Canada Asia Commentary

Number 18
February 2001

Foreign direct investment (FDI) has become the main source of capital for developing countries, to the mutual benefit of the recipient countries and investors. However, in part because of financing constraints faced by Canadian companies, very little Canadian investment flows to developing economies. For instance, less than 2% of our total stock of FDI is in the developing countries of Asia, including major economies like China and India. This hinders both the opportunities available to Canadian businesses and Ottawa's ability to meet its goal of nurturing the private sector in developing economies. Many countries have addressed the special financing needs of private-sector investment in developing and transitional economies through the establishment of development finance institutions (DFIs). Canada is alone among the leading industrialized economies in not having a DFI. Although proposals for the creation of a DFI have been making the rounds of government departments and agencies in Ottawa for more than a decade, to date nothing has been done. We envisage an independent institution capitalized with a one-time injection of new public funds, but subsequently living off its earnings. Its funding decisions would be based on commercial criteria, though yielding benefit to both Canada and the recipient country. And it would provide a logical new home for the Industrial Cooperation Program, currently located within the Canadian International Development Agency (CIDA).

The Case for a Canadian Development Finance Institution

The 1990s saw global capital flows grow rapidly, mostly in the form of FDI. Total annual flow, just US $209 billion in 1990, topped US $1.1 trillion in 2000, with about 12% of that going to Asia. However, FDI is still mostly directed at the developed markets of the OECD. Although 80% of the world's people live in developing economies, little more than 15% of global FDI flows to these countries — and less than half of that to Asia, the most populous developing region. Still, an increasing number of investors are willing to put their faith in the developing world. Through the 1990s, capital flows to developing countries grew from US $100 billion in 1990 to US $285 billion last year. The private funding component of this was up from US $40 billion in 1990 to US $240 billion. As a portion of the private funds, FDI also grew from roughly US $25 billion in 1990 to US $170 billion in 2000. As private investment has grown, official flows have shrunk in absolute and relative terms, falling from US $60 billion in 1990 to US $45 billion in 2000. The result is that private FDI has become the largest source of capital for developing countries.

Asia Pacific Foundation of Canada
Fondation Asie Pacifique du Canada

Canada Asia Commentary is published 12 times a year and is available by fax or e-mail and on the APFC Website
www.asiapacific.ca

ISSN 1481-0425

FDI yields gains to both host and source countries

FDI generates significant gains for both the host and source countries. A 1997 Industry Canada policy paper concluded that "outward FDI contributes to the growth of the Canadian economy." In particular:

- Outward FDI has a positive impact on Canada's current-account balance.
- Outward-oriented firms have out-performed domestically-oriented firms in terms of growth, productivity and profit.
- FDI provides market access for firms that can not realize efficiencies in Canada's small domestic market.
- Investment leads to exports, and the elasticity of exports to FDI is high and positive.
- Outward FDI has indirect spill-over benefits for other Canadian firms.
- Canadian investment abroad results in technology inflows to Canada.
- Outward FDI creates new, higher-skilled jobs in Canada.
- Outward FDI is part of on-going industrial restructuring which rationalizes industry, makes production more efficient, industry more competitive, and improves long-term economic health.

Investment leads directly to a reduction in poverty

Economists have studied the impacts of FDI on recipient countries through a two-step process, linking FDI growth to GDP (or income) growth, and GDP growth to poverty reduction. They have shown that FDI reduces poverty in developing countries through GDP growth. While the link between FDI and GDP growth is generally accepted, the link between GDP growth and poverty reduction is sometimes questioned. However, a 1997 study of 26 developing countries provides rather convincing evidence of the link. The study by Michael Roemer and Mary Kay Gugerty at the Harvard Institute for International Development, found a direct relationship between GDP growth and the income growth of the poorest 40% of the population. The researchers concluded that not only does growth reduce poverty, but that "the fear that growth will bypass the poor is misplaced." The following year, Theodore Moran, in his book *Foreign Direct Investment and Development*, provided significant evidence of the link between FDI and development. In his investigation of 183 projects spanning 30 countries over 15 years, Moran found a majority of the projects contributed to development. Of course, it is up to host-country governments to fine-tune their domestic environments to maximize potential benefits.

