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- foreign direct investment (FDI):
 - there are two types of foreign private equity capital flows: 1) portfolio investment (an investor holds shares in a firm in a developing country but is not involved in its management) and 2) foreign direct investment (investment where the investor participates in the management of the firm in which he owns shares); FDI comprises a larger proportion of foreign private capital flows to developing countries than portfolio investment
 - from the 1970s to the 1990s, total financial flows to LDCs have increased; however, the composition of foreign financial flows changed over this period: the proportion that was aid decreased, the proportion that was commercial loans first increased then decreased, and the proportion that was FDI increased (see page 522, table 14-1)
 - most FDI is conducted by multinational corporations (MNCs), also known as transnational corporations (TNCs), as opposed to individuals, small businesses, etc. (although FDI in this form also exists)
- multinational corporations:
 - most multinational corporations are headquartered in North America, Japan, and Europe, although some of the largest ones are based in Brazil, South Korea, and India
 - page 526, table 14-2 – the sizes of MNCs relative to developing countries:

MNCs can be large relative to the economies of some LDCs (measured by the ratio of sales by the MNC to the GDP of the developing country)

for example, in 1998 the largest MNC, General Motors, had US\$161.3 billion of sales, which was larger than the entire GDP of Poland (US\$149 billion), Algeria (US\$29.6 billion), and Kenya (US\$11.1 billion), the 10th, 25th, and 50th largest LDCs by GDP, respectively

although China had a population of 1.2 billion people, its GDP (US\$960.9 billion) was only about six times as great as General Motors' sales

an alternative method to illustrate the size of MNCs could compare the assets of MNCs to the wealth of a citizen in a country

the large size of MNCs relative to some LDC economies might be a cause for concern because an MNC's substantial bargaining power possibly could allow it to create an exploitative arrangement with a developing country

- page 527, table 14-3 – the distribution of FDI by country:

FDI tends to be concentrated among a few countries, such as China (US\$44 billion), Brazil (US\$19 billion), and Mexico (US\$12 billion); some developing countries are more successful at attracting FDI than others

FDI as a proportion of GDP varies from 12.5% to less than 1%

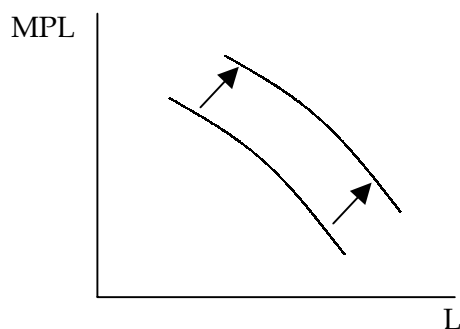
- the benefits for LDCs of MNC investment:
 - MNCs used to be considered exploitative and developing countries used to adopt policies to keep them out and nationalize their assets; by the 1990s, however, developing

countries were competing with each other to attract MNCs; even those countries that used to completely keep MNCs out (Mozambique, Angola, China, Vietnam, etc.);

- MNCs can be considered to bring a “package” of 5 benefits with their investment in a developing country:

1) transfer of capital (funds, not necessarily physical capital):

- the foreign funds MNCs bring is not necessarily their most important contribution – only about 20-25% of the total investment funding of poor countries is of foreign origin, with MNC investment being less than half of that; the MNCs often borrow some of the funds they use in the developing country by issuing bonds, borrowing from local banks, etc.; thus, because LDCs are capable of saving sufficiently, foreign saving is only supplementary and not a primary benefit of MNCs
- because MNCs borrow locally, they possibly crowd out other domestic investment
- the returns to foreign private funds are repatriated to owners abroad, limiting their benefit to the LDC; however, the host country still benefits from foreign funds because the additional capital created from foreign investment raises the marginal productivity of domestic labor (by increasing the amount of capital per worker) and of other domestic resources:



2) employment creation:

- MNCs do not create much employment in the host developing countries; this could be because MNCs have a tendency to use capital-intensive technology developed in an industrialized country
- MNCs offer wages that are high relative to other wages in a developing country; however, MNCs are often criticized because these wages are still very low relative to the wages they offer in their home country; MNCs might offer high wages for political reasons (so they are not accused of exploitation) and/or for efficiency-wage reasons (that is, better workers can be attracted and motivated to work harder at higher wages)

3) technology transfer:

- although MNCs might not use technology best-suited to a developing country (the technology might be too capital-intensive or the skills required to use the technology might not be available in the LDC), technology transfer is a significant benefit of investment by MNCs
- developing countries have tried to catch-up technologically with industrialized countries; for example, when China found it was technologically falling behind its

neighbors in the late 1970s/early 1980s, it moved toward a market system and tried to bring in technology from abroad

