Date: January 13, 1999

To: [redacted]

From: Guy V.G. Stevens

Subject: Restrictions on Portfolio Capital Flows and U.S. Direct Investment Abroad

The question posed is whether a judiciously designed capital control program, intended to restrict only portfolio capital and to exempt direct investment activities, will nevertheless have an adverse impact on some or all activities of direct investors. In my view there are at least three interrelated questions that must be examined. Will restrictions limited to portfolio flows affect important sources of finance relied on by U.S. direct investors? If so, will U.S. MNCs be able to easily substitute alternative sources of finance for the now restricted portfolio flows? And finally, even if a control program begins as one limited to portfolio flows, is it reasonable to believe -- and to assume direct investors believe -- that it will remain limited? Addressing these questions leads, in my view, to the conclusion that it will be difficult and probably impossible to insulate direct investment activities from the impact of even a carefully crafted program of controls.

The available evidence, collected by BEA in its quinquennial censuses, suggests strongly that controls on portfolio capital will have a negative effect on the traditional sources of direct investment finance. The attached table establishes that an important source of the financing of direct investment assets are funds raised outside the multinational firm. The BEA data focus on the *geography* of external financing, rather than the nature of the external institutions providing that finance. (Thus, one cannot tell what percentage comes from banks, trade credit, or longer term debt.) The first column gives the percentage of direct investment assets financed by current liabilities and long term debt raised from sources external to the firm. The third and fourth columns break these external sources down into those raised in the subsidiary's host country and those raised outside the host (but not in the United States). I present this breakdown worldwide by major industry and for four important host countries: Canada, the United Kingdom, Brazil, and Mexico. Data for 1994 are presented because this is the last year for which country breakdowns of the aggregate data are available and because the most recent data, for 1996, are little changed from 1994.

For all industries worldwide, the top panel shows that just under half (49 percent) of the $2 trillion of total assets of U.S. direct investors was financed by current liabilities and long term debt from external sources. About two-thirds of this total -- 33 percent overall -- was accounted for by *host-country* sources (column 3). The rest, 15 percent overall, was financed by external sources located in foreign countries outside the host (and outside the United States). The last two lines of this panel show that the percentages for manufacturing worldwide are somewhat, but not dramatically, below the average, and those for finance are somewhat above. When one breaks the data down by country, the percentages vary, with developing countries like Brazil and Mexico financing less, but nevertheless significantly, from external sources. At the low end, Brazil still financed a third of its assets from external sources, 27 percent from institutions inside Brazil.

These data show that sources external to the firm finance an important part of the assets of U.S. direct investors, roughly half worldwide.[1] Would capital controls adversely affect these external sources? Although we would like more information on the institutional composition of this external finance, even without it, the answer is probably yes. Clearly, a significant part, if not all of the last column -- financing from external sources outside the host country (and the United States) -- would be directly affected. Moreover, and possibly more important, part of the third column -- the percentage of assets financed by host country sources -- would also be directly affected by portfolio capital controls. Within this category, for example, fall branches of U.S. banks located in the host country. If one can credit anecdotal evidence that U.S. banks often follow their clients abroad, then a significant part of column three could come from U.S.-owned financial institutions located in host countries.

The strong probability of the disruption of traditional avenues of external finance may not, at least logically, imply a disruption of direct investor operations or expansion. Theoretically at least, a well-designed capital control program could be formulated to exempt direct investment related capital flows. U.S. parent firms could then, in principle, make up for the restricted sources of external finance (with higher levels of direct investment). There are, however, a number of reasons to doubt the realism of this felicitous, but hypothetical case. First, the parent firm would have to be comfortable with a substantial increase in its exposure in the host country; the inevitable increase in the percentage of subsidiary assets financed by the U.S. parent would raise the parent firm's exposure to currency and inconvertibility risk,

---

[1]The other half is primarily capital flows from the U.S. parent and retained earnings; however, a small percentage, 3 percent worldwide in 1994, comprises minority equity interests.

risks that already would be seen to be higher under the shadow of a program of capital controls.

Moreover, U.S. parent willingness to substitute direct investment for external sources of finance would be lessened by concerns about the viability of a program containing exemptions for direct investment. If direct investment flows were to be treated differently from other financial flows, an institutional apparatus would be required to rule on the nature of all capital flows; this would be seen as subjecting all direct investors to regulatory costs and control. Further, the system would most likely induce attempts throughout the economy to shift as much finance as possible to the preferred direct investment category, possibly leading to the system's collapse. Direct investors would recognize the system's vulnerability and, thus, any such system would tend to lack credibility from the start. Should the control program be modified to affect direct investors directly, particularly the free repatriation of profits, there is strong empirical evidence that direct investment operations and expansion would then be devastated.[2]

[2] I have found repatriation restrictions to have a particularly strong negative effect on the plant and equipment spending of direct investors in the following studies: "U.S. Direct Investment to Mexico: Politics, Economics and NAFTA," *Contemporary Economic Policy* (April 1998); "Politics, Economics, and Investment," *International Finance Discussion Paper #490*, (December 1994).

External Financing of U.S. Direct Investment Assets

	Total Assets (billion - $)	External Sources of Finance (% of Total Assets)	External Finance Raised in Host Country (% of Total Assets)	External Finance Raised in Third Countries (non - US) (% of Total Assets)
WORLDWIDE				
All Industries	2023	49	33	15
Manufacturing	541	39	29	10
Finance (excluding banks)	951	58	38	19
CANADA				
All Industries	199	41	34	3
Manufacturing	70	30	26	2
Finance (excluding banks)	66	53	48	3
UNITED KINGDOM				
All Industries	521	62	47	14
Manufacturing	76	46	34	11
Finance (excluding banks)	359	70	53	15
BRAZIL				
All Industries	33	32	27	4
Manufacturing	24	28	23	4
Finance (excluding banks)	2	21	20	1
MEXICO				
All Industries	27	36	29	4
Manufacturing	18	25	22	3
Finance (excluding banks)	4	39	39	0

Note: The percentages in columns 3 and 4 do not always add up to the percentage in column 2; also included in column 2 are funds from "other U.S. persons" – entities other than the U.S. parent firm. This source is small quantitatively – only 1 percent of column 2 worldwide.