Financing gap hits Canadian firms in developing countries

Very little Canadian FDI flows into the developing world, and most of that goes to a few of the higher-income developing countries. Africa, for instance, accounts for less than 0.6% of Canada's stock of overseas FDI. At less than 2%, holdings are also low, in the developing countries of Asia where Canada has virtually no profile as an investor. Canadian FDI flows to developing countries are minimal for several reasons including our lack of past colonial ties and, more importantly, our proximity to the US marketplace. However, there is also a significant barrier in the lack of financing available in Canada for projects outside the developed economies, according to firms interested in the developing markets. This financing gap is a result of a combination of the risk-averse nature of Canadian financial institutions, the limited capital resources of Canada's predominantly small and medium-sized businesses, and the lack of government support in encouraging or facilitating investments in developing countries. The financing gap has long been supported anecdotally, but it was again substantiated by respondents to the Asia Pacific Foundation of Canada's annual *Investment Intentions Survey* carried out in December, 2000. In the survey, which sampled Canadian firms currently operating in Asia, 60% of respondents reported an interest in investing in developing countries in Asia. Almost 50% of those firms also reported that they had previously decided against such investments "due to a lack of financing available for projects in these economies."

Official promotion of outward FDI is politically sensitive

Canada has a project preparation facility (CIDA's Industrial Cooperation Program, or CIDA-INC), insurance and export credit facilities (the Export Development Corporation — EDC), and a network of financial institutions willing to work on mainstream projects. However, Canada lacks an institution willing or mandated to work with investors in developing countries, something most other developed countries have. The end-to-end support available to our competitors is not available to Canadian firms. Because of this financing gap, Canadian firms must compete on an uneven playing field in important growth markets – or not compete at all. Although decision makers may recognize the benefits of outward FDI, it is, nevertheless, a politically sensitive issue. Willingness to speak out on the need for outward FDI, or to advocate its benefits, is made difficult by the misconception that investment overseas does not help Canada or Canadian workers. But, politically difficult or not, FDI has become far too important an agent of domestic economic and industrial development for the subject to be avoided. As long as this financing gap remains, the Canadian government will not have fulfilled the pledge made in *Canada in the World* to provide assistance to private-sector development overseas.

A Sample DFI Project

In 1999, DEG, Germany's development finance institution, provided an 18 million euro (C $25.5 million) loan to North Pole Limited, a manufacturer of camping equipment and baggage. The loan will help to finance new production centers in China, Sri Lanka and Bangladesh, creating hundreds of jobs. Local sub-contractors will also be used to supply various inputs, providing additional jobs and strengthening local small and medium-sized businesses.

Most developed countries have established DFIs

Most industrialized countries have found it in the interest of their domestic industry, and in line with their responsibility in terms of development assistance, to facilitate the flow of FDI to developing countries. Most have done so through the creation of a development finance institution. These are financial institutions, owned either by the government, or jointly by the government and the private sector, which provide debt and equity to projects in developing countries. DFIs invest only in projects which are commercially viable, and only where private-sector investors will not go alone, usually due to lack of market knowledge, perceptions of high or unmanageable risks, or below-market returns. Each year, DFIs invest billions of dollars in developing countries, and leverage many times more in private financing. They have become important stimuli for investment in developing countries. Today there are at least 17 DFIs in Europe, the US, Japan, plus the World Bank's International Financial Corporation (IFC). Norway and Switzerland are the most recent countries to have added DFIs to their development assistance strategies, in 1997 and 1999 respectively. As it stands, Canada is the only G-7 country without a DFI. This places us in the company of Greece, Luxembourg and Ireland as about the only developed countries without DFIs.

DFIs receive public start-up funds, then live off earnings

DFIs are capitalized with government funds or with joint government and private capital. Switzerland recently established the first DFI with majority private-sector ownership, and Britain's Commonwealth Development Corporation (CDC) is moving to privatize a majority of its ownership after 50 years of successful operation by the public sector. DFIs do not normally receive on-going funding. Rather, they are required to live off the returns from their investments, growing their capital bases over time as equity positions are sold, dividends are received and loans are repaid. New capital may be injected to expand a DFI's geographic reach, such as when Eastern Europe and the former Soviet republics moved into DFI portfolios. While most of these institutions focus on debt and equity as their main business lines, those in France and the US specialize in loan guarantees and political-risk insurance respectively. Most also offer for-fee financial advisory services, or other for-fee services, such as the administration of public funds which the government does not have the in-house ability or authority to administer. Overall, DFIs have been commercially successful, with few annual losses on record and with net returns on investments usually between 3% and 8%.