- whether technological know-how will transfer to local nationals or continue to be dominated by foreign companies and its expatriates is a concern; to aid the transfer of technical skill, a developing country could implement clauses in contracts/agreements with MNCs requiring the proportion of employees that are domestic nationals to increase over time or requiring the MNC to train domestic nationals

- developing countries have had varied experiences capturing the benefits of MNCs, which depends on both a country's policies and its ability to absorb technological knowledge; for example, China was able to significantly benefit from MNC's technological transfer because of its high level of education – countries that do not have such high levels of education might not be able to absorb technological knowledge as quickly

- this is one of the main benefits of investment by MNCs in LDCs

4) managerial capability:

- this is a transfer of managerial ability (this is similar to the transfer of technology, only for managerial skills)

- this is one of the main benefits of investment by MNCs in LDCs

5) access to world markets:

- developing countries have had difficulty breaking into world markets because they lack connections and knowledge of how the markets work

- using their connections and knowledge of international markets, MNCs have helped developing countries enter international trade

- this is one of the main benefits of investment by MNCs in LDCs

most economists agree MNC investment is beneficial to the host developing country; the main benefits of MNC investment are 3), 4), and 5) above

the degree to which MNC investment benefits a developing country depends on the relationship the MNC has with the developing country – for example, an MNC that does not hire many domestic nationals, sends its profits abroad, etc. will not benefit an LDC as much as one that is more involved

- developing countries and foreign investment policies:

- protected monopolies:

in the 1970s some developing countries granted MNCs monopolies in protected domestic markets (the domestic markets were protected from imports by tariffs); the MNCs that were granted access to these markets established factories locally and charged high, artificially-expensive monopoly prices; this policy led to windfall profits for the monopolies at the expense of local citizens

this occurred in Kenya and Zambia in the 1970s with tire manufacturing

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this has occurred under import substitution industrialization, where the LDC wanted to be producing the manufactured good locally rather than importing it

- tax holidays:

a policy mistake by developing countries is granting tax holidays (a waiver of taxes) to MNCs in order to attract foreign investment; taxes paid to foreign governments are tax-deductible in an MNC's home country; thus, when a tax holiday is implemented in a developing country, the MNC will not pay taxes to the host LDC government, but will pay the same amount of taxes it would have paid without the tax holiday to the LDC government, instead, to its home country government

thus, investment is not made any more attractive because of the tax holiday (the MNC still has to pay the same amount of taxes, just to different entities); the payment of taxes to the home country government instead of the LDC government can be considered "reverse foreign aid"

for instance, suppose an MNC based in the United States establishes a factory in Kenya and is granted a tax break; instead of paying, say, \$10 million dollars in taxes to the Kenyan government (the tax is waived because of the tax holiday), the MNC will have to pay the \$10 million in taxes to the US government instead

it would be more advantageous for developing countries to work cooperatively instead of competing by lowering tax rates

- protected monopoly operation with a tax holiday:

this is a combination of the two mistakes in economic policy by developing countries; not only does a protected monopoly work inefficiently, but the tax revenue that the country would have earned without the tax holiday is lost

- trade balances and debt crisis:

a country must pay for its imports using foreign currency; it will earn this foreign currency through its exports; if there were no financial flows between countries, then the value of exports must equal the value of imports for the current account (the balance of goods and services imported and exported) to balance

a trade imbalance will result if the value of exports is less than the value of imports (see page 405 for more information):

$$X < M$$

X = value of exports

M = value of imports

this trade balance could be made up by foreign loans (foreign saving):

$$S_f = M - X$$

S_f = foreign loans

M = value of imports

X = value of exports

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chronic imbalances between imports and exports have been associated with import substitution industrialization

in order to produce goods they import on their own, countries have implemented import substitution industrialization (ISI) (“substitute” because they intend to substitute domestic goods for imports) by protecting domestic markets, overvaluing the exchange rate, etc.; although this reduces demand for exports, a country must import goods from abroad to implement ISI (oil is especially significant); imports end up growing faster than exports; the difference between M and X must be made up by foreign loans – over several years, the current account deficit (the difference between M and X) leads to a debt

it is possible for a country to continue borrowing indefinitely with positive economic growth if the growth of output and exports is high enough relative to the interest rate (the growth in output is more than enough to pay off the interest on the debt)

- domestic investment and foreign saving:

a country can invest more than it saves if it receives resources from abroad – foreign saving can bridge the difference between domestic investment and domestic saving:

$$S_f = I - S_d$$

S_f = foreign saving

I = domