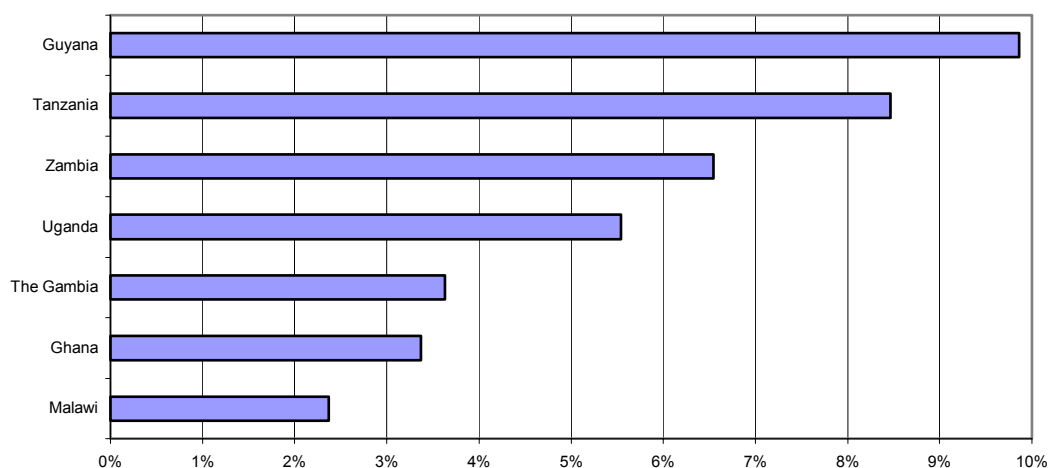
<sup>2</sup> I am most grateful to Nils Bhinda and Hendrie Scheun of DFI for comments on the draft of this paper, and to Momodou Ceesay (The Gambia), Kassim Yahya and Addomah-Gyabaah (Ghana), Gobind Ganga (Guyana), Paul Mamba and Lizzie Chikoti (Malawi), Peter Noni (Tanzania), Muwanga Zake and David Behena (Uganda), and Denny Kalyalya (Zambia), for leading country teams in the projects.

improved their monitoring, it has become obvious that they are very important. Initially, while international organisations were still reporting outdated data on gross inflows, this meant that inflows tracked by the countries reached 2-3 times the levels of internationally published figures (see Bhinda et al 2001 and Martin 1999). This is because vital components of inflows, notably retained earnings, intra-company debt transactions and borrowing “offshore” (ie outside the recipient country), were not recorded by the exchange control or foreign investment monitoring systems in low-income countries.<sup>3</sup>

However, now countries are using survey techniques which further improve the coverage of inflows and also stress reporting of the returns on foreign private capital inflows (profit remittances and loan repayments), and the outflows related to outward investment from low-income countries. As a result, especially in years of negative developments in the economy, outflows are revealed to be much higher, and net inflows considerably lower than previously published (eg in Ghana in 2000), due to large outflows for one company and knock-on effects on new investment by others in 2000. On the other hand, dramatic improvements in the recording of private sector debt have pushed up flows and stocks in this area dramatically (see Baball 2002).

Figures 1 and 2 look at the scale of the gross private capital inflows and accumulated stocks in relation to GDP in the countries. They show that, viewed in this light, both are extremely high and they equal or surpass the scale of stocks and flows in emerging market and East Asian economies.

**Figure 1: Private Foreign Capital Inflows (% GDP in the period surveyed )**

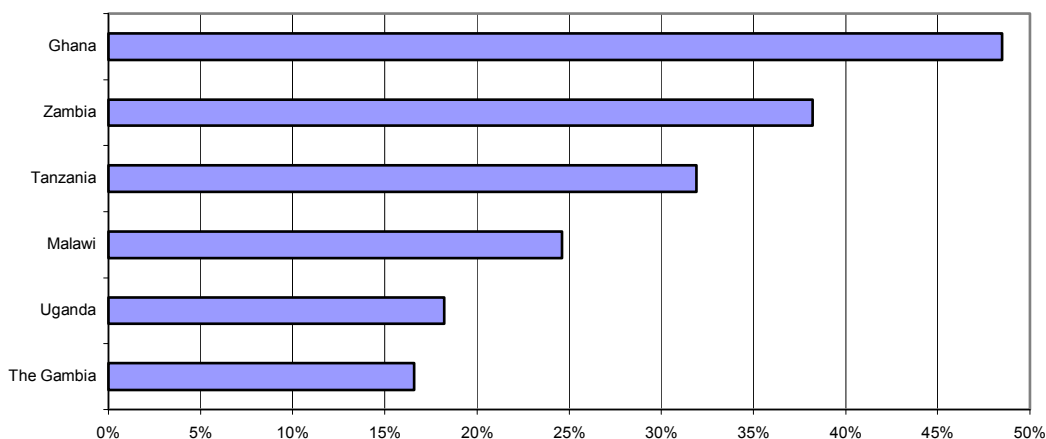


As Figure 1 shows, private foreign capital inflows represent an average of 6% of GDP, with Guyana and Tanzania above 8%.

Figure 2 shows that accumulated stocks average 30% of GDP, reaching almost 50% for Ghana.