A Potential Canadian DFI Project
In 1996, the Canadian Centre for Marine Communications (CCMC), an alliance of 70 small and medium-sized companies in the marine information and communications technology sector, completed a World Bank feasibility study of a project in the Malacca Strait. The project is now proceeding and the CCMC has been asked to continue playing the lead role. However, as the downstream project is commercially viable, the firms involved are expected to finance the implementation of the project. CCMC lacks the necessary capital. Its member firms have small capital bases, and they engage in projects with long payback periods, already tying up much of their resources. CCMC's competitors include firms from Norway, France and the US, and they are all expected to bring DFI support to the project. Though now a lost opportunity, the Malacca Straits project would be ideal for a future Canadian DFI to support.

Much DFI funding goes into financial intermediaries

Although DFIs are thought of as sources of funding for traditional manufacturing facilities, they actually make about one-third of their investments in each of infrastructure, financial intermediaries and production projects (manufacturing and natural resource extraction). Increasingly DFIs are investing in infrastructure and financial intermediaries. Studies have shown that investments in these sectors have the greatest developmental impacts. Typically, investments in financial intermediaries involve equity or loans for investment funds, such as infrastructure and agriculture; for microfinance funds; development banks; leasing companies; venture capital funds; and other lending and business start-up programs. Investments in host-country financial intermediaries would be particularly relevant to Canada because they can provide in-country funding for smaller projects which can not be done economically from DFI headquarters, and they can provide a source of local currency loans. Investments in private infrastructure are also particularly important for DFIs, as such projects have strong developmental impacts and are increasingly a private-sector responsibility. Globally, about 29% of DFI investments are in Asia, 27% in Latin America, 22% in Sub-Saharan Africa and 14% in Central and Eastern Europe. Portfolios are sometimes targeted to certain countries or sectors, often where there are historical linkages or geographical proximity. For instance, Swedfund's portfolio is invested primarily in the Baltic countries and Africa; France's PROPARCO works in the former French colonies; the US Overseas Private Investment Corporation (OPIC) has a heavy Latin American focus; and the Netherlands' FMO has a strong presence in Latin America and Asia, and a sectoral focus in finance.

FDI brings jobs and environmental gains to host countries

Many studies have shown significant host-country gains in terms of jobs and environmental standards from DFI investments. According to the IFC, "DFIs have played a crucial role in laying the foundations for much of the dramatic increase in private capital flows to emerging markets – by investing in high-risk countries and catalyzing the flow of private capital, by deepening capital markets and pioneering new financial instruments, by establishing the framework for private infrastructure investment and by providing critical advice in the areas of privatization and foreign direct investment." Home-country benefits have also been assessed, and have been shown to be positive, particularly in the case of OPIC which has found overwhelmingly positive results.

The idea of establishing a DFI in Canada has been discussed for years. In 1987 the Standing Committee on External Affairs and International Trade recommended "that CIDA undertake an in-depth analysis of the implications of establishing an equity instrument." The Mulroney government rejected the recommendation, but since then the idea has surfaced time and again, becoming more timely as internationalization has become a more integral

Creation of Canadian institution has been studied for years

part of business success, and as FDI has become the primary source of capital for developing countries. During the 1990s, several federal government departments, private firms and industry organizations recommended the formation of a Canadian DFI. Over the past two years the DFI initiative has been moved forward by an interdepartmental group in Ottawa, including the departments of Finance, Industry, Foreign Affairs and International Trade, CIDA and EDC. The DFI proposal has also been the subject of several reports. A 1993 study, commissioned by the Department of Foreign Affairs and International Trade (DFAIT), found demand in Canada for DFI services and surveyed the Canadian business community on preferred investment destinations. A 1998 review of CIDA's activities acknowledged that a financing gap exists in Canada, and it was recommended that, should a DFI go ahead to address the gap, CIDA should participate in shaping the initiative. Last year, the EDC's submission to its legislative review pointed out that: "Canadian firms may have fewer financing sources to draw on than similar-sized firms in countries with deeper capital markets and more global financial institutions. The issue of foreign investment funding, both equity and debt, for Canadian firms needs to be addressed in much greater detail . . ." The most comprehensive study of the DFI concept was commissioned by CIDA and completed last year by Consulting and Audit Canada (CAC). The CIDA-CAC study confirmed the financing gap and recommended that Canada move to the next stage in the development of a DFI. The study also suggested operational and structural guidelines, concluding with a recommendation that a Canadian DFI be set up as a Crown corporation or a subsidiary of EDC, with an initial capitalization of around $300 million. After that, it should be operated as a self-sustaining business.

