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**TRAINING PACKAGE
ON ECONOMIC AND LEGAL ASPECTS
OF INTERNATIONAL INVESTMENT AGREEMENTS (IIAs)**

**MODULE 1
ECONOMIC ASPECTS OF FDI**

**THEME 1
FOREIGN DIRECT INVESTMENT AND TRANSNATIONAL CORPORATIONS:
CONCEPTS, DEFINITIONS AND MEASUREMENT**

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A OVERVIEW

It is important to understand the basic concepts and measures related to foreign direct investment (FDI) and transnational corporations (TNCs) – the main entities that engage in FDI – in order to undertake further study and analysis of the economic and policy aspects of FDI.

Individuals and firms may invest in their home countries and/or abroad. The concept of FDI relates to investment in a foreign location to engage in economic activities there. Such investment is characterized by cross-border control and involvement in management by the investor of the use of the resources that are invested. TNCs are firms that control assets in their home country as well as at least one other country, usually by owning a certain minimum stake in the capital stock. A more elaborate and therefore more precise definition is given in section 3 of this theme. The impressive growth of FDI in the past few decades and the growing importance of FDI as a form of external finance to developing countries reflect not only the fact that firms increasingly find benefits in expanding their production and other economic activities internationally but also that host developing countries see potential advantages in FDI over other forms of international investment, including foreign portfolio investment, in their economies.

Firms engaged in FDI establish foreign affiliates under their control in host economies, creating TNC systems comprising parent companies and foreign affiliates. Foreign affiliates may be wholly-, majority- or minority-owned by their parents. There are two main modes of FDI entry into a host economy: greenfield investment or investment in newly established enterprises, and mergers and acquisitions (M&As). TNCs choose one or the other depending on their industry, objectives and strategies regarding FDI and host-country conditions. FDI made through the two modes may have different possible effects on the host economy in some respects.

The most common measures – though far from perfect – of FDI are FDI flows and stocks. FDI inflows and outflows of countries as measured for balance-of-payments purposes relate to capital transactions between direct investors (mainly TNC parent enterprises) and their affiliates abroad (defined in terms of a minimum ownership of the host-country enterprises by the investors) each year. FDI flows have three components: equity capital, reinvested earnings and intra-company loans. The way in which these components are defined and measured in statistics is important for understanding FDI flow data and analyses based on it. FDI stock measures the accumulated value of capital owned by parent firms in their foreign affiliates; data on stocks are derived from company surveys or as cumulative totals of FDI flows. For several purposes, particularly for understanding the role and significance of FDI and TNC activity for host and home countries, data on variables such as sales, employment and exports by foreign affiliates and parent TNCs are more revealing than those on flows and stocks of FDI, but their availability is much more limited than that of data on FDI flows.

B LEARNING OBJECTIVES

Upon completion of this theme, the students should be able to:

- Understand the concepts of investment and foreign direct investment;

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- Define TNCs and distinguish between the different types of foreign affiliates;
- Understand the differences between FDI and portfolio investment;
- Understand the main entry modes of FDI;
- Understand the main components included in the measurement of FDI flows and the nature and sources of FDI flow data; and
- Understand how FDI stock and other variables related to TNC activity are measured and the nature and sources of data related to them.

C HANDBOOK

1 CONCEPTS OF INVESTMENT

In a broad sense, investment is usually understood as a sum of money or other resources (including, e.g. knowledge or time) spent with the expectation of getting a future return from it. Investment may, however, be viewed more narrowly in different ways, depending upon the context and purpose. The three main approaches to the concept of investment are the following:

- In macro-economics and national accounts, investment means expenditure on new capital goods (goods that are not consumed but instead used in future production), including factory buildings. Such investment is the source of new employment and economic growth.

Examples: production of industrial machinery, building a factory, building a ship for the transport of goods.

- In finance, investment refers to the purchase or ownership of a financial asset with the expectation of a future return either as income (such as dividends), or as capital gain (such as a rise in the value of the stock).

Example: buying shares of an enterprise on a stock market.

- Legal definitions of investment, found in laws and legal agreements, focus on the issue of property, notwithstanding the productive or financial nature of the investment, unless specific limitations are made. Broad definitions in international agreements, for instance, may cover any kind of asset that belongs to a foreign enterprise or an individual. Such definitions would encompass the two forms of investment mentioned above, adding to them non-profit private assets. Definitions in laws or legal agreements can be very different, broad or narrow, depending on the type and the purpose of the legal instrument. They do not serve to shape the concept of investment, but to establish the scope of assets covered by a legal instrument.

Investment by private sector entities is usually undertaken with the expectation of profit. In the first case mentioned above it involves an addition to the firm's productive capacity. In the second case it may or may not increase this capacity: it does when the financial assets

purchased by investors are newly issued by firms to raise funds to create productive capacity. It does not when assets change hands from one owner to another. Acquisitions of assets for non-profit purposes, not used in production (for instance, buying a house), are not considered investment.

As regards FDI, as will be seen below, it can encompass the first (national accounts) approach and elements of the second (financial) approach. As a concept, FDI can be identical with national accounts investment: expenditures on capital goods and factory buildings by foreign enterprises in an economy do not differ from similar expenditures by domestic companies. Production of goods and services by foreign enterprises can be measured as their value added, constituting part of GDP. Differences arise, however, at the entry of foreign investors into a host country, which can take place through a new, so called greenfield, investment (a national accounts concept) or the acquisition of an existing company (a concept of financial investment). As regards definitions of investment for the needs of legal instruments, they typically include both FDI and other types of assets.

Question 1

What are the main differences between the definitions of investment from the macroeconomic, financial and legal points of view? Give examples of investment that falls under each definition.

2 FOREIGN DIRECT INVESTMENT: CONCEPT AND DEFINITIONS

Firms and individuals may invest and hold assets in countries other than their home country in more than one way. When an investor obtains a lasting or controlling interest in the foreign entity, typically an enterprise created or acquired by the investor, the investment is known as foreign direct investment (FDI). For practical purposes this lasting interest is generally assumed if the equity stake of the foreign investor is at least 10 per cent. Definitions of FDI tend to vary across countries and organizations though (see boxes 1 to 4).

Control of (or 'lasting interest in' as in the IMF's definition) an enterprise by a foreign investor is central to the concept of FDI, distinguishing it from other types of international investment. The concept has evolved along with increased understanding of the activities of transnational corporations (TNCs) or multinational corporations (MNCs), which account for most FDI. Firms engage in FDI in order to expand, for instance, their production outside the national boundaries of their home countries, becoming transnational (or multinational) corporations in the process. To produce, TNCs need control to decide what is produced, with what technology, where, etc. For a long time it was thought that majority ownership is the only source of control of one enterprise by another. With time this assumption has been relaxed. First, it has been observed that in many cases a minority ownership can be sufficient to exercise control. And second, certain types of agreements (such as franchising agreements or management contracts) can also be a source of control strong enough to allow controlling firms make production decisions, giving rise to so called non-equity forms of FDI. International production of TNCs such as McDonalds or transnational hotel chains is largely based on control through non-equity forms (see below).

Box 1. UNCTAD experiences with varying FDI definitions - a summary

UNCTAD is very much applying a balance-of-payments definition of FDI, thus following the IMF and OECD definitions (boxes 2 and 3). Nevertheless the organization is dealing with all the different definitions countries are applying. The three important characteristics of FDI definitions elaborated on below give an impression of the existing differences in the definition across countries.

"Components of FDI

The components of FDI are equity capital, reinvested earnings and other capital (mainly intra-company loans). As countries do not always collect data for each of those components, reported data on FDI are not fully comparable across countries. In particular, data on reinvested earnings, the collection of which depends on company surveys, are often unreported by many countries.