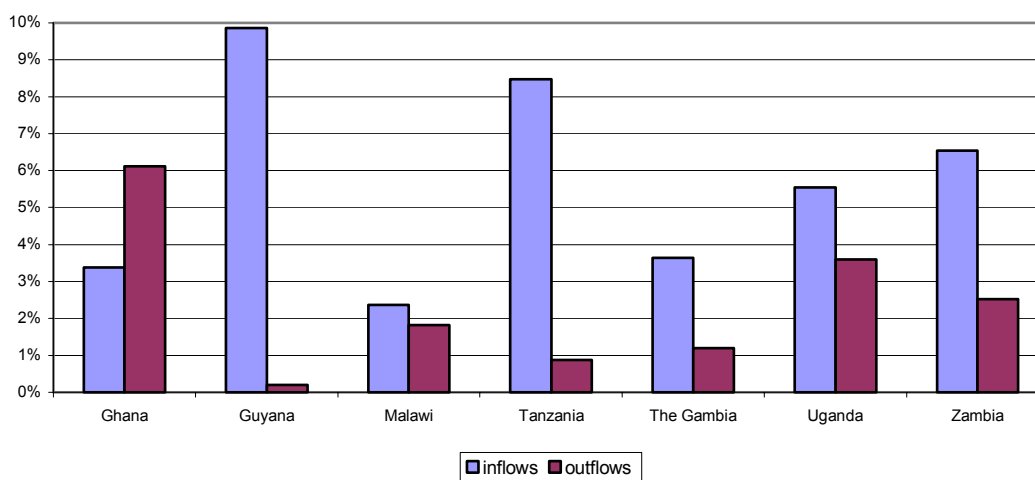
<sup>3</sup> IFC studies of India indicate flows 3-4 times as high as recorded amounts, due to the same factors.

**Figure 2: Foreign Private Capital Stock  
(% of GDP at the end of the period surveyed)**



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

**Figure 3: Inflows and Outflows (% of GDP)**



On the other hand, they are undesirable because they demonstrate the vulnerability of low-income economies to reversal of net flows in the event of any change in the economic situation. Ghana shows this vulnerability clearly, as its outflows were almost twice as high as inflows in the year 2000, reflecting a crisis in one huge investing company – Ashanti Goldfields – which was widely reported in the international press, and which caused a collapse in the currency and in national foreign exchange reserves.

As a result, net flows average only 3.5% of GDP a year across the range of 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 stabilise these flows or adjust to changes in their direction (see section 4).

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

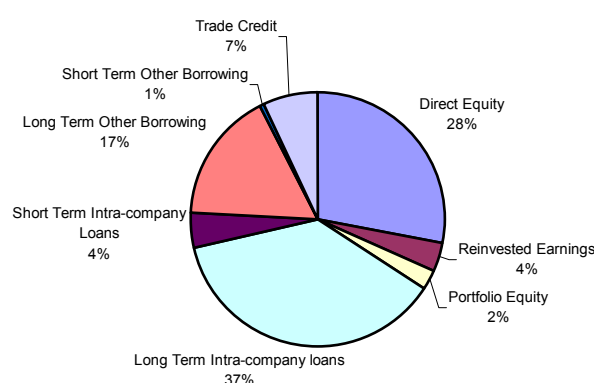
## 2.2. Composition of the Stocks and Flows

Another problem with previous systems for monitoring private capital flows is that they have tended to assume that almost all flows are foreign direct equity investment. This is because they have been based on asking Investment Promotion Agencies how much “investment” they have approved, and then estimating that a certain percentage of it might have turned into actual investment. Yet virtually no IPAs ask investors how they are going to fund their investment, even though different methods of funding have dramatically varying implications for the sustainability of private flows.

Private foreign capital can be divided into four main types of flows:

- 1) Foreign Direct Equity Investment (divided in turn into new direct equity and earnings from existing equity which are reinvested in the company rather than being expatriated)
- 2) Foreign Portfolio Equity Investment – new equity (or reinvested earnings on existing equity) which is less than 10% of the equity value of a company
- 3) Foreign Direct Non-Equity Investment – this is loans provided by related (parent or affiliated) companies to the company in the recipient country.
- 4) “Other Investment” – representing loans from unrelated companies and less formalised short-term credit to companies for trade and services payments

**Figure 4: Composition of Foreign Private Capital Flows**

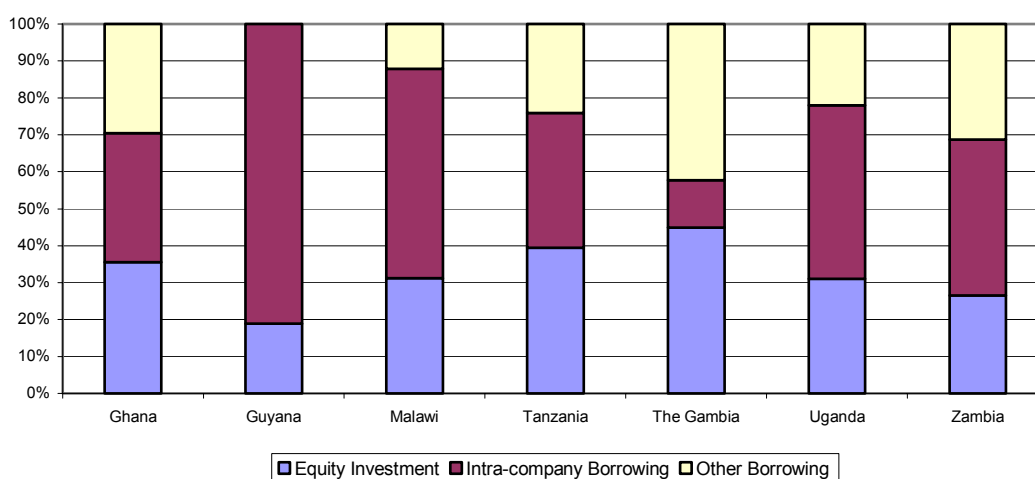


The recent country data has revealed some surprising new findings, shown in Figure 4 about the average composition of flows to the seven low-income countries studied:

- on average, new direct equity investment (including reinvested earnings, which were previously entirely unrecorded) represent 32% of the total

- portfolio investment is very low, at only 2%, but there continue to be large gaps in reporting these flows, especially the many non-resident investors who put money into treasury bill or bond markets via nominee local companies.
- intra-company loans are a crucial source of funding for equity investors, overall higher than total equity flows at 41%.
- debt to/credit from unrelated companies is also important at 25% of flows.
- this means total private sector debt flows are very high, averaging 66% (though two-thirds come from related companies, and 82% are long-term).