Ottawa should move now to set key principles for a DFI

There have been many other studies and recommendations supporting the establishment of a DFI, and the need has been increasing as FDI has grown as a proportion of capital flows. The Government of Canada should move to the next step by holding formal stakeholder consultations and flesh out key policy issues on which the success of the institution would hinge. While there are numerous details to be considered, a number of key principles should be foremost:

- *The need to address both development assistance priorities and domestic industry needs.* Industry Canada, EDC and DFAIT, all of which have been active in the Canadian DFI initiative and reflect, to a greater or lesser extent, the interests of domestic industry, must remain involved. CIDA must also remain engaged as the voice of development assistance. The DFI should only proceed if both domestic industry and development assistance interests are met.

- *Independence from government and politics.* A DFI is not a concessional instrument, and the commercial success of a DFI requires that government keeps out of daily operations and investment decisions. The DFI should get its mandate and operating principles from government, its board should include representation from key government departments, and it should have annual reporting requirements. Otherwise, the DFI should be independent.

- *Funding for the DFI should not be taken from the ODA budget.* Initial capital should be in addition to current Official Development Assistance (ODA) outlays. Most DFI funds do not qualify as ODA, and given Canada's already low level of aid contributions, ODA funds should not be redirected to the DFI. Once the DFI has a proven track record, private investors should be brought in to expand the capital base.

- *Project selection should be based on commercial viability, risk diversification, and delivery of both host- and home-country benefits.* While most outward FDI will be beneficial to Canada, the DFI must analyze the potential impacts of every investment before it goes ahead. Canada can look to the USA's OPIC for guidance in analyzing home-country impacts. A Canadian DFI should apply Canadian environmental standards to the projects in which it participates but, provided all other impacts are neutral or better, the developmental impact in host countries should be the creation of jobs and delivery of other typical host-country benefits. Commercial criteria will be paramount in selecting projects for financing. Failed projects do not help countries develop.

- *A limited number of countries, including lower-income developing economies, should be targeted.* The DFI should target selected countries in order to develop its expertise, networks and information resources, and to enable it to help build a critical mass of private-sector development in the target countries. For risk diversification and political reasons, the DFI's portfolio should include a number of countries from each developing region, focusing on countries that are key to Canadian industry, and in which Canada has significant knowledge, contacts and business networks. There are several Asian economies that would be good targets for a DFI as they fit these basic criteria. These countries could provide relative stability in the portfolio while benefiting from other developmental impacts such as improved corporate governance and environmental sustainability. There at least 25 countries in Asia in the low and low-middle income category from which a DFI could choose for inclusion in its portfolio.

The Canadian DFI could become home to CIDA-INC

Once establishment of the DFI is accepted, the government might consider moving CIDA's Industrial Cooperation Program into the new agency. CIDA-INC provides funding to Canadian firms wishing to carry out feasibility studies of potential investments in developing countries. Additionally, CIDA-INC can provide funding for training programs or gender, community or environmental programs associated with a new investment. The objective is to advance the development of the private sector in developing countries and to leverage home- and host-country benefits. While INC is a well-intentioned program which directly addresses Canada's ODA priority of private-sector development, it has long been an uncomfortable fit within CIDA. The agency's culture is not conducive to private-sector development initiatives. The relocation of INC to the DFI could be a win-win proposition. Within a DFI, INC would benefit from a more supportive operating environment, enhanced business expertise, increased information resources, and the business culture, networks and contacts of the DFI. In this environment, INC would likely deliver better results. Similarly, without INC, CIDA could totally focus its energies on its comparative advantages, and deliver even better results in the traditional aid areas.

The financing and policy gaps which combine to sideline Canadian firms in important markets impede Canada's development assistance work. A DFI is a proven policy instrument which has been used in many other countries to fill these gaps and, if structured well, could do the same in Canada. It is time for the Government of Canada to move ahead with the establishment of a Canadian DFI.

For general information on APFC publications
Tel: (604)684-5986
Fax : (604)681-1370
e-mail: info@apfc.apfnet.org
or visit our website:
www.asiapacific.ca

APFC is funded in part by the Department of Foreign Affairs and International Trade and by the Canadian International Development Agency.