The threshold equity ownership

Countries differ in the threshold value for foreign equity ownership which they take as evidence of a direct investment relationship. This is the level of participation at or above which the direct investor is normally regarded as having an effective say in the management of the enterprise involved. The threshold value usually applied for FDI is 10 per cent, for data on the operations of TNCs, it involves chosen ranges of between 10 and 50 per cent. Some countries do not specify a threshold point, but rely entirely on other evidence, including companies' own assessments as to whether the investing company has an effective voice in the foreign firm in which it has an equity stake. The quantitative impact of differences in the threshold value used is relatively small, owing to the large proportion of FDI which is directed to majority-owned foreign affiliates.

Defining a controlling interest and treatment of non-equity forms of investment

Other than having an equity stake in an enterprise, there are many other ways in which foreign investors may acquire an effective voice. Those include subcontracting, management contracts, turnkey arrangements, franchising, leasing, licensing and production-sharing. A franchise (a firm to which business is subcontracted) or a company which sells most of its production to a foreign firm through means other than an equity stake are not usually collected, some countries have begun to contemplate doing so. For example, the OECD treats financial leases between direct investors and their branches, subsidiaries or associates as if they were conventional loans; such relationships will therefore be included in its revised definition of FDI."

Source: UNCTAD 2008.

The expansion of TNC activity worldwide since the early 20th century led to growing interest in FDI as a form of international resource flow as well as a basis for the organization of production activity across national borders. Previously, interest focused on international investment in the form of cross-border bank lending and later on, on portfolio investment and the purchase of shares and bonds of enterprises in one country by investors based in another: these kinds of investment were dominant at that time. The rapid growth of FDI and its growing importance as a source of external finance as well as other resources to developing countries (discussed in module 1, theme 2) in the past two decades has further increased interest in FDI and the international activities associated with it.

FDI is distinguished from other forms of international investment by two characteristics (Dunning 1993, p. 5):

- All international investments are made outside the home country (country of residence) of the investing company, but FDI, in distinction from other forms, is made *inside* the investing firm: control over the use of the resources transferred remains with the investor, allowing him/her to make investment and production decisions.

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- While all investments involve the transfer of capital across borders, FDI involves, in addition to capital, other assets and resources, such as technology, management and other skills, access to markets, entrepreneurship, etc.

Thus, FDI involves more than just the flow of capital to the host country: it is a package of assets and resources, which are many times resources much needed by host countries for their growth and development. It also involves control of the (production) activity by the foreign investor in host countries. The factors giving rise to FDI as well determining its location in different host countries are discussed in theme 3 of module 1 (determinants of FDI).

Since FDI involves control of (or lasting interest in) the enterprise abroad in which investment takes place, it might be expected that FDI would involve a high degree of ownership by the investor. The dominant current definitions of FDI – that prescribed by the IMF for balance-of-payments compilations of data on flows of FDI (box 2) and income related to FDI, and a very similar one adopted by the OECD (box 3) – are formulated in terms of the direct investor having a lasting interest, i.e. a long-term relationship and significant degree of influence on the management of the direct investment enterprise abroad; but they prescribe a relatively low threshold of ownership (10 per cent or more) as the basis for identifying foreign direct investors and the corresponding direct investment enterprises abroad. However, it has been noted that the actual criteria used by countries to identify FDI enterprises (for data gathering purposes, for instance) may deviate from those prescribed in the IMF and OECD definitions (box 4).

Box 2. IMF definitions of FDI and related concepts

Direct investment is the category of international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in an enterprise resident in another economy. (The resident entity is the direct investor and the enterprise is the direct investment enterprise.) The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise. Direct investment comprises not only the initial transaction establishing the relationship between the investor and the enterprise but also all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated.

(...) A **direct investment enterprise** is (...) an incorporated or unincorporated enterprise in which a direct investor, who is resident in another economy, *owns 10 per cent* or more of the ordinary shares or voting power (for an incorporated enterprise) or the equivalent (for an unincorporated enterprise).

Direct investors may be individuals; incorporated or unincorporated private or public enterprises; associated groups of individuals or enterprises; governments or government agencies; or estates, trusts, or other organizations that own (...) direct investment enterprises in economies other than those in which the direct investors reside. The members of an associated group of individuals or enterprises are, through their combined ownership of 10 per cent or more, deemed to have an influence on management that is similar to the influence of an individual with the same degree of ownership.

Source: IMF 1993, pp. 86-87.

Box 3. OECD definition of FDI

Foreign direct investment reflects the objective of obtaining a lasting interest by a resident entity in one economy ("direct investor") in an entity resident in an economy other than that of the investor ("direct investment enterprise"). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise.

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Direct investment involves both the initial transaction between the two entities and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated.

A foreign direct investor is an individual, an incorporated or unincorporated public or private enterprise, a government, a group of related individuals, or a group of related incorporated and/or unincorporated enterprises which has a direct investment enterprise – that is, a subsidiary, associate or branch – operating in a country other than the country or countries of residence of the foreign direct investor or investors.

OECD recommends that a **direct investment enterprise** be defined as an incorporated or unincorporated enterprise in which a foreign investor owns 10 per cent or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise.

The numerical guideline of ownership of 10 per cent of ordinary shares or voting stock determines the existence of a direct investment relationship. An effective voice in the management, as evidenced by an ownership of at least 10 per cent, implies that the direct investor is able to influence or participate in the management of an enterprise; it does not require absolute control by the foreign investor.

Source: OECD 1996, pp. 7-8.

As mentioned earlier, foreign firms may also be able to control or exercise effective voice in the management of enterprises in a host country through non-equity arrangements of some kinds. Non-equity or contractual agreements vary in the nature of the relationship between the parties involved. Some of them, such as franchising (popular in fast food, car rentals and retail trade), management contracts (popular in the hotel industry) and partnership agreements (popular in business consultancy and legal services) may give companies providing the brand names and proprietary technology (including soft technology such as organizational and managerial practices and other knowledge) to host-country enterprises sufficient voice in management and control over the latter for them to be considered direct investors engaged in FDI. For practical purposes of data collection, the IMF and OECD definitions of FDI do not, however, include non-equity forms of FDI within their scope (box 5). FDI is generally conceived of as involving a minimum equity share by the investor.

Box 4. Other approaches to identifying FDI

Although not recommended by the OECD, some countries may still feel it necessary to treat the 10 per cent cut-off point in a flexible manner to fit the circumstances. In some cases, the ownership of 10 per cent of the ordinary shares or voting power may not lead to the exercise of any significant influence while, on the other hand, a direct investor may own less than 10 per cent but have an effective voice in the management. OECD does not recommend any qualifications to the 10 per cent rule. Consequently, countries that choose not to follow the 10 per cent rule in all cases should identify, where possible, the aggregate value of transactions not falling under the 10 per cent cut-off rule, so as to facilitate international comparability.

Some countries may consider that the existence of elements of a direct investment relationship may be indicated by a combination of factors such as:

- a) Representation on the board of directors;
- b) Participation in policy-making processes;
- c) Material inter-company transactions;
- d) Interchange of managerial personnel;
- e) Provision of technical information;
- f) Provision of long-term loans at lower than existing market rates.

Other relationships may exist between enterprises in different economies which exhibit the characteristics set out above, although there is no formal link with regard to shareholding. For example, two enterprises, each operating in different economies, may have a common board and common policy-making and may share resources including funds but with neither having a shareholding in the other of 10 per cent or more. In such

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cases where neither is a direct investment enterprise of the other, the transactions could be treated as between related subsidiaries (...). These are not regarded as direct investment.

Source: OECD 1996, p. 8.

Box 5. What is not FDI

a) An enterprise undertakes to build for a foreign client, usually a Government, a complete manufacturing plant, to provide technical know-how, and to manage and operate a plant for a number of years, without an ongoing on-site managerial presence and without other criteria for existence of a direct investment enterprise being met. It has complete control over day-to-day operations and receives a management fee, paid either in cash or in goods produced by the plant. However, the enterprise has no equity stake in the plant and is performing a cross-border service.

b) An enterprise has a long-term contract with a foreign company, provides it with technical know-how, and has considerable influence over the quality and quantity of output. The enterprise may provide a loan to the foreign company and sometimes will have a member on the company's board. However, there is no equity stake. It is once again a cross-border service.

c) Some host countries have made agreements with a number of foreign enterprises where the host country supplies factory accommodation, electricity, staff accommodation, administration and labor. The foreign enterprise supplies all production machinery, fixtures and fittings for the building and production materials, and is responsible for the initial training of the labor force. The foreign enterprise then pays an agreed piecework rate for each item produced. Where the production machinery and fixtures and fittings remain the property of the foreign enterprise, there is technically a direct investment branch, though the branch's profits will be zero. There is no direct investment interest if the machinery becomes the property of the host country.

d) Some professional firms operate much like a multinational firm, but do not hold equity in one another. For example, unaffiliated (in an equity sense) accounting or management consulting firms may operate globally under a single name, refer business to one another and receive fees in return, share costs (or facilities) for such items as training or advertising, and may have a board of directors to plan business strategy for the group. This is not direct investment, and would be difficult or impossible to account for as such, but it does have much in common with direct investment.

e) Other cases might include foreign sales and representative offices, as well as foreign stations, ticket offices, and terminal or port facilities of domestic airlines or ship operators. Such offices or activities can be treated as direct investment only if they meet the requirements of residence and the attribution of production in an economy as defined in the IMF Balance of Payments Manual, Fifth Edition.

Source: OECD 1996, p. 9.

Question 2

List and discuss the main characteristics that define FDI.

How can a lasting interest be identified? In your opinion, what other type of interest can an investor have in an enterprise?

Question 3

Give examples of possible reasons for not applying the 10 per cent threshold of foreign equity ownership in identifying FDI.

3 TRANSNATIONAL CORPORATIONS (TNCs) AND RELATED CONCEPTS

As noted in the preceding section, FDI is undertaken mainly by transnational corporations (TNCs), and the concepts of FDI and TNCs are closely interlinked. Broadly defined, a TNC

is an enterprise that engages in FDI and owns or controls value-adding activities in more than one country (Dunning 1993, p. 3). Definitions that elaborate further the characteristics considered necessary for a firm to be considered a TNC are given below (box 6).

Box 6. Definitions of transnational corporations and enterprises

A. The Draft United Nations Code of Conduct on Transnational Corporations (para. 1) has defined “transnational corporations” to mean: “an enterprise, comprising entities in two or more countries, regardless of the legal form and fields of activities of these entities, which operates under a system of decision-making, permitting coherent policies and a common strategy through one or more decision-making centres, in which the entities are so linked, by ownership or otherwise, that one or more of them may be able to exercise a significant influence over the activities of others, and, in particular, to share knowledge, resources and responsibilities with the others.”

B. The Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices adopted by the United Nations General Assembly on 5 December 1980 provides that the term “enterprises” means: “firms, partnerships, corporations, companies, other associations, natural or juridical persons, or any combination thereof, irrespective of the mode of creation or control or ownership, private or State, which are engaged in commercial activities, and includes their branches, subsidiaries, affiliates, or other entities directly or indirectly controlled by them.”

C. The OECD Guidelines for Multinational Enterprises (para. 8) describe a multinational enterprise as: “These usually comprise companies or other entities whose ownership is private, state or mixed, established in different countries and so linked that one or more of them may be able to exercise a significant influence over the activities of others and, in particular, to share knowledge and resources with others. The degrees of autonomy of each entity in relation to the others varies widely from one multinational enterprise to another, depending on the nature of the links between such entities and the fields of activity concerned.”

Source: UNCTAD 1999b, pp. 45-46

Question 4

Give examples of TNCs you know, preferably from your country. Discuss them in groups to identify their common features.

TNCs are thus incorporated or unincorporated enterprises comprising parent enterprises (based in their home countries) and their foreign affiliates (located in host countries) (see UNCTAD 2008):

- ❑ **A parent enterprise** is defined as an enterprise that controls assets of other entities in countries other than its home country, usually by owning a certain equity capital stake.
- ❑ **A foreign affiliate** is an incorporated or unincorporated enterprise in which an investor, who is resident in another economy, owns a stake that permits a lasting interest in the management of that enterprise (an equity stake of 10 per cent for an incorporated enterprise or its equivalent for an unincorporated enterprise is the usual threshold).

Question 5

In your opinion, are all TNCs large companies in terms of assets or sales? Justify your answer.

Foreign affiliates include subsidiary enterprises, associated enterprises and branches, as defined below (see also box 7 and UNCTAD 2005, p. 297):

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- ❑ A subsidiary is an incorporated enterprise in the host country in which the parent entity directly owns more than half of the shareholders' voting power and has the right to appoint or remove a majority of the members of the administrative, management or supervisory body.
- ❑ An associate is an incorporated enterprise in the host country in which the parent entity owns a total of at least 10 per cent, but not more than half, of the shareholders' voting power.
- ❑ A branch is an unincorporated enterprise in the host country that is wholly or jointly owned by the parent entity.

Subsidiaries and associate enterprises are incorporated in the host country and are hence legal entities that are directly or indirectly owned or controlled by foreign nationals or companies. Branches are unincorporated enterprises and are not legal entities separate from their owners; the fixed and other assets used in branches do not belong to them but to the parent entities. Branches as such can neither engage in transactions with other economic units nor can they enter into contractual relationships with other units or incur liabilities on their own behalf.

Box 7. Subsidiaries, associate companies and branches

OECD recommends the following definition of these enterprises:

Subsidiary companies

Company X is a subsidiary of enterprise N if, and only if:

- i) enterprise N either
 1. is a shareholder in or member of X and has the right to appoint or remove a majority of the members of X's administrative, management or supervisory body; or
 2. owns more than half of the shareholders' or members' voting power in X; or
- ii) company X is a subsidiary of any other company Y which is a subsidiary of N.

Associate companies

Company R is an associate of enterprise N if N, its subsidiaries and its other associated enterprises own not more than 50 per cent of the shareholders' or members' voting power in R and if N and its subsidiaries have a direct investment interest in R. Thus company R is an associate of N if N and its subsidiaries own between 10 and 50 per cent of the shareholders' voting power in R.

Branches

A direct investment branch is an unincorporated enterprise in the host country that:

- i) is a permanent establishment or office of a foreign direct investor (...); or
- ii) is an unincorporated partnership or joint venture between a foreign direct investor and third parties (...).

Source: OECD 1996, p. 10.

Question 6

Define a TNC. Define parent enterprises and foreign affiliates.

Define the main types of foreign affiliates. What is the difference between them?

The production of goods and services under the control or governance of TNCs. constitutes what is called international production. For the world economy as a whole, international production comprises the production of parent firms (and their domestic affiliates) in their home countries and that of their foreign affiliates in host countries.

International production in TNC home countries includes production by parent firms and their domestic affiliates in those countries, while international production in host countries includes production by foreign affiliates located in those countries. The concept of international production is generally confined to production by TNC systems narrowly defined (comprising parents and their domestic and foreign affiliates). A broader view of TNC systems would include also other firms associated with TNCs, such as suppliers and partners in various kinds of alliances and agreements related to their production activities.

The universe of TNCs is large, diverse and expanding. By the early 1990s, there were an estimated 37,000 TNCs in the world, with at least 170,000 foreign affiliates. Of these, 33,500 were parent corporations based in developed countries. By 2004 the number of TNCs had risen to some 70,000 with at least 690,000 foreign affiliates, almost half of which are now located in developing countries (UNCTAD 2005, p. 14).¹

Because large TNCs account for a significant part of world FDI and international production – with some of them operating hundreds of plants around the world – attention is often focused on them. However, the number of small- and medium-sized TNCs has been growing and their role in international production activity receiving recognition in recent years.

4 FDI AND PORTFOLIO INVESTMENT

As noted, the most important characteristic of FDI is that it is undertaken with a view to control or exercise significant management interest over the enterprise in which the investment is made. In contrast, portfolio investment is not made with the objective of exerting a significant influence over the invested enterprise, but only with the expectation of a future return such as dividends or capital gain (box 8). Foreign direct investors are generally producers of goods and services, while foreign portfolio investors are often financial institutions, institutional investors or individuals. Nevertheless, the dividing line between the two is not always clear cut, and an arbitrary 10 per cent equity stake is used to distinguish between them for data collection purposes.

Traditionally, investment in companies has been categorized as either direct or portfolio investment. In the nineteenth century, because of the difficulties of controlling an enterprise from abroad, the dominant form of investment in foreign companies was portfolio investment, with the principal exceptions being in specific sectors (e.g., public utilities, natural resources). By the mid-twentieth century, however, with the liberalization of foreign investment regimes as well as further improvements in transportation and communication, the stock of FDI exceeded the total amount of foreign portfolio investment (UNCTAD 1999b, p. 8).

This evolution may have also reflected a change of perception regarding FDI. The question of ownership and control by foreigners has become less problematic as awareness has grown of the role that FDI can play as an external resource, especially for countries with difficulties in obtaining access to other types of financing. Perceptions regarding the potential economic impact of the two kinds of flows and experience have also played a role. For instance, developing countries concerned about the vulnerability of their balance of payments to volatile capital flows have often been cautious about foreign

¹ For regular updates, see the annual reports in UNCTAD's World Investment Report series and www.unctad.org/wir.

portfolio investment, sometimes perceived as purely speculative, while favoring FDI, perceived as productive investment. As FDI by definition involves a lasting interest of the foreign investor, it is usually associated with long-term flows, more stable compared to portfolio investment, which is often short-term.

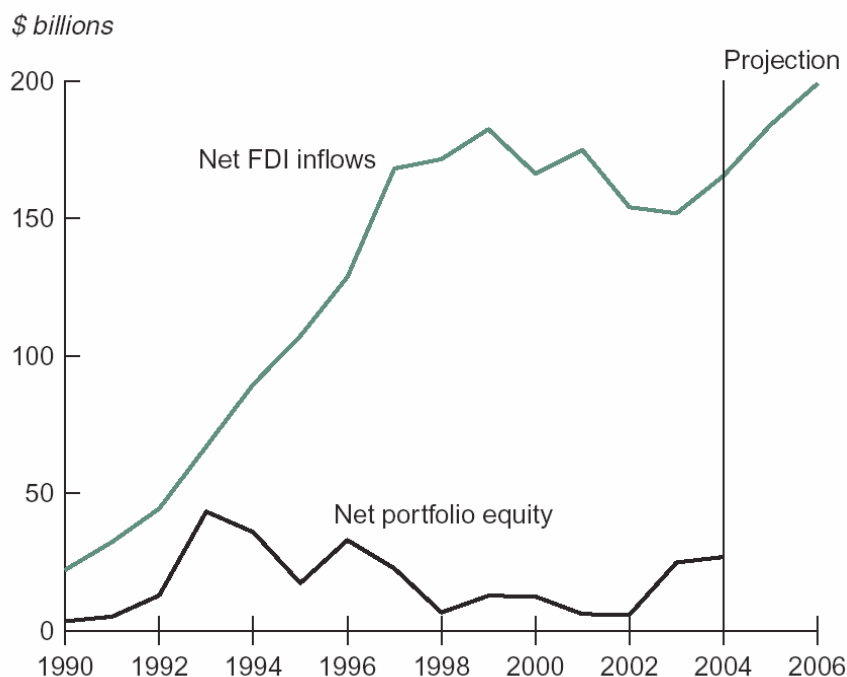
Box 6. Direct and portfolio investment - different interests of investors

The benefits that direct investors expect to derive from a voice in management are different from those anticipated by portfolio investors having no significant influence over the operations of enterprises. From the viewpoint of direct investors, enterprises often represent units in a multinational operation, the overall profitability of which depends on the advantages to be gained by deploying the various resources available to the investors in units located in different economies. Direct investors are thereby in a position to derive benefits in addition to the investment income that may accrue on the capital that they invest (e.g., the opportunity to earn management fees or other sorts of income). Such extra benefits are likely to be derived from the investors' associations with the enterprises over considerable periods of time. In contrast, portfolio investors are primarily concerned about the safety of their capital, the likelihood of appreciation in value, and the return generated. Portfolio investors will evaluate, on a separate basis, the prospects of each independent unit in which they might invest and may often shift their capital with changes in these prospects, which may be affected by short-term developments in financial markets.

Source: IMF 1993, p. 86.

Since the beginning of the 1990s, FDI flows to developing countries have become larger than portfolio investment flows to those countries (figure 1). FDI now represents the largest source of external finance for developing countries (see theme 2 of this module). Figure 1 also illustrates the rapid growth of FDI inflows in this period, discussed in more detail in module 1, theme 2.

Figure 1. FDI and portfolio flows to developing countries, 1990-2004



Source: World Bank 2005, p. 16.

However, it must be noted that enterprises with active financial policies often engage in portfolio investment, and not necessarily for financial speculation purposes but for risk management. Foreign portfolio investment can often be found as part of the investment

activity of a TNC. Moreover, even though in most cases, portfolio investment is a short-term investment, and more sensitive to financial crises, exchange rate fluctuations and other changes than FDI, the investment horizon for portfolio investment can also be long-term in nature. This helps explain why many countries nowadays seek to attract both FDI and foreign portfolio investment.

Question 7

What is portfolio investment? Give examples.

Question 8

Does only short-term investment classify as portfolio investment? Justify your answer.

Discuss in two groups possible reasons why, in your opinion, a country may prefer one form of foreign investment to the other.

What reasons can you find for the fact that, in a host economy that allows both FDI and portfolio investment, FDI flows are larger than portfolio flows? Discuss them in groups.

5 MODES OF FDI ENTRY

FDI may enter a host country in two different ways: through new or greenfield investment; or through a merger with or acquisition of an enterprise that already exists in the host country. Mergers and acquisitions (M&As) are the dominant mode of TNC entry in developed countries, and are growing in importance in developing countries as well. TNCs choose between the two modes of entry on the basis of their objectives, as well as industry characteristics and host-country characteristics and regulations. The choice of entry mode has implications for both TNCs and host countries.

Greenfield investment. A TNC can choose to undertake greenfield investment – that is, set up a new production venture -- in a host country: While the factors underlying the choice are specific to individual firms, the greenfield mode of entry is more likely when speed of entry and access to proprietary assets are not priorities for the investing firm, and when the possibilities for entry through M&As, the alternative mode of entry, are limited due to lack of suitable target firms to acquire or regulatory obstacles to M&As. Greenfield FDI is the principal form of FDI entry into developing countries, in many of which enterprise development is limited, acquiring proprietary assets is rarely the motive for FDI, and M&As by foreign firms are often restricted (box 9). Developing countries may prefer greenfield investment to M&As because the latter, which by definition involve a transfer of assets from domestic to foreign investors, at least initially do not add to the productive capacity of host countries.

Mergers and acquisitions. The second possible mode of FDI entry is for an investing firm to merge with or acquire an existing local firm in the host country.

- ❑ In a cross-border merger, the assets and operations of two firms belonging to two different countries are combined to establish a new legal entity.
- ❑ In a cross-border acquisition, the control of assets and operations is transferred from a local to a foreign company, the former becoming an affiliate of the latter.

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Cross-border acquisitions dominate the M&A mode of FDI entry. Mergers are relatively rare: for instance, less than 3 per cent of cross-border M&As by number were found to be mergers in 1999 (UNCTAD 2000, p. 101). Moreover, even when mergers are supposedly between relatively equal partners, most are in fact acquisitions with one company controlling the other. The number of “real” mergers is so low that it has been suggested that for all practical purposes, “M&As” basically means acquisitions.

Question 9

Discuss in two groups the possible reasons for which an investor might prefer a merger to an acquisition and vice versa.

As noted, cross-border M&As are the principal mode of FDI entry into developed countries. Their importance in developing countries has also grown, partly because of privatization programmes open to foreign investors and special circumstances such as the Asian financial crisis of the late 1990s when distressed private firms in affected countries were made available for acquisition by foreign firms. The 1990s, in particular, saw a dramatic increase in cross-border M&As, which rose in value from \$US150 billion in 1990 to a record \$US1.1 trillion in 2000, which represented 82 per cent of world FDI inflows. Although the wave of M&As has slowed down after 2000, they continue to account for a significant part of global FDI flows, e.g. the \$US880 million of M&As in 2006 accounted for 67 per cent of the \$US1306 million FDI inflows in the same year.²

Question 10

Name two reasons that would make M&As more popular as modes of FDI entry in developed countries than in developing countries.

The choice between M&As and greenfield investment as modes of entry depends on the motives and strategies of firms as well as host-country conditions. From the foreign investor’s end, the choice between M&A and greenfield modes of entry is driven by several factors. The most important reasons why firms prefer to expand internationally through M&As rather than greenfield ventures include the speed with which M&As enable the attainment of desired goals such as a certain production capacity, market size or level of profit, and the quest for strategic assets that host-country firms may possess. Other factors, which play out differently in different industries and markets, include the search for new markets and market power; anticipated efficiency gains through synergies; the quest for a greater size (particularly in operations requiring economies of scale, large expenditures for R&D or the expansion of distribution networks for example); desire for risk reduction through product or geographical market diversification; financial motives; and even personal gains for corporate managers. At the host-country end, the main factors affecting the choice include the availability of suitable target firms for M&As and the policy and institutional framework for M&As (box 9).

Box 9. Host country factors that influence FDI entry modes

Level of economic development. While both modes may be options in developed countries with a large pool of strong private enterprises and well-functioning markets for corporate control, this is not always the case in developing countries and economies in transition. For example, M&As are typically not a realistic alternative to greenfield investment in the least developed countries, in which investment opportunities may exist but there are few firms to acquire. In other developing countries with a more advanced industrial sector

² For regular updates, see the World Investment Report series at www.unctad.org/wir. As shown in box 11 caution is though needed not to necessarily count M&As entirely as FDI flows.

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and more developed capital markets, the acquisition of a local firm can represent a realistic alternative to greenfield FDI. Mergers between local firms in many developing countries and developed country firms are typically not feasible because of large differences in size, technology or management experience. In general, the higher the level of development of a host country, the larger the supply of firms that may be targeted for cross-border M&As.

FDI policy. Another obvious prerequisite for cross-border M&As is that they have to be permitted by the national regulatory framework. The liberalization of FDI regimes has gone far, and most countries now actively promote the inflow of FDI. In many cases, liberalization applies to both greenfield FDI and cross-border M&As. However, in a number of developing countries, foreign takeovers are de facto (if not de jure) restricted. Even in some developed countries, authorization is needed for the acquisition of companies in certain industries. Policy liberalization as regards foreign acquisitions has been shown to have a strong impact on the pattern of inward FDI in countries with a strong industrial base. In Argentina, for example, cross-border M&As accounted for almost 60 per cent of total FDI inflows between 1992 and 1999. While privatization was initially responsible for the bulk of M&As, foreign acquisitions of private firms also gradually increased in importance.

Institutional framework. The balance between cross-border M&As and greenfield FDI is also related to the institutional environment. For example, even among developed economies, the use of M&As is affected by differences in corporate governance and ownership structure. These help to explain the diverging patterns of M&As in the United States and the United Kingdom, on the one hand, and Germany and Japan on the other. In developing countries, underdeveloped asset markets and poor accounting standards may make it more difficult to assess accurately the value of corporate assets.

Exceptional circumstances. Examples include financial crises (as in East Asia in 1997-1999) and large privatization programmes (as in Latin America and Central and Eastern Europe). Both produced, though for different reasons, a large one-off supply of firms in financial or competitive trouble. In both sets of circumstances, policy-makers have welcomed the cross-border acquisitions of local enterprises: greenfield FDI could not in these circumstances play the role of cross-border M&As in rescuing ailing companies and restructuring state-owned firms.

Source: UNCTAD, UNCTAD 2000, pp. 160-161.

Question 11- Role-play

A TNC specialized in textile manufacturing wants to invest in your country. It seeks to increase its productive capacity through opening a plant there; it intends to export a part of the production of this plant to developed country markets, the rest being sold on the host country market.

Find possible arguments in favour (group 1) and possible arguments against (group 2) the choice of a greenfield investment instead of a merger or acquisition from the point of view of the host country.

Find the same from the point of view of a TNC (group 3 for greenfield versus group 4 for merger or acquisition).

At the end, discuss your arguments as follows: group 1 with group 4 and group 2 with group 3. The purpose is for each group to convince the other that investment according to its preferred entry mode is the preferable option.

6 MEASUREMENT OF FDI AND TNC ACTIVITY

The measurement of FDI and related economic activities is useful for monitoring trends and patterns in FDI at the country, regional and global levels, analyzing the impact of FDI and international production on home and host economies and providing a basis for informed policy decisions about FDI and for international negotiations on FDI. Overall, data gathering on FDI is much less developed than that on international trade and systematic

data at the industry level are lacking for most countries. But data on a few indicators are widely available and on a larger number, available for selected countries.

The most common indicators are FDI flows and stocks. Data on these are gathered on the basis of an ownership criterion for identifying FDI, generally based on the IMF and OECD definitions (section 2) and exclude non-equity forms of FDI. Though they have various limitations, flow and stock data are available for many countries and thus allow inter-country comparisons and provide a basis for obtaining regional and global totals.

Other measures relate to the activities or operations of parent firms and foreign affiliates, e.g. investment expenditures, sales, assets, employment, output, exports, etc., on which data are collected in some countries. Data on the number of TNC parent companies and foreign affiliates by country are collected by UNCTAD from individual countries. UNCTAD also collects data on the assets, sales, employment and number of affiliates of the hundred largest TNCs world-wide and the 50 largest TNCs in developing countries.

6.1 FDI flows and stocks

FDI flows are measured as the value of all capital transactions between direct investors (parent enterprises) and their foreign affiliates during a given period. Data are collected by each country separately on its FDI outflows (capital provided either directly or through other related enterprises by direct investors based in the country to their foreign affiliates) and FDI inflows (capital received by foreign affiliates located in the country from their parent firms, either directly or through other related enterprises), on an annual basis. The data are reported in the country's balance-of-payments accounts as "direct investment, credits"(referring to inflows) and "direct investment, debits" (referring to outflows).

FDI flows measured as described above include three components: equity capital, reinvested earnings and intra-company loans (box 10; UNCTAD 2005, pp. 297-298).

- ❑ Equity capital is the direct investor's purchase of shares of an enterprise in a country other than that of its residence.
- ❑ Reinvested earnings comprise the direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by its foreign affiliates, or earnings not remitted to the direct investor. Such retained profits are considered to be reinvested.
- ❑ Intra-company loans or intra-company debt transactions refer to short- or long-term borrowing and lending of funds between direct investors and their foreign affiliates.

Data on FDI flows are reported on a net basis for each FDI project (capital transactions' credits less debits between direct investors and their foreign affiliates) in countries' balance of payments accounts. Net decreases in assets (outward FDI) or net increases in liabilities (inward FDI) are recorded as credits (recorded with a positive sign in the balance of payments) while net increases in assets or net decreases in liabilities are recorded as debits (recorded with a negative sign in the balance of payments). In common or analytical usage, the negative signs are reversed for practical purposes in the case of FDI outflows; hence, data on FDI flows with negative signs usually indicate that at least one of the three components of FDI is negative and is not offset by positive amounts of the other

components. These are instances of reverse investment or disinvestments by direct investors of the country concerned, in the case of outward FDI flows and disinvestments by direct investors of other countries combined, in the case of inward FDI flows.

Box 10. IMF definitions of FDI components

Equity capital covers equity in branches, shares (whether voting or non-voting) in subsidiaries and associates, and other capital contributions (such as the provision of machinery by a direct investor to a direct investment enterprise) that constitute part of the capital of the direct investment enterprise. Equity capital also covers the acquisition by a direct investment enterprise of shares in its direct investor. However, nonparticipating preference shares are not part of equity capital but are treated as debt securities and classified as other direct investment capital. Purchases and sales of land and buildings by nonresidents are also included in the equity capital component.

Reinvested earnings are the direct investors' shares (in proportion to equity held) of the undistributed earnings of the direct investment enterprises. Reinvested earnings are considered to be additional capital of the direct investment enterprises. They are recorded as direct investment income, with an offsetting capital transaction.

Other capital (or inter-company debt transactions) covers the borrowing and lending of funds, including debt securities and trade credits, between direct investors and direct investment enterprises, and between two direct investment enterprises resident in different countries that share the same direct investor. Debt claims on the direct investor by the direct investment enterprise are also included as direct investment other capital. As indicated above, nonparticipating preference shares are treated as debt securities and are therefore classified as other capital.

Source: IMF and OECD 2003, p. 35.

Data on FDI flows of countries have a number of shortcomings. The data are collected primarily by the central banks for balance-of-payments purposes and often exclude reinvested earnings, which can be an important component of FDI flows. In some countries, boards of investment or investment promotion agencies are the main sources of data on FDI flows, and the data they provide are often on FDI approvals rather than values of implemented projects; they also tend to be incomplete, as these agencies typically deal only with manufacturing FDI. Annex 1 provides guidelines provided by the OECD on the compilation of FDI data and annex 2, information on sources and methods of FDI data collection.

In addition to data on FDI inflows and outflows, the balance-of-payments statements of countries also report data on flows of direct investment income from foreign affiliates to parent firms. Thus for each country, data are reported on inflows of direct investment income from foreign affiliates of parent firms based in the country and outflows of such income from foreign affiliates located in the country to their parent firms abroad.

While FDI flows are measures of annual inflows and outflows of FDI, FDI stock is the accumulated value of assets due to those flows. It is measured as the share of a parent enterprise in its foreign affiliates' capital and reserves (including retained profits), plus the net indebtedness of the foreign affiliates to the parent enterprise. A country's outward FDI stock is the sum of the FDI stocks of parent enterprises based in the country, and its inward FDI stock, the sum of FDI stocks held in foreign affiliates located in the country by their parent enterprises abroad.

FDI stocks show the direct investment positions of countries at a given point in time. As long as FDI flows are positive, even if they decline from year to year, they increase

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countries' FDI stocks. FDI stocks provide a better long-term picture of a country's FDI performance than flows, which can fluctuate from year to year.

Data on outward and inward FDI stock are collected in some countries through periodic surveys of direct investment enterprises (parent companies and their foreign affiliates and foreign affiliates in the country) that also collect other financial and operational data. The stock values obtained from these surveys generally reflect the book value of assets (on a historical basis) rather than market value which is considered preferable (e.g. by the OECD – see annex 1) as the basis for stock valuation to compare assets of different vintages. Between periodic surveys, and in the case of countries that do not conduct such census or benchmark surveys, stock data can be estimated by adding annual FDI flows; this is done, for example, to calculate the FDI stock figures in UNCTAD's World Investment Reports.

Data on FDI flows and stocks are widely used to monitor trends in countries' FDI and to make inter-country comparisons, both of the flows and stocks themselves and of their importance relative to other national aggregates such as gross fixed capital formation and GDP. They are used as indicators not only of the capital or resource flows (annual and accumulated) due to TNC activity, but also as rough indicators of the international production activity of TNCs. It must be recognized, however, that FDI flows are not investment in the national-income accounts sense (expenditure on new capital goods or fixed assets), but capital flows in the balance-of payments-sense (credits and debits on the international capital account). Thus, although the concept of FDI relates to the cross-border expansion of production by TNCs (and hence, investment in fixed capital or production facilities), changes in FDI flows and stocks may, or may not, be accompanied by closely corresponding changes in production capacity and production activity by TNCs (annex 3). This could happen, moreover, not only because all of the financial flow recorded as FDI may not go into fixed investment in foreign affiliates, but also because TNCs can draw on other resources (such as borrowing in host-country or international markets) besides their FDI flows to finance capital formation in foreign affiliates.

Box 11. FDI flow data vs. M&A data

Mergers and acquisitions (M&As) have a large share in FDI flows, but M&A transactions are not necessarily counted entirely as FDI, even if undertaken by a foreign investor. Indeed there are other sources of finance for foreign investors not captured by FDI flows. A simple case could be that the foreign investor is using local or international capital markets to finance parts of the acquisition, thus reducing the financial transfer from his home country that is counted as FDI. Furthermore, the payment might be phased over several years such that the year of acquisition is not the year the FDI flow is registered.

A practical example is reported from Brazil. In July 1998, Brazil privatized Telebrás System, the state-owned Brazilian group comprised of some 20 Brazilian telecommunications companies. The state sold its interests in Telebrás System for \$US18.9 billion. Foreign investors invested \$US12.62 billion (or about two-thirds of the total sale). The payments were supposed to be phased over three years, with 40 per cent in 1998, 30 per cent in 1999 and 30 per cent in 2000.

The payments from 1998 were made in 1998; the payments for 2000 were advanced in 1999 and made together with the 1999 payments. Out of the total of \$US12.62 billion, \$US5.26 billion were paid in 1998, of which \$US2.72 billion were borrowed in international capital markets.

If the total amount paid by foreign investors for the privatization of Telebrás (\$US12.62 billion) would have been calculated as a per cent of total 1998 FDI inflows (or \$US26 billion), the ratio would have been 48 per cent. In reality, however, only about 10 per cent consisted of FDI inflows on account of Telebrás privatization in 1998.

Caution is therefore needed when calculating M&A as a percentage of FDI. It should be kept in mind that the concepts are different and therefore M&A is not always simply a part of FDI.

Source: UNCTAD 1999a, p. 8.

6.2 Other measures of TNC activity

Measures of various operational aspects of international production activity by TNCs can provide a fuller and clearer picture of the role and impact of FDI in home and host countries. Statistical offices in a limited number of countries collect data on sales, gross product, assets, exports and/or employment of foreign affiliates of parent firms based in the countries, and of the TNC parent firms themselves, on the basis of company surveys. These data are particularly useful when they are disaggregated by industry, and are widely used in research and analysis on FDI and TNCs. They are also used to prepare indicators such as UNCTAD's transnationality index of host economies, which is a measure comprising the average of four shares: FDI inflows as a percentage of gross fixed capital formation; FDI inward stock as a percentage of GDP; value added of foreign affiliates as a percentage of GDP; and employment of foreign affiliates as a percentage of total employment (UNCTAD 2005, p. 16).

A calculation of the number of parent TNCs and foreign affiliates worldwide is prepared annually by UNCTAD, which collects data from individual countries and reports them and the totals for the world annually. UNCTAD also collects data annually on the world's 100 largest TNCs and the 50 largest TNCs from the developing countries, ranked by foreign assets, and their foreign and total assets, sales and employment.

Question 12

What are the main components of FDI flows? How are they measured?

Question 13

What is the difference between inward and outward FDI?

What is the difference between stocks and flows of FDI?

What is the main relevance of FDI flows compared to FDI stocks for the purpose of economic analyses related to FDI?

7 CONCLUSION

Firms and individuals may invest and hold assets in their home countries and/or in other countries. One way in which they may invest abroad is through FDI, which involves control or effective voice in the management of and lasting interest in the invested enterprise by the foreign investor. FDI is undertaken mainly by TNCs, which establish foreign affiliates through investment in new production facilities or M&As with existing firms in host countries. It is commonly defined in terms of a minimum threshold of equity ownership by the parent TNC in its foreign affiliate but it may also take the form of non-equity investment or contractual agreements that provide firms with control over foreign firms with which they have such agreements. Driven by liberalization and increased transnationalization of companies worldwide, FDI flows have increased rapidly in the past decades and not only

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exceed foreign portfolio flows, but are the largest source of external financing for developing countries.

The extent and pattern of FDI and TNC activity are measured through several indicators. The most common are FDI flows and stocks on which data are available for a large number of countries, although with several shortcomings. Other measures include those related to various aspects of TNC activity and international production, such as foreign affiliates' assets, output, employment and exports. Data on these magnitudes, available for a limited number of countries, are useful for obtaining a fuller picture of international production by TNCs and the impact of FDI on various aspects of host and home countries.

D PRACTICAL EXERCISE

Privatization-related foreign investment in Bolivia's telecommunication services

Bolivia privatized its long distance telecommunication company ENTEL through an international public bidding, open to national and foreign investors. ETI Euro Telecom International (an affiliate of Telecom Italia) made the winning bid. Through the capitalization of ENTEL, it agreed to inject fresh capital equal to \$US610 million in the exchange for a 50 per cent of equity participation (of the newly enlarged capitalized company) and 100 per cent management control. These resources were deposited in accounts of ENTEL to be used later for investments in the modernization and expansion of the company, in accordance to investment plans and the fulfillment of technical (quality) requirements. This arrangement stipulated that the privatized enterprise could not invest abroad until it had met its commitments to expand services in rural areas and in public telephone. Priority had to be given to:

- The installation of telephone services in every community of over 350 inhabitants;
- The installation of local services in every community of over 10,000 inhabitants;
- The replacement of manual and similar telephone exchanges with digital ones; and
- A five-fold increase in the number of public telephone booths.

The privatization contract also obliged the new owners of ENTEL to submit an updated investment programme every three months, to be verified by the telecommunication regulator (SITTEL). ENTEL enjoyed exclusivity for long distance services and its local partners up to end-2001, on condition that it meets the goals of expansion and service improvement. These goals, too, were monitored and certified by the telecommunication regulator.

Source: UNCTAD 2005, p. 169.

Questions

- 1. Does the investment made by ETI qualify as FDI? Justify your answer.**
- 2. After the privatization, did ENTEL become a foreign affiliate? If yes, what type?**
- 3. What was the entry mode chosen by ETI? Would the alternative have been a better solution from the investors' point of view? Discuss in groups and give arguments.**
- 4. What was the host country's influence on the privatization outcome?**
- 5. What are the benefits of this acquisition for ETI?**

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F ANNEXES

ANNEX 1. COMPILATION OF FDI DATA: RECOMMENDATIONS BY THE OECD BENCHMARK DEFINITION OF FDI

20. The OECD Benchmark Definition recommends market value as the conceptual basis for valuation. Market valuation places all assets at current prices rather than when purchased or last revalued, and allows comparability of assets of different vintages. It allows for consistency between flows and stocks of assets of different enterprises, industries, and countries, as well as over time.

21. Although OECD affirms the principle of market value as the basis for valuation, it recognizes that in practice book values from the balance sheets of direct investment enterprises (or investors) generally are utilised to determine the value of the stocks of direct investment. This approach reflects the fact that enterprise balance sheet values – whether they are regularly revalued on a current market value basis, reported on a historical cost basis, or are based on some interim but not current revaluation – represent the only source of valuation of assets and liabilities readily available in most countries. (In the first case, the balance sheet value is, in fact, the market value). The collection of data from enterprises on a current market value basis is to be encouraged, to narrow the gap between principle and practice. If feasible, countries that produce data on market values derived indirectly should also produce data on a book value basis, if the two differ.

1. Stock components

22. OECD recommends that the stock of direct investment be measured as:

a) *for subsidiary and associate companies:*

- i) the market value (or where market value is not available for statistical purposes, the book value – derived from the balance sheets – which is likely to be used by a number of countries for practical purposes) of their share capital and reserves attributable to the direct investor. (Reserves include retained profits. Share capital and reserves should be measured as the market value or written-down book value of the company's fixed assets and the market value or book value of its security holdings and other assets, less its liabilities and provisions);
- ii) plus loans, trade credit and debt securities (bonds, notes, money markets instruments, financial derivatives, etc.) due from the subsidiaries and associates to the direct investor, including dividends declared but not yet paid to the direct investor;
- iii) less loans, trade credit and other liabilities (including equity and debt securities) due to subsidiaries and associates from the direct investor.

b) *for branches, the net worth of these concerns to the direct investor measured as:*

- i) the market value (or, where market value is not available, written-down book value – derived from balance sheets) of the concern's fixed assets, and the market value (or, where market value is not available, the book value) of its investments and current assets, excluding amounts due from the direct investor;

- ii) less the concern's liabilities to third parties.

23. OECD recommends that short-term loans and trade credit be included as there is often no clear distinction between short-term finance such as a loan repayable on demand but never repaid and long-term finance. Inclusion of inter-company debt and of loans from subsidiaries to parent companies may result in some cases in negative values of direct investment stocks. As a matter of practice, some countries may not include (or may net out) inter-company debt and loans provided by subsidiaries to their parents. However, OECD recommends that countries provide information on gross amounts outstanding – *i.e.* claims on direct investor and liabilities to affiliated enterprises – to facilitate international comparability of direct investment stock data.

24. According to the IMF *Balance of Payments Manual*, Fifth Edition, cross-equity holdings of at least 10% in both directions give rise to two direct investment relationships and should be recorded as direct investment claims and liabilities for both the economy of the direct investment enterprise and the economy of the direct investor.

25. OECD recommends that the stock of outward investment be converted from foreign currency to the investor's national currency using the closing mid-market spot exchange rate (*i.e.*, average of the closing buying and selling rates) on the day to which the stock figures relate, *e.g.* if stocks are evaluated at 31st December, the closing mid-market spot rate at 31st December of that same year applies. OECD does not recommend using the historical exchange rate when the assets and liabilities were acquired.

26. Where subsidiaries, associates and branches resident in one country have assets and liabilities denominated and payable in other currencies, OECD recommends that these be valued at the closing mid-market spot exchange rate on the day to which the stock figures relate.

4. Capital flows

35. OECD recommends that direct investment flows be defined as:

- a) *For subsidiary and associated companies:*
 - i) the direct investor's share of the company's reinvested earnings;
 - ii) plus the direct investor's purchases less sales of the company's shares, debt securities (bonds, notes, money market and financial derivative instruments) and loans (including non-cash acquisitions made against equipment, manufacturing rights, etc.);
 - iii) less the company's purchases less sales of the direct investors' shares, debt securities (bonds, notes, money market and financial derivative instruments) and loans;
 - iv) plus the increase, net of decreases, in trade and other credit (including debt securities) given by the direct investor to the company – usually measured as the net balance of trade and other credit outstanding at the end of the period owing to the direct investor, less the balance outstanding at the beginning of the period, and less the net increase between the opening and closing balances which is due to revaluations and exchange rate movements.

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- b) For branches, the increase in unremitted profits plus the net increase in funds received from the direct investor – measured as the increase in the net worth of the enterprise to the investor less increases (net of decreases) due to revaluations and exchange rate movements.

36. In instances of *reverse investment*, in which the enterprises noted in para. 35 a) and b) have an interest in the direct investor, “that interest is regarded as an offset to capital invested by the direct investor (*i.e.*, as disinvestment)”, as indicated by the IMF *Balance of Payments Manual*, Fifth Edition. [“In cases in which the equity participation is at least 10% in both directions, (...) such transactions are recorded as direct investment claims and liabilities in both directions (...)” (para. 371).]

37. OECD recommends that separate figures be collected and published for transactions in shares and in loans and other indebtedness, and that outward investment should be shown separately from inward investment. It is possible for these items to be recorded gross showing investment separate from disinvestment, or recorded net of disinvestments, or recorded net for each enterprise. Analytical usefulness would be improved if the flows were reported at least partly on a gross basis. OECD recommends that separate figures should be collected for each enterprise of its net flows of investment, *i.e.*, net of disinvestment, in each country; that the net investment for each enterprise should be split between reinvested earnings, shares, loans plus other indebtedness; and that countries in their published figures should give separate totals for the sum of net investments and for the sum of net disinvestments for each item. For example, if Country X’s flows of outward direct investment in the share capital of concerns in country Y consisted of gross purchase of 140, 170, 25 and 10 by investors A, B, C and D respectively and of gross disposals of 40, 20, 75 and 90 by A, B, C and D respectively then A and B would have a net investment of 100 and 150 respectively and C and D a net disinvestment of 50 and 80. Country X in its published statistics should show three figures: overall net investment of 120 split between investors with net investment of 250 (sum of A + B) and investors with net disinvestment of 130 (sum of C + D).

38. Some components of the flows will be in foreign currency. OECD recommends that these be converted into national currency for:

- a) Outward retained profits at the average mid-market spot exchange rate in the period in which the profits were earned.
- b) Shares and loans
- i) at the closing mid-market spot exchange rate for amounts received and at the closing mid-market spot exchange rate for amounts paid on the day received or paid;
 - ii) or if converted immediately prior to purchasing the shares and loans, or sold immediately after receipt, the amount of national currency paid or received.
- c) Net balances of subsidiaries and associates and net worth of branches due to the direct investor, at the closing mid-market spot exchange rate at the date to which the balances relate.”

Source: OECD 1996, pp. 12-16.

ANNEX 2. SOURCES AND METHODS FOR FDI DATA COLLECTION

Variety of sources for FDI data

Many countries have a variety of sources for FDI data, including those collected by the central bank for balance-of-payments purposes and those collected by the board of investment or a similar institution for monitoring and investment promotion purposes.

Owing to the lack of comprehensive FDI data, especially in some developing economies, it is necessary to draw upon the data provided by institutions responsible for the regulation or promotion of FDI. Allowances must then be made for the regulatory framework within which the data were gathered. For example, not all FDI may have to be registered with the authorities in question; it is possible that reinvested earnings or investments in ventures in which the foreign equity stake is below a certain percentage are excluded.

A typical occurrence is that data provided by those institutions are on approved FDI investments rather than on the investments actually implemented. Sometimes, data on geographical and sectoral distribution of FDI is available only for approved investments. In such cases, data on approved investments provide crucial information, but their limitations must be acknowledged. Normally, approved investments are larger than those actually implemented.

Foreign exchange records versus company surveys

Very often it is difficult for a country to comply with the recommended definitions and report on all three components of FDI because it relies exclusively on foreign exchange records of the central bank. Thus it is only able to account for capital that crosses its borders and not reinvested earnings. Another approach taken by some countries involves a requirement by the central bank of additional information from foreign investors.

Data on FDI flows are collected primarily for balance-of-payments purposes. However, the data are usually based on the exchange records of the central bank in the framework of the International Transactions Reporting System (ITRS) and are extremely limited in details. Some countries supplement their exchange records data with company surveys or secondary sources. In most cases, this involves a request for information on components of FDI not properly covered in the recording of foreign exchange transactions, the most important of which is reinvested earnings. This generally entails an annual company survey. In some countries, there is also a periodic census or benchmark survey, which covers all aspects of FDI and may extend to other related variables. In several cases - such as Australia, Canada and the United States - surveys are the main sources of FDI information.

Very often, however, stock data are not available for countries because of their reliance on the exchange records. Stock data may also be obtained from company surveys. If FDI flows were also obtained on the same basis, then cumulative FDI flows would equal FDI stocks because it would include, for example, changes in valuation due to depreciation. However, where FDI flow data are collected from exchange records and FDI stock data are derived from company surveys, cumulative FDI flows do not generally match stocks.

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Once again, one major source of discrepancies is that reinvested earnings are excluded from FDI flow data.

Another difficulty is that equity capital, as well as changes in intra-company loans between parents and affiliates, and reinvested earnings tend to fluctuate considerably between years and can be substantially revised. Although there may be attempts to revise the FDI flow-data series accordingly, it can be difficult to attribute revisions to particular previous years. For that reason, proper adjustments are normally made only at the time of comprehensive surveys. Surveys also allow for a revaluation of assets, which helps to ensure a more accurate assessment of investment stocks.

Source: UNCTAD, FDI statistics, "Methods of data collection and national policies in the treatment of FDI", www.unctad.org.

ANNEX 3. WHAT DO CHANGES IN FDI MEAN?

Trends in FDI often differ greatly from indicators of economic performance such as fixed investment flows or stocks, sales and employment in parent firms and/or their foreign affiliates. Nonetheless, FDI is a commonly used indicator of economic activity in TNCs primarily because it is the most widely available indicator published in a timely fashion. Thus, changes in flows or stocks of FDI are often interpreted to signal changes in real economic activity of TNCs, even when there may be no major changes, or vice versa.

The major reason for differences in trends in FDI and trends in the indicators of economic activity, such as those indicated above, is conceptual. When examining investment trends, the net stock of fixed assets (cumulative fixed investment less depreciation) is used as one of the most common measures of capital. On the other hand, FDI flows are a source, not a use, of corporate finance, which makes them different from fixed investment flows conceptually. FDI flows are the sum of equity, reinvested earnings and loans remitted from the parent firm and related firms abroad to an affiliate in which it controls an ownership share above a certain threshold (i.e. 10 per cent). Using the corporate balance sheet that shows total liabilities (equity + loans) equals total assets, FDI stock can then be related to more common measures of capital such as fixed asset stocks as follows:

$$\text{FDI stock} = \text{FDI equity} + \text{FDI reinvested earnings} + \text{FDI loans} = \text{fixed assets} + \text{non-fixed assets} - (\text{non-FDI equity} + \text{non-FDI loans})$$

In short, an increase in FDI stock (positive net FDI flows) can be used to finance purchases of fixed assets, non-fixed assets (of which the majority are usually financial assets), or a reduction in non-FDI liabilities (equity and/or loans). Thus, to the extent that FDI is used to purchase non-fixed assets or finance reductions in non-FDI liabilities, trends in FDI stock can easily diverge from trends in the accumulation of fixed capital. Moreover, trends in fixed assets may also differ from trends in other measures of real activity, which makes it very important to use the indicator that best describes the activity of concern in a given case.

For example, in both Japan and the United States, FDI flows have increased much more rapidly than fixed investment flows of foreign-owned affiliates, but the reverse is true in China. In China, fixed investment flows of affiliates have always been smaller than FDI flows, but this has not been the case for several years in Japan and the United States when FDI flows were relatively small. In contrast, FDI stocks have increased much more rapidly than measures of real activity, such as fixed asset stocks, sales and employment in China and the United States, but this has not necessarily been the case in Japan where FDI stock, fixed asset stock and employment have all increased rapidly, but sales have grown much more slowly. Finally, in the United States, the rapid growth of FDI stock has been accompanied by much more rapid growth in total assets than in fixed assets, indicating that large portions of the rapid growth in FDI were used to finance the purchase of non-fixed assets. Thus, even these three examples show a great variety of experience, and underline the importance of choosing the indicator that most closely reflects the activity of concern when analyzing TNC activities.

Source: UNCTAD (2004). *World Investment Report 2004: The Shift Towards Services*. New York and Geneva: United Nations, p. 347.