The Effect of Foreign Ownership Limits on FDI and Debt

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Abstract: High indebtedness has usually been the precursor to financial crises in many countries. Following the financial crises in Asia in 1997-98 and the Mexican peso crisis in 1994, there have been calls to raise foreign ownership limits as a way to increase foreign direct investment and reduce reliance on foreign debt. This paper argues that when the probability of a crisis increases with the level of debt, relaxing ownership limits may not necessarily have these intended consequences. The argument hinges on the existence of multiple equilibria (one low-debt/high-FDI and another high-debt/low-FDI) which results from the lack of coordination in the choices of debt and FDI. The results also suggest that debt-relief may be needed to go from a high-debt to a low-debt equilibrium.

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