I Introduction

Since the early 1970s, foreign direct and portfolio equity investment flows into developing countries, although continuing to increase in absolute terms, have been relatively less important than in previous years, as foreign private capital flows have been dominated by debt-creating bank credit. This shift in the composition of private capital flows may arguably have increased the vulnerability of the developing countries to external payments difficulties, since debt requires regular repayments, while equity implies payments only when the investment earns a positive return. It has also been evident that, with a relatively slow growth of bank lending projected for these countries for the medium term, other sources of external financing, including private equity investment, will be needed if the development effort is to resume its former impetus. In this context, this paper examines the causes and consequences of the decline in the relative importance of direct and portfolio equity investment since the early 1970s, and discusses the modifications in policies in both lending and borrowing countries that might encourage larger flows.

Direct investment can be new equity capital, reinvested earnings, or net borrowing from a parent company or its affiliates. A guiding criterion is that it is investment made to acquire a lasting interest and an effective voice in the management of an enterprise, while portfolio equity investment does not usually have such an aim. In fact, portfolio equity investment in developing countries—although potentially of significance—has been relatively small. Consequently, much of the paper will focus on direct investment, although many of the issues are common to both types of capital inflow. Direct investment also generally involves the transfer of a package of resources, including technological, managerial, and marketing expertise in addition to capital; these may have an even greater impact than the capital flows on a recipient country's production capabilities. However, this paper is mainly concerned with the macroeconomic aspects of direct investment, in particular with its role in capital transfers and adjustment.

Two of the principal issues addressed are why the upsurge in private capital flows to developing countries during the 1970s largely took the form of medium- and short-term bank credits rather than foreign direct or portfolio equity investment; and to what extent equity capital could have been substituted for some of the bank credits if different policies had been adopted by capital-exporting or -importing countries. The increased role of banks in financial intermediation reflected changes in the structure of the international financial system that were accelerated by the increase in oil prices and the accumulation of substantial short-term deposits by the principal oil exporting countries. Much of the expansion in the borrowing from banks was undertaken either by governments of developing countries, to finance balance of payments or fiscal deficits, or by state enterprises, to finance their investment programs. It might have been difficult for foreign equity capital, which is more directly associated with private enterprise investment, to substitute for a substantial proportion of such borrowing, especially in the short term. Most developing countries have limited and fragmented capital markets which makes substitution more difficult, and major differences in economic structure and resource endowments also cause wide variations in their ability to attract direct investment. Moreover, some observers have argued that there are limits on the global supply of funds available for overseas direct investment, because of capital market constraints on transnational corporations. Even so, the longer-term possibilities for substitution between direct investment and commercial bank debt can be significant, especially for those countries with substantial domestic markets or natural resource endowments, which were often among the largest borrowers from commercial banks. In this regard, the policies many developing countries adopted toward foreign equity investment also seem to have contributed to the greater reliance on bank credit.

Developing countries may find it advantageous to rely more on direct and portfolio investment than they have both because of the effects of the composition of capital inflows on adjustment and because of their impact on long-term development strategy. It has already been mentioned that the distribution of a country's external liabilities between debt and equity can significantly affect its vulnerability to unanticipated changes in economic conditions. This is because, unlike interest payments on external debt, no profit payments are required on equity unless the investment earns a positive return. However, the distribution of profits between remitted dividends and reinvested earnings also affects the short-

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term foreign exchange outflow and there are some indications that—at least during the recent recession—remitted dividends fluctuated less with changes in economic conditions than did reinvested earnings. In addition, it can be argued that a larger share of direct investment in capital inflows makes these more sensitive to a country's adjustment policies, since direct investment can increase significantly as more appropriate exchange rates and interest rates are established that make investment more viable.

Foreign direct investment can have a longer-term beneficial impact on a country's development since it is generally directly linked to productive investment and also facilitates the transfer of technology and managerial and marketing skills, the diffusion of which can have substantial effects on productivity growth. In addition to the direct impact of such transfers, the introduction of efficient and internationally competitive enterprises into an economy can also help foster a more general, longer-term improvement in productivity by stimulating the adoption of improved technology and management in other sectors of the economy, in particular among local competitors and suppliers. There are, however, a wide variety of institutional arrangements through which such transfers can be channeled, and alternatives to transfers through wholly- or majority-owned foreign affiliates may sometimes be better suited to the sensibilities of host countries.

In addition, foreign direct and equity investment has become more important in the light of the sharp decline in new commercial bank lending since the onset of widespread debt-servicing difficulties among borrowers. New net bank lending is likely to continue to be constrained, particularly for those countries with especially large amortization payments of rescheduled debt falling due over the next several years. A greater emphasis on policies designed to attract direct and portfolio equity investment could offset part of the overall decline in bank lending.

Section II of this paper discusses trends in the size and composition of foreign private investment and in income payments on such investment. Section III examines the role of direct investment in the transfer of resources, discusses the scope for substitution between direct investment and other forms of resource transfer, and considers some of the possible advantages and disadvantages of allowing foreign private investment a greater role in the development process, with emphasis on the policies of host countries and attitudes of transnational corporations that are likely to increase net benefits from such investment. Sections IV and V describe the policies of host developing countries and capital-exporting industrial countries, respectively, toward such investment. Section VI discusses the influences of foreign private investment on a developing country's adjustment to economic disturbances, and Section VII considers future prospects for and policies toward such investment, in the context of the medium-term scenario for developing countries given in the *World Economic Outlook* series published by the International Monetary Fund. Appendix I discusses some of the difficulties of measuring direct investment. Appendix II lists some of the restrictions and regulations concerning foreign direct and portfolio investment in 25 of the largest borrowing countries. Appendix III contains an empirical examination of the relationships between payments on direct investment and external debt, and host countries' ability to make such payments.

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