**Figure 5: Composition of Private Capital Inflows**



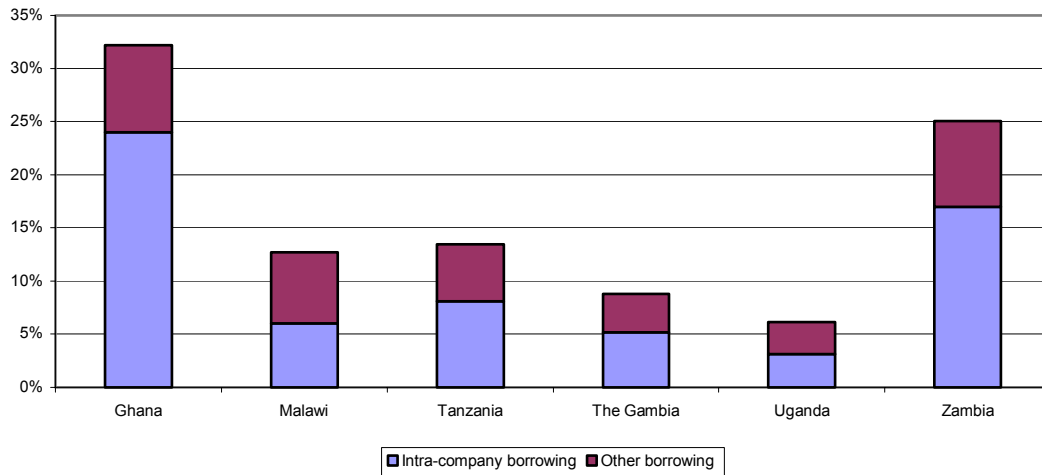
However, as Figure 5 shows this picture hides wide differences among countries (with equity representing only 19% of total flows to Guyana, and 45% for The Gambia. Even within the debt flows, related debt is much more significant than unrelated debt for Malawi, Tanzania and Zambia, and much less significant 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%. This is relatively high and comparable to the debt/equity ratios for the East Asian and Pacific countries in recent years (World Bank 2003), contributing part of the explanation as to why companies are highly vulnerable to shocks to their markets or to prices of the goods they produce.

In order to explain composition of flows it is necessary to look at individual sectors in which investment is taking place and even the situation of key major 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, the 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% of total national external debt, in countries such as Ghana and Mozambique they are closer to 30%. With the reduction of public sector debt under the HIPC Initiative and the rapid accumulation of private sector debt (66% of new inflows), this is set to become a key element of national debt burdens and HIPC Finance Ministers have demanded it be paid more attention (HIPC Ministerial Network 2003).

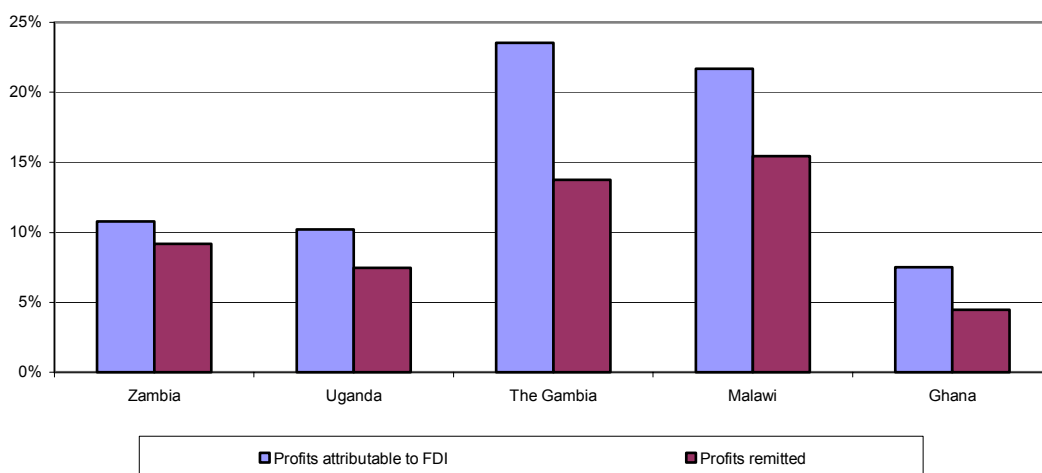
**Figure 6: PSED stocks by type (% of GDP)**



Why is the composition of flows so important? Because it determines the volatility of the flows and rate of return demanded on them. Typically in the international literature on private flows to developing countries, it has been assumed that there is a hierarchy of the desirability of private capital flows which starts with the least volatile and those which demand the lowest return, and descends to those which are most volatile and demand the highest return (see also Martin 2002a).

The most desirable flows have therefore been assumed to be foreign direct investment, which is believed to be less volatile and more long-term because it consists of fixed capital investment which 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% but exceeding 20% in The Gambia and Malawi. Of course, many of these companies are foreign-local joint ventures, so that they are also generating large profits for local investors.

**Figure 7: Profitability of Equity Capital**



However, of this amount, around 75% is repatriated as remittances, which therefore exceed 10% of capital each year. These figures way exceed previous IMF balance of

payments estimates which averaged only 65% remittance (of much lower stock estimates). There is also strong evidence that in years of crisis in a recipient economy, equity investors increase dividend repatriation and repayment of intra-company loans, implying that flows vary pro-cyclically (ie exacerbating trends in the wider economy).

