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FOREIGN PORTFOLIO AND DIRECT INVESTMENT

Complementarity, Differences, and Integration

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In light of the various capital crises in the past few years, there has been a tendency to denigrate portfolio investment, while singing the praises of direct investment. Yet, it is also recognized that efficient capital markets help to mobilize financing for growth and development. Both direct and portfolio investment can promote sustainable growth in developing, and industrialized, economies, albeit in different ways.

Both portfolio and direct investment provide economic benefits, and the two together can enhance those benefits. It is not helpful to discriminate against one type of investment or the other, although it is necessary to recognize their differences. With the right policies, both can contribute to a strong and healthy economy.

This paper will explore both the relationships between portfolio and direct investment, and their differences under the assumption that the difference between the two is whether the investor has control over the investment, or not. It will first look at the benefits of each type of investment: how those benefits differ and how they are complementary. It will also look at the different policy needs of and approaches to the two types of investment, and where those are shared or complementary. Lastly, it will look at how the two types of investment are integrated in their operations, and at the margin between them. In this way, the paper is intended to show why the best policy is to welcome both forms of foreign investment, with full respect for their differences.

Benefits – Complementarity and Differences

Adequate capital flows are a basic and now universally acknowledged requirement for economic growth. The provision of capital is probably the most fundamental point of complementarity between portfolio and direct investment. Both forms of foreign investment provide capital flows beyond those available through domestic savings. Both serve to boost investment and economic activity in the domestic economy, allowing a higher level of economic growth than would otherwise be possible.

Both foreign direct and portfolio investment bring a range of benefits for economic growth, though there may be a marked difference between those benefits.

Benefits of Foreign Portfolio Investment

Foreign portfolio investment increases the liquidity of domestic capital markets, and can help develop market efficiency as well. As markets become more liquid, as they become deeper and broader, a wider range of investments can be financed. New enterprises, for example, have a greater chance of receiving start-up financing. Savers have more opportunity to invest with the assurance that they will be able to manage their portfolio, or sell their financial securities quickly if they need access to their savings. In this way, liquid markets can also make longer-term investment more attractive.

Foreign portfolio investment can also bring discipline and know-how into the domestic capital markets. In a deeper, broader market, investors will have greater incentives to expend resources in researching new or emerging investment opportunities. As enterprises compete for financing, they will face demands for better information, both in terms of quantity and quality. This press for fuller disclosure will promote transparency, which can have positive spill-over into other economic sectors. Foreign portfolio investors, without the advantage of an insider's knowledge of the investment opportunities, are especially likely to demand a higher level of information disclosure and accounting standards, and bring with them experience utilizing these standards and a knowledge of how they function.

Foreign portfolio investment can also help to promote development of equity markets and the shareholders' voice in corporate governance. As companies compete for finance the market will reward better performance, better prospects for future performance, and better corporate governance. As the market's liquidity and functionality improves, equity prices will increasingly reflect the underlying values of the firms, enhancing the more efficient allocation of capital flows. Well-functioning equity markets will also facilitate takeovers, a point where portfolio and direct investment overlap. Takeovers can turn a poorly functioning firm into an efficient and more profitable firm, strengthening the firm, the financial return to its investors, and the domestic economy.

Foreign portfolio investors may also help the domestic capital markets by introducing more sophisticated instruments and technology for managing portfolios. For instance, they may bring with them a facility in using futures, options, swaps and other hedging instruments to manage portfolio risk. Increased demand for these instruments would be conducive to developing this function in domestic markets, improving risk management opportunities for both foreign and domestic investors.

In the various ways outlined above, foreign portfolio investment can help to strengthen domestic capital markets and improve their functioning. This will lead to a better allocation of capital and resources in the domestic economy, and thus a healthier economy. Open capital markets also contribute to worldwide economic development by improving the worldwide allocation of savings and resources. Open markets give foreign investors the opportunity to diversify their portfolios, improving risk management and possibly fostering a higher level of savings and investment.

Benefits of Foreign Direct Investment

With its orientation to developing enterprises directly, foreign direct investment helps to strengthen economic potential. Sometimes, this is accomplished through greenfield investment, adding new and different economic activity and consequently diversifying the economy. Other times, this will be achieved through building up existing enterprises and enhancing their potential. Both of these activities will add a new and healthy element of increased competition to an economy, which is itself a powerful force for economic development.

Competition is one of the ways a foreign direct investment can have a broader effect on the economy. It spurs other enterprises to increase their own efficiency and productivity. Competition plays a major role in improving the allocation of resources, boosting the economic prospects of the domestic economy and worldwide sustainable economic development. Technology transfers and the development of human capital are often seen as two of the primary benefits of foreign direct investment. Competition has a role to play in both, as it encourages domestic competitors of the foreign investment to build up their own technological capabilities and the productivity of their labor force. They will, among other things, learn from the technology of the foreign investor and the ways in which it improves the productivity of its labor and management.

The development of human capital can be one of the chief contributions of foreign direct investment. The foreign owners will bring their management skills and technology to their enterprises. In training the local workforce, they will pass on those management skills and technology. As their workers move on to other jobs in domestic firms, or start their own businesses, they will bring with them the management, working skills, and the technology that they have learned. Thus, in a very direct manner, the human capital of the host country can be developed by foreign direct investment, and the investment' technology transferred.

Human capital development and technology transfer also occur through the foreign investment's relationships with its suppliers and the downstream users or sellers of its products. The investment will require from its suppliers a certain standard of product, perhaps a higher standard than they are accustomed to producing. In order to meet that higher standard, they will have to improve their workers' skill levels and their management system. They may also gain new technological expertise needed for the required product standard from the foreign investment. The current trend toward outsourcing and closer collaboration along the supply chain means that there will be a greater tendency to pass management, production and technology know-how to suppliers, enhancing the transfer of technology and skills. Enterprises that are downstream in the supply and sales chain will receive similar benefits, although less obviously and perhaps less frequently, both through the direct use of a higher standard product incorporating technological improvements, and through efforts by the foreign investment to maximize the value of its product.

Foreign enterprises often incorporate foreign trade, either with the parent company or with customers, or both. Thus, another benefit that foreign direct investment brings is increased opportunities and avenues for trade. Trade and investment are increasingly integrated, as are their benefits.

Foreign direct investment can also provide environmental and social benefits. Often, international investors will operate at higher environmental and social standards than their domestic competitors. Although they may not bring standards up to the highest level possible, they will have the effect of raising the standards above existing levels. These standards may also be adopted over time by domestic companies, further raising the country's environmental and social standards.

Shared Attributes and Complementarity of the Benefits

Many of the benefits mentioned above for either type of investment will not be immediately apparent. A foreign direct investor's relations with the domestic economy, with suppliers, users, and sellers of its products, will develop over time. Likewise, the portfolio investor's relationship to the domestic capital markets and effect on the markets' efficiency will evolve over time. Few, if any, of these benefits are guaranteed. For both direct and portfolio investment, having an adequate policy and regulatory structure is necessary to reap the potential benefits. Both types of investment, each in their own way, also reward transparency and good corporate and public governance – thus providing an incentive to improve in those areas.

A healthy domestic economy also enhances the benefits that foreign direct investment can provide, and a sound financial sector is a prerequisite for economic health. As shown below, the benefits of foreign portfolio investment require a suitable prudential regulatory system, but prudential regulation is also necessary for a sound domestic financial sector and overall economic health. The contribution of foreign portfolio investment to strengthening domestic capital markets and their infrastructure, which enhances the domestic allocation of capital, can help to boost the benefits of foreign direct investment. Therefore, the two are also complementary in that their benefits are enhanced when both are present.

Policy Differences and Complements

Complementarity, however, does not mean that the two types of investments are the same, or that they should receive the same policy responses. We have seen in the previous section that although the benefits of foreign portfolio and direct investment are often shared or complementary, there are also marked differences between them.

Differences between portfolio and direct investors stem from the differences in motivation and expectation for these two types of investment. For the foreign direct investor, the purpose is control and operation of an enterprise. Just as it will be slower and more costly for such an investor to commit to the host economy, it will be slower and more costly to divest. In the medium to long term, he expects a profitable operation. The portfolio investor, on the other hand, is interested in putting his funds where they get the maximum return for a given level of risk. Portfolio investment will be faster to move in search of higher returns and/or lower risk, and have a shorter time horizon. Therefore, it will tend to be more volatile. Volatility can be useful in providing opportunities for profit, or arbitrage, which will attract investors and encourage market efficiency. Volatility also indicates that the market is seeking the best allocation of capital for the current economic opportunities. But, portfolio investment, with its volatility, can also experience system-wide movements of capital which can have broad economic repercussions. These differences in motivation and attributes necessitate differences in policy approach for the two types of investment.

Policies for Foreign Portfolio Investment

For foreign portfolio investment, strong and well-regulated financial markets are necessary to deal with the inherent volatility. The financial system must have the capacity to assess and manage risks if it is to prudently and productively invest capital flows, foreign or domestic. Its central role of financial intermediation and credit allocation is a key element of economic growth and development. As has been shown above, foreign portfolio investment can be an important player in this function, and bring additional strengths and benefits, but those benefits will be most effective when working within a healthy financial system.

For a financial system to maintain its health, the institutions within it must be able to identify, monitor and manage business risks efficiently. The payments system, through financial institutions and clearing houses, must be efficient and reliable. The financial system must also have the ability to withstand economic shocks, such as a substantial shift in the exchange or interest rates, or a sudden capital withdrawal. It must, as well, be able to withstand systemic shocks, such as financial distress or bank failure. Systemic risk, from economic or systemic shocks, is a central, and perhaps unique, element of capital markets. It demands adequate capitalization and risk management capabilities.

Adequate and sound prudential supervision is necessary for a healthy financial system. Financial institutions face a myriad of risks: from credit risk to exchange rate risk, from liquidity risk to exposure concentration risk, from various risks stemming from the institution's internal operations to risks inherent in the payments system. Supervisors need to have a sound understanding of all these types of risk and how they can be managed. They also need to understand the environment in which the banks operate, and the various ways these risks can be transmitted. Adequate capital is a necessary element of prudential regulation, providing a safeguard against losses and a cushion in the face of institutional or systemic problems. Financial institutions should also limit their exposure to individual or associated counterparties, to related parties, to market risk, to short-term debt or mismatches in liquidity. The IMF and World Bank have developed effective banking supervision frameworks through financial sector surveillance and assessment, carried out, at least in part, through the Financial Sector Assessment Programme and through Reports on Observance of Standards and Codes.

Although supervisors need to be able to verify that a financial institution's exposure is balanced and capital is adequate, the extent of specificity in the regulations should be a function of the overall soundness and structure of the financial system. Regulation and regulators will be most effective when they create incentives for sound behavior and when their application and practices are able to evolve with the needs of the market. Supervisors need to be aware of the risks and costs of excessive prudential regulation. The costs will be seen in the time and resources required to comply with the regulations, which should be balanced against the need for regulation, but they will also be seen in the effect on innovation and evolution in the markets, which can bring benefits to both the financial markets and the broader domestic economy. Excessive regulation and supervision can put the onus for effective management of financial institutions on the supervisory authorities, rather than the directors and managers of the institutions. This will reduce the effectiveness of management and of market disciplines, potentially the most practical and efficient "regulators." The right balance is essential.

Market discipline can provide the greatest incentives for effective risk management. Therefore, it is important not to subvert it by excessive regulation, but there are other factors to watch to ensure that market discipline is effective. Market discipline depends on clear signals from the market. Government guarantees of financial institutions, or implicit government support, can keep the market from signaling a growing problem, as can government ownership. Financial safety nets and market failure response arrangements need to be able to effectively resolve market distress situations, without creating unnecessary moral hazard. If financial safety nets and market failure responses are not appropriately designed, they can take away, or at least reduce, the financial institution's incentive to manage its risks adequately, the first and best line of defense against risks. Competition in the financial sector will also strengthen market disciplines, and a financial sector open to foreign investment, which can bring with it new and different outlooks and approaches to these problems, will help attain the benefits of competition.

A sound financial system is best sustained when the broader legal, political and economic environment is also marked by sound policies. As these boost the benefits of both portfolio and direct investment, we will return to them below.

Policies for Foreign Direct Investment

To maximize the economic benefits of foreign direct investment, the key element is the state of economic development and sophistication in the domestic economy. The closer the match to the foreign enterprise's needs and sophistication, the more ties to the domestic economy are likely to develop over time. This will facilitate the transfer of technology and know-how.

In general, then, sound policies for foreign direct investment mirror sound policies for domestic economic development. Policies that will maximize the benefits of foreign direct investment, and minimize its costs, or potential drawbacks, are those that will do the same for domestic investment. One of the basic aims of investment policy should be to create an enabling business environment, facilitating the growth and development of all businesses, small and large, domestic and foreign.

Just as with portfolio investment, sound regulation is important for foreign direct investment. However, regulatory details for the myriad business sectors and activities in which a foreign direct investor are involved would be impossible to summarize. In all cases, however, maintaining health and the environment are legitimate and necessary subjects of regulation. As a basic approach to regulation, creating an incentive structure to encourage compliance with the spirit and letter of the laws and regulations is more productive than surrounding the business operations with rules that may, or may not, be the best way to reach the regulatory goals envisioned. For instance, markets in pollution credits have proved an effective way to stimulate firms to find the most efficient ways to reduce pollution.

To get the greatest benefit from foreign direct investment's potential to transfer technology and strengthen the skills of both labor and management, domestic human capital needs to be developed to the point where it is able to absorb and integrate the knowledge that the foreign investor has to offer. Therefore, a policy of developing domestic skills and knowledge is necessary to reap the full benefits of foreign direct investment. The two most fundamental elements to that policy are health and education. Basic human health and primary education are prerequisites to developing the skills and knowledge needed to get the full benefits of foreign direct investment, and for domestic economic development, as well.

The health and education prerequisites require infrastructure. Not only must there be an infrastructure to deliver the health and education services, either public or private, but there must also be infrastructure to deliver clean water and to manage waste. To integrate the foreign enterprise into the domestic economy, and thus maximize the benefits it has to offer, adequate commercial infrastructure is necessary, which would include energy, communications, transport, and financial infrastructure.

These are the elements needed to derive the greatest benefit from foreign direct investment. Other than the need for regulation acknowledged in both cases, these elements are different from the policies outlined above to minimize the risks from portfolio investment. Yet, there are underlying policy needs, such as the need for good governance, that apply to both types of investment.

Policies for Both Foreign Direct and Portfolio Investment

A stable macroeconomic environment is conducive to sustainable, non-inflationary growth. Volatility in interest rates or exchange rates and high inflation have had obvious deleterious effects in financial markets, but their negative effects are not limited to portfolio investment. Direct investors also find it harder to operate their investments successfully in such an environment. Policies that minimize, or eliminate, distortions to price signals – be they signals for interest, wages, or goods and services prices – aid improved resource allocation in both the capital markets and the economy as a whole.

The rule of law is paramount for healthy economic growth. Portfolio and direct investors need a reliable legal system ensuring that agreements and arrangements in either the public or the private sector will be honored. Yet, neither should need to rely purely on pursuing their rights through the legal system. Good and honest governance will help to keep resources focused on their most productive use, rather than pursuing legal rights or paying bribes. Reliable corporate governance provides for stronger relationships throughout the economy and helps to promote financial stability. Financial disclosure is particularly important for portfolio investment, and for a strong and stable financial system.

For both direct and portfolio investment, the policies promoted through international investment agreements and treaties are beneficial. Transparency, first and foremost, guarantees that investors will know what is expected of them, and the rules of the game. For portfolio investors, if transparency is in place for both the government and their counterparties, they will be better able to anticipate and deal with market disruptions. Thus, transparency can make the capital markets more stable. For direct investors, transparency allows them to plan ahead for the most productive use of their resources. If transparency includes plans to change policies or rules and regulations, which it should, then transparency can also give direct investments a chance to anticipate and prepare for a change in the political regime.

Preventing discrimination on the basis of nationality is a central aim of our investment agreements. For direct investors, they will clearly hesitate to invest if they have reason to believe that the host government will hamper their ability to compete on an equal footing in the markets. For portfolio investors, discrimination will harm their potential return or raise their potential risk level. They will have no compunction about looking elsewhere for a better deal. For the domestic economy, discrimination on the basis of nationality, or most any other form of discrimination, will deprive the economy of the full contribution that could have been provided by the investment.

Both types of investment and investors must be able to count on their property rights. For direct investors this is a broader issue, as there are more types of rights involved, including intellectual property rights. Protection against expropriation is vital, and if expropriation is necessary, it must be carried out with due process and prompt, adequate and effective compensation. The portfolio investor may have a smaller range of issues to be concerned with under property rights, but that does not make them less important to the investor. Although the government cannot, and should not, guarantee a stable value for the portfolio investment, or guarantee against default, the investor should be assured of his rights vis a vis the financial markets and the financial instruments he holds.

Clearly, the right to move their capital freely in and out of the country will be crucial to both types of investors, and perhaps more so, in this case, to the portfolio investor. In either case, however, they will be loathe to invest if they do not have assurance that they will be able to remove the capital as needed or desired.

Integration

Thus far, we have treated portfolio and direct investment as if they were separable entities. That is a bit misleading. Although, as we have seen, portfolio and direct investment have different needs and will react to situations in different ways, driven by the differing motivations of the investors, they cannot be completely separated.

There is no identifiable dividing line between portfolio and direct investment, but only an area of overlap where the two merge. For instance, a portfolio investor may be active in the equities market, but equity holdings are also one of the main means of direct investment. At what point does the portfolio investor become a direct investor? The same overlap can also be found with debt holdings. Corporate bonds are a typical portfolio investment, and in most cases would not be considered a direct investment. But, what about the case where a venture capitalist loans a start-up company a large amount of money, underwriting a large share of the start-up's assets? The venture capitalist may not hold any evidence of ownership because no shares have been issued, only debt. Nor may he have measurable control over the start-up, but he is actively helping management to run the business efficiently, to boost the likelihood of making good on his investment. Is he a portfolio investor, or a direct investor? At what point does he cross the line between the two?

Another way in which foreign direct investment and portfolio are integrated is the concomitant use of the two types of investment. Direct investors will be engaged in portfolio investment as they manage their cash flows. For example, the treasurer of a large retail chain will be in and out of the capital and money markets as he manages the cash and other financial assets involved in the business. Any classic direct investment of any size and autonomy will have a similar treasurer's function, and be an active portfolio investor.

Therefore, there is no bright dividing line between portfolio and direct investment, but instead overlap and integration. At what point does portfolio investment become direct?

For legal and policy purposes, it is at the point where the investor exerts some measure of control over the underlying economic entity. This does not have to be full control, or even majority control. There can be more than one investor exerting control over an investment – a partnership or joint venture are familiar examples. The point where the investor gains some real measure of influence over the operation of the investment is the point where he crosses the line from portfolio to direct investment. That will vary with each different type of business structure, and each different investment within that structure.

Ten percent ownership by a single foreign entity has been cited as a bright line of division that a number have tried to turn to recently. Ten percent ownership is used by the IMF, the OECD, the U.S. and many others as a statistical dividing line for investment statistics. As such, it may give a reasonable picture of investment stock and flows, portfolio and direct, but for policy and legal purposes, it is too arbitrary. There have been cases where a 5% holding was enough to give control over certain major decisions about an enterprise, and therefore conferred direct investor status. The single "golden share" held after some privatizations also gives rights to the holder over certain major decisions, and therefore must be considered more than a portfolio investment; i.e., a direct investment.

In addition, it is not always so easy to identify a given percentage of ownership. In a straightforward stock ownership situation it may be easy, but how about a large partnership, or the debt example given above? Many business structures are more complex than simple and straightforward stock ownership. A better approach is to ask whether the investor has a say in the running of the business.

Thus, portfolio and direct investment are firmly integrated, with one flowing into the other at the margin. What is done to one will affect the other. Although policy approaches should take into account the differing considerations arising under the two forms of investment, a policy that liberalizes one while trying to keep the other out will negatively affect both.

Conclusion

To characterize portfolio investment as “bad” and direct investment as “good” oversimplifies a much more complex situation. Both bring risks, and both require their own policy approaches. There seems to be a certain fear attached to foreign portfolio investment, due perhaps to its complexity and the central economic role of the financial system. (At one time there was a fear of foreign direct investment.) Does *foreign* portfolio investment engender greater concern? Certainly, financial disturbances have not been confined to foreign investors.

If you take “foreign” out of foreign portfolio or direct investment, most policy makers would acknowledge that domestic portfolio and direct investment are both necessary for healthy economic growth and development. Portfolio investment and the financial system it is part of are central to any healthy economy. Put “foreign” back in and you have effectively increased the quantity and diversity of investment to even greater effect. As shown above, both portfolio and direct investment can bring powerful benefits to the economy, and together the benefits are increased.

The best answer is not to shut either type of investment out – not to label one “bad” and the other “good.” Instead, both should be welcomed within the proper regulatory structure to maximize the benefits, and to manage the drawbacks and potential negatives. Both portfolio and direct investment bring value for economic growth. They are not intrinsically good or bad, but they are different. Liberalize both with respect for their differences.

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