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The rise of FDI income, and what it means for the balance of payments of developing countries

by
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Multinational enterprises (MNEs) multiplied their profits made in developing countries by four between 2002 and 2011 (at current prices).[1] In Latin America and the Caribbean, they rose from US$20 billion in 2002 to US$113 billion in 2011. The growth rate has been even higher in Africa and China, but much lower in developed countries.[2] This rise is explained by an increase in FDI stock in developing economies and the higher average profitability of MNEs.

Companies investing in services and manufactures for the domestic market have benefited from high growth rates across developing regions, which has boosted domestic demand for modern goods and services. Companies in the natural resources sector have enjoyed high commodity prices. Conversely, MNEs in export-oriented manufacturing saw their profits grow at a much more modest rate. Overall, high rates of return on existing investments are a sign of success and will likely lead to more FDI inflows into developing countries. At the same time, FDI income generated in Latin America is now almost as large as FDI inflows into Latin America, meaning that the activities of MNEs can no longer balance a current account deficit as they did in the 1990s. This has been the case for several years in Latin America and the Caribbean as a whole, as well as in many other developing economies.[3]

FDI is now the largest external liability in developing countries and also the largest contributor to debits in their income accounts. FDI income is now higher than portfolio or other investment income and one of the largest items in the balance of payments as a whole. Between 2008 and 2011, FDI income originating in Latin America was almost double the surplus in goods trade. In other words, the profits of MNEs are a major determinant of the external constraint for the economies of Latin American and other developing countries, and could play a major role in any potential balance-of-payments crisis, as loans and portfolio flows have in the past.

However, some characteristics of FDI income will attenuate its negative impact during a potential crisis. To start with, FDI inflows are much less volatile than portfolio and other investments and very rarely turn negative during crises. Second,

FDI income expands with economic growth, but contracts during downturns, producing a counter-cyclical effect on the host country economy. The same events that could trigger a balance-of-payments crisis, such as a sudden drop in the price of exports, are likely to reduce FDI income outflows as well.

In Latin America, mining has generated the largest part of FDI income over the past decade, but FDI in market-seeking activities may have a larger impact on the balance of payments, as they do not generate exports that can compensate for FDI income. This is notably the case in Brazil, where most FDI income is generated in services and manufacturing for the local market. On the other hand, FDI income generated in activities for the local market will fall if the exchange rate depreciates.

Policies for restricting capital outflows normally target portfolio investments, but given the high level of FDI income, some governments may need to consider measures to restrict FDI income repatriations as well during times of crisis. So far, very few countries have done so—and those that have done so have used informal mechanisms—but more could be done to impose restrictions in the future. Before doing so, however, governments have a range of other options, such as trade policy, exchange rate manipulation or directly raising taxes on the profits MNEs make in their jurisdictions. But governments' ability to raise taxes may be limited if they have granted certain tax advantages to foreign investors. A material rise in tax rates can also push some MNEs to move their profits abroad, for example, through transfer pricing.[4]

The notable rise in FDI income in developing countries has followed—with some lag—the rise in FDI flows to these economies. This should be a reminder that FDI is a financial liability that needs to be repaid. It remains a powerful instrument to change a host country's production structure and raise productivity, but not to alleviate external imbalances over the long term.

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[1] Profits of foreign affiliates are accounted in the balance of payments as FDI income; 89% of them are profits on equity investments, while the remaining 11% are interest income on debt between fellow enterprises. Of the former, a little less than half are reinvested in the same affiliate, while the rest is repatriated.

[2] For more data and other analysis related to Latin America, *see* ECLAC, *Foreign Direct Investment in Latin America and the Caribbean 2012* (Santiago: ECLAC, 2013).

[3] FDI income credit (profits that national companies make abroad) has also grown across the developing world, but in Latin America, it still amounts to only 14% of the debit and is concentrated in a handful of countries.

[4] *See* OECD Centre for Tax Policy and Administration, "Base erosion and profit shifting," http://www.oecd.org/ctp/beps.htm.

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