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

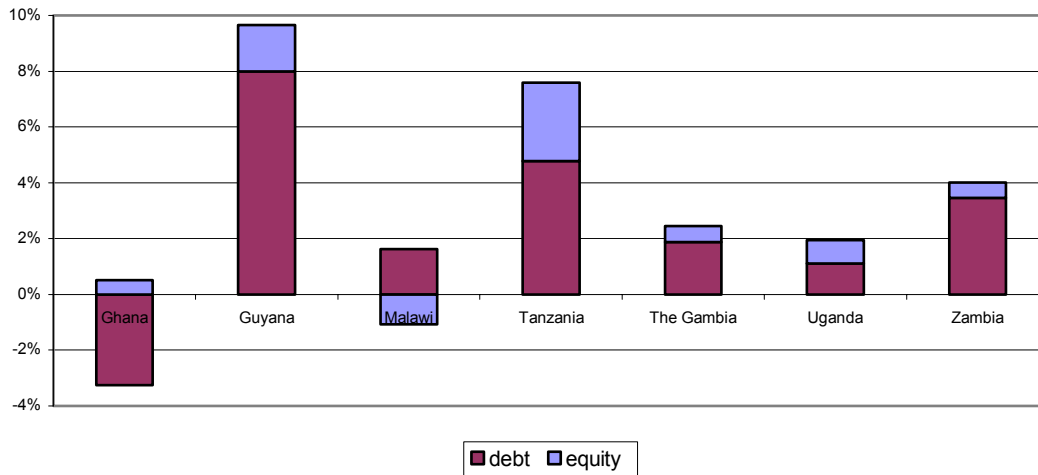
The next most desirable flows in international studies have been assumed to be long-term loans, followed by short-term loans and portfolio equity flows. However, the evidence from low-income countries argues for a much more nuanced analysis of the stability and return on such flows.

In particular, it is vital to distinguish between loans from institutions related to the investors, and those from unrelated institutions. They have fundamentally different purposes and rates of return. Related parent companies of multinational investors often provide large amounts of intra-company loans to support working capital or imports of capital goods. Typically these loans have low or 0 interest rates but very short (1-year) or undefined repayment dates. The subsidiaries prefer these funds largely because they cannot access international bank loans at such low interest rates, and because intra-company loans provide flexible repayments depending on their cash flow positions. The parent companies lend them because their subsidiaries cannot get access to cheap funds otherwise, and because they provide a large “float” which can be withdrawn quickly if there is any sign of economic, political or commodity price instability in the recipient country. These flows therefore represent a large proportion (20-40%) of total foreign capital flows to low-income countries.

Loans from unrelated institutions are very different. They may also 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 (which are usually longer-term than those from related institutions) and higher interest rates, related closely to commercial lending interest rates in their home countries. Nevertheless, the multinationals which have access to such international finance appear to be relatively efficient at mobilising such capital with low interest rates, around international commercial rates for the borrowing currency plus a spread of around 2%. For those companies borrowing in US dollars, this meant rates of around 6% in 2000, falling to 3-4% in 2001-02. Companies borrowing in South African rand were much less fortunate, as rates were 15% on a currency which has recently been appreciating.

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 intra-company and unrelated debt can also be very procyclically volatile, their costs in normal years are much lower than those of equity (see also Martin 2002b).

Figure 8: Net equity and debt flows as a % GDP



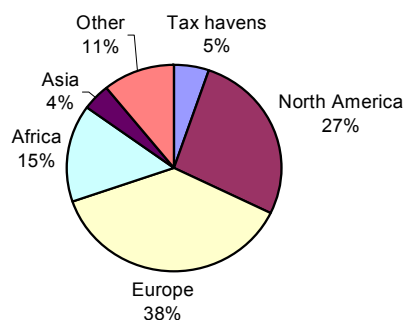
The result for the balance of payments and stability of the economy is shown in Figure 8. Most net inflows are accounted for by debt in the bulk of countries but, in difficult years, both debt (Ghana) and equity (Malawi) can lead to net outflows.

### 2.3. Direction of the Stocks and Flows

#### 2.3.1. Source Countries

Most low-income countries' investment promotion agencies have until recently focussed the bulk of their investment promotion efforts on Europe and North America. Yet the evidence from the countries we have studied is that this focus is rapidly becoming less appropriate. As of the end of 2001, accumulated historical stocks of investment had come 65% from Europe and North America. However, already 35% of stocks were from other regions of the world, especially intra-African and intra-Caribbean, and flows from Asia and Australasia. Of these, a surprisingly high 5% had come from offshore tax havens such as Bermuda, the British Virgin Islands, the Isle of Man, Panama and the Turks and Caicos Islands.

Figure 9: Sources of Foreign Direct Investment



Three further elements of data reinforce this conclusion:

- large amounts of investment by companies which take their decisions in South Africa is classified as from the Netherlands (eg South African Breweries) or UK (eg Anglo American, Old Mutual) because that is where companies are registered. When adjustment is made for this 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%

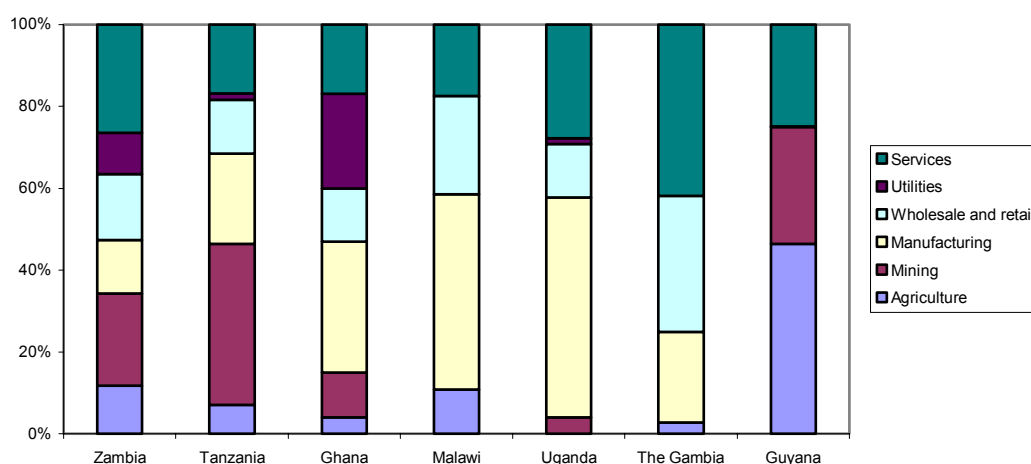
- there is strong evidence that the investment from offshore havens represents investors based in African countries taking decisions to keep funds in these havens, in order to minimise risk, until they are ready to bring them in as FDI.<sup>4</sup> This would push the percentage of intra-African investment to over 30%.
- Flow data indicate that in recent years diversification has been accelerating.

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

### 2.3.2. Recipient Sectors

In international investment fora, it is often suggested that most foreign investment in low-income countries goes into mining and petroleum. However, the evidence from our countries shown in Figure 10 belies this. 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% 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, and tourism in Malawi. Even agriculture receives 5-10% 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 indicate that the diversification is accelerating, with higher proportions of recent flows even than of total stocks in manufacturing and services.

Figure 10: FDEI stocks by sector



<sup>4</sup> 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 the offshore haven) which should be excluded from FDI as it is investment by residents of the country.

### 2.3.3. Recipient Regions

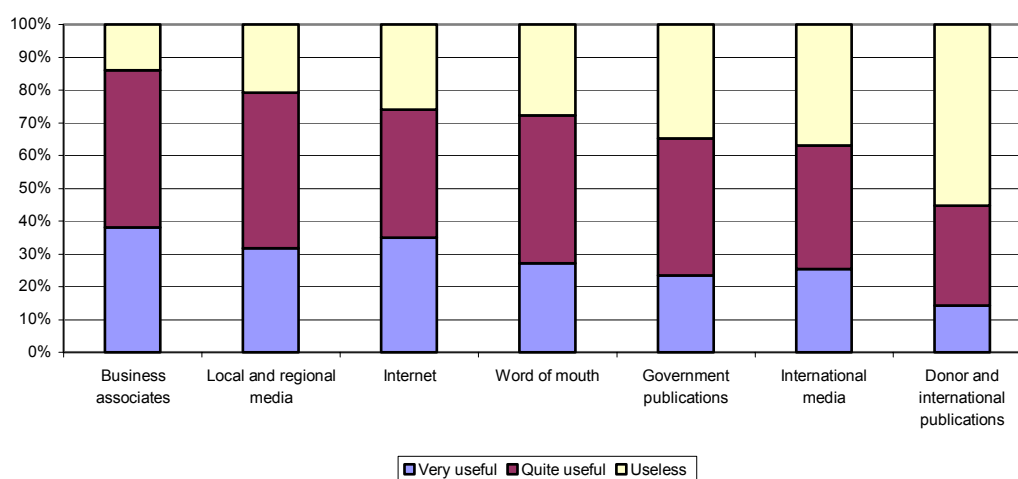
Investment still remains concentrated in one or two regions in most countries - generally those with the best infrastructure (eg where government and business centres are located), human capital and natural resources. Poorer regions in each country tend to lag behind – which is of major concern for policymakers trying to foster more regionally-balanced development under their national poverty reduction strategies. Even where some poorer regions receive massive investment, this can sometimes consist of 1-2 massive enclave projects, making these regions highly dependent on the projects and vulnerable to any problems they may encounter.

## III. WHY IS IT HAPPENING ?

Section II already gave a strong hint as to one reason why foreign private capital is so significant in these countries – profitability. The 2200 international and domestic investors surveyed in these countries indicated a very high level of confidence in the future prospects of their enterprises: 60% indicated responses that they had plans for further expansion (only 10% indicated plans for reduction) and 65%+ indicated that they anticipated increased turnover and profitability in the next 3-4 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 very resilient and have identified techniques to cope with shocks to the wider economy, notably relying on intra-company borrowing as a more flexible form of financing.

A second key reason is that these investors do not share (or even take any notice of) the continuing negative perception of much of Africa as a “basket case” region with high risk and low return, which determines the attitudes of many transnational

Figure 11: Rating the utility of sources of information for investment decision making



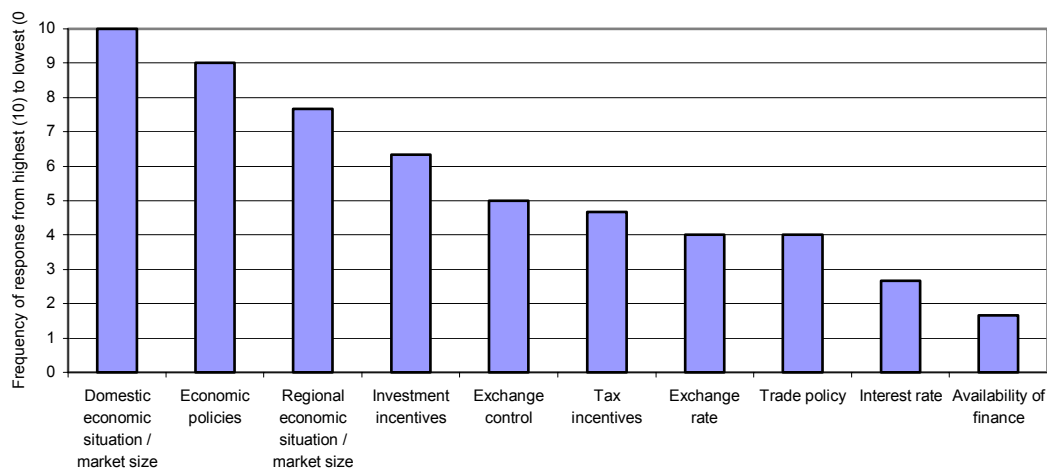
corporation headquarters, the international media, and some rating agencies.<sup>5</sup>

Investors ignore these perceptions in determining risks, and base their decisions on their experience, using the real information available to them. When asked which **sources inform their investment** decisions, as shown in Figure 11, they stress the

<sup>5</sup> For more details of this attitude see Bhinda et al.

views of business associates and the local and regional media, and attach the lowest value to international media and donor and international publications.

**Figure 12: Pull factors motivating initial investment**

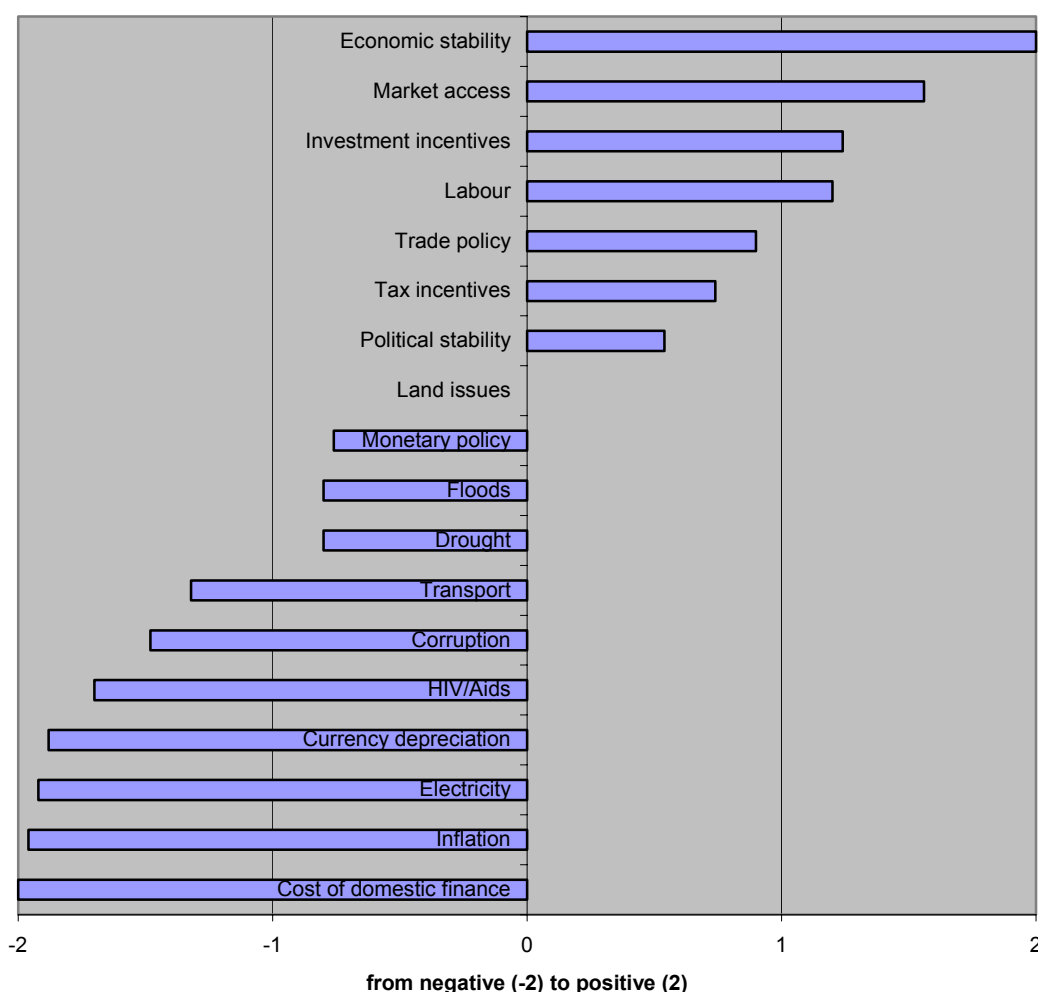


A third reason for the high flows is the large number of components of the business climate which are perceived positively by investors. Their initial decision to invest was motivated by several **positive pull factors**.

However, the most important of these were domestic economic and political stability and access to domestic markets, regional economic and political stability and access to regional markets, and economic policy. Investment incentives (ie liberalisation and one-stop facilitation) came only fourth, and tax incentives only sixth. Privatisation did not feature at all, except for the few investors who had bought privatised companies.

Asked what continues to motivate their positive outlook, as shown in Figure 13, investors continue to stress national economic stability, and market access through regional integration and trade policy. Those who have benefited from investment and tax incentives value these highly, pushing up their importance compared to the initial decision. A major new factor is growing labour skills and productivity. Trade policy is also important because it guarantees regional market access. High ratings for political stability in some countries such as Malawi and Zambia are undermined by negative ratings for political instability in neighbouring Zimbabwe.

Figure 13: Current Investment Influences



As with positive perceptions, negative factors affecting investment are rooted in investors' real experience of constraints 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-initial investment perceptions of low cost 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 in efficiency of (especially electricity) utilities and weak (especially transport) infrastructure. Investors are also increasingly concerned about the effect of HIV/AIDS on their ability to maintain a stable and skilled workforce, and corruption, and occasionally hit hard by climatic shocks.

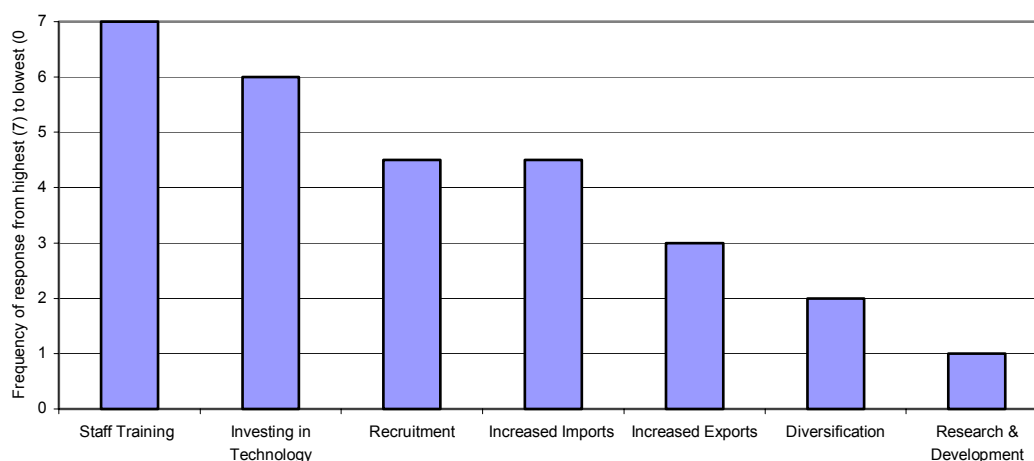
Country-level analysis reveals even more interesting results. For example, the most negative scores are for HIV/AIDS in Malawi and Zambia, demonstrating how in touch actual investors are with key problems facing their societies. In addition, there is a marked variation in country scores, with Tanzania and The Gambia only marginally negative overall across the range, and Malawi and Zambia much more negative. This is in 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 the perceptions of investors are not always in accord with those of international or donor institutions: for example, what most interests them is not the principle of a policy (eg liberalisation) but the practical result (eg devaluation).

The surveys of investor perceptions have also included the **perceptions of resident investors** and therefore the policy measures needed to promote domestic investment and savings. They differ on several issues from foreign investors. In particular, whereas foreign investors (depending on the relative balance between imports and export earnings) are relatively happy with exchange rate depreciation, domestic investors (which are often import-dependent) place a high premium on exchange rate stability. Similarly, foreign investors can usually access relatively cheap offshore finance, and therefore are not as concerned as domestic investors by the high interest cost or lack of access to domestic finance. Thirdly, domestic investors are much less concerned with (or informed about) investment and tax incentives than non-residents.

Investors' positive expectations for the future motivate how they intend to spend their future investment. They prioritise developing the skills of their workforce, investing in technology, and recruiting more labour. In addition, investors also indicate their intention to increase their imports and exports in the medium term.

**Figure 14: Key aims of future investment**



On the other hand, they give lower priority to diversifying their activities. This suggests both that they do not feel pressured by competitors into managing their own business risk by broadening the base of their activities, and that they lack access to capital which would enable them to diversify. Nor do they intend to devote much attention to their own research and development (as opposed to investing in technology supplied by others). Both of these cautious strategies are less positive for future national economic development in that they make the economy less diversified and more dependent on imported technology, but are typical in low-income countries.

## IV. IMPLICATIONS FOR GOVERNMENT POLICY

### 4.1. The Macroeconomic Effects of the Flows

It is no exaggeration to say that, until these new data have emerged, countries had little idea what is happening in their balance of payments, let alone the impact of foreign private capital on the wider economy. While the new data series are 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 (Bhinda et al):

- 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 rather be that country circumstances favour all types of investment. However, the growing numbers 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 very 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, doing most of their business and financing offshore, and paying virtually no tax due to incentives, as a result dramatically reducing their positive contribution to the economy.
- In addition, the high rate of dividends remitted by some sectors indicates a worrying short-term attitude, with companies wanting to get their money back quickly rather than reinvesting it for the long-term. Similarly, many companies are too dependent on loan finance linked to commodity production. The resulting volatility of flows in conditions of commodity price or wider macroeconomic instability makes the flows highly procyclical (ie exacerbating the effects of economic booms or slumps), and therefore an unreliable financing source for long-term sustainable development.
- Many low-income countries have suffered as a result from foreign private capital crises caused by the withdrawal of key large investors or the general reaction of investors to wider national or international factors. Some (fewer) countries have also faced the 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 countercyclical rapidly-mobilised official flows in preserving economic stability and avoiding private capital crises (one which they are failing to play).

### 4.2. Potential Policy Responses

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

- Macroeconomic stability and predictability of policy appear to be the most reliable aims - though investors are anxious that stability not turn into targeting very 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). Especially 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 liberalised their financial flows in the 1990s, partly under pressure from the IMF and partly because they realised

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 liberalisation should be gradual and carefully sequenced, and that countries should retain means of monitoring and analysing flows after liberalisation. Yet, though after many a crisis, this now become accepted wisdom among the G8, very few countries can 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 works even less well in low-income countries with very undeveloped monetary markets in which transmission mechanisms work badly. Measures which have worked better in low-income countries – and been used more often in recent years – have included non-market mechanisms such as moving government deposits from commercial to central banks, and varying reserve requirements on different types of foreign private capital.
- Disastrously, most low-income countries have had to rely on fiscal policy to adjust to foreign private capital crises. This means either using tight fiscal policy to reduce booms caused by too much FPC, or cutting expenditures to make up for shortfalls in private investment. Both are highly undesirable and ruin long-term fiscal and poverty reduction expenditure plans.
- The low level of portfolio flows in almost all countries should not be expected to be reversed in the short-term. There are in most small low-income economies few assets which can be privatised with sufficient profit to be floated on the stock exchange, and international investment funds are (with a few pioneering exceptions) relatively uninterested in these countries. Given the instability of portfolio flows in other regions, countries should focus most of their efforts on encouraging fresh *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.

#### **4.3. Policy Implications of Investor Perceptions**

Obviously investor perception results should not be used in a knee-jerk way to influence policy. They need to be disaggregated and compared with economic reality. For example, if domestic investors are complaining about exchange rate depreciation, but government analyses that such depreciation is necessary as the basis of an export-led development strategy, policy needs to be better explained and discussed, and compensatory measures such as import duty/VAT drawbacks considered, rather than changing the exchange rate policy. Similarly, if investors do not perceive the health of their labour force as a key issue, government needs to do more to explain why it is a key constraint to business success and why all involved must focus on the issue.

However, when well analysed, surveys which cover the opinions of 70-80% of investors provide a much better basis for action than many public-private fora which have been created in recent years, in which analysis is sometimes replaced by grandstanding speeches 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. As a result, it is vital for governments to transmit these results to the international media and donor organisations, and to use them as part of their investment promotion drives.

The main interesting lessons from the investor perceptions results are:

- investors intend to increase their investment. Future surveys will provide more detail on the scale of such increases, as well as checking whether investors lived up to their (probably) optimistic projections. However, the evidence is positive enough to indicate 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 debt cancellation for the poorest countries, are the top priority for investment promotion.
- Investment incentives are also an important factor in decisions, just as bureaucracy is a strong negative factor, so efforts to streamline investment procedures should be reinforced wherever possible.
- Availability of skilled local staff is also vital. This indicates that the current focus on primary education in national poverty reduction strategies is laudable, but also underlines for expanding priorities to include secondary and vocational education.
- Tax incentives are of little importance in investment decisions. This is consistent with findings by many other authors, 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), though very high tax burdens can deter investors (see Bergsman 1999; Martin 1999; Wells et al 2001). This implies that countries need to move away from blanket tax holidays for foreign investors, where major investors have received 5-10 year tax holidays, including all corporate and profits tax, and in some cases even going so far as staff income tax and indirect taxes. Countries should move towards more targeted tax allowances or credits for particular actions such as capital investment or training, as part of a level playing field of a relatively low corporate tax rate for foreign and domestic companies. significantly with the received wisdom and current policy emphasis on tax and investment incentives.
- Investors' intended targets for their future investment fit well with this more nuanced approach. Staff training and upgrading technology are their top priorities and could therefore benefit from incentives (though they might be less needed if companies are keen anyway. On the other hand, encouraging diversification of activities and research and development, and promoting linkages between domestic and foreign investors, look to be more difficult and will require more analysis and carefully targeted incentives.
- It is also essential to combat the negative factors which discourage investors from expanding their businesses. Given that utilities, infrastructure and health (especially malaria and HIV/AIDs) issues are the most important, the intentions in NEPAD and national poverty reduction strategies to overcome these problems are well targeted. So are the governance peer review mechanisms in NEPAD, which should reduce corruption and political instability over time.
- The lack of domestic financing is the major constraint to business. Given that commercial banks are not able 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 be first on the list of policy reforms (see also AERC 1998).

## **V. CAPACITY-BUILDING NEEDS**

Though the current projects are unearthing a huge amount of additional information about the foreign private capital in developing countries, the perceptions and intentions of their suppliers, and the policy implications for the recipient countries, countries are continuing to demand more intensive assistance in this field. They have developed a system to evaluate their capacity in this area each year, of which the latest results indicate a lot of progress on data collection and basic analysis but a need for more 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 derived from approvals of projects by 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. For more detail on the current projects please refer to Annex 1.

As a result of these needs and undertakings, the Governments of Denmark, Sweden, Switzerland and the UK are jointly financing the extension of the 1-year, 8-country pilot Foreign Private Capital Capacity-Building Programme (FPC CBP) into a 3-year programme 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.

## Annex 1

Developing country governments in Africa and Latin America have requested assistance in improving strategies for monitoring foreign private capital, in particular that they want:

- to move rapidly forward to meeting international data dissemination standards for the 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 the simple analysis of motivations to invest and look at 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 analyse 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 analyse for themselves (as opposed to consuming analysis done by donor agencies) the actual and potential contributions of foreign private capital to poverty reduction, including via corporate social responsibility policies (see also Bhinda 2002)
- to collect and analyse all of this information through an integrated national programme which is run by a task force of all relevant government and private sector agencies, who build their own capacity rather than relying on external consultants or international agencies.

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

The programme is run by Development Finance International (a non-profit UK-based company) in partnership with regional organisations run by the countries themselves, to ensure that capacity to assist countries is decentralised and moved closer to the countries.

These organisations are the:

- Banque Centrale des Etats 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 7 low income countries currently participating in the FPC-CBP.

The latest published survey data is: Tanzania (1999); The Gambia, Ghana, Malawi and Uganda (2000); 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 later this year.

For this study on low-income countries, in-country analytical teams provided DFI with their latest finalised survey data. This information is in the public domain, as survey countries disseminate their analytical reports distributing print copies, 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 reinforce their legal and institutional structures, human resources, management and supervision procedures and working environments, to give more 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 is established and a methodology and budget finalised.

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 3 to 1 by close cooperation between the Bank of Uganda, the Uganda Investment Authority and the Uganda Bureau of Statistics.

- Prior to the launch of a survey, 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 3 sections with questions on:

- 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.

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%, producing a 75-80% average response rate among the 7 countries. The data used here is drawn from a total of 2196 processed returns: Ghana 255; Guyana 33; Malawi 155; Tanzania 900; The Gambia 204; Uganda 326; 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.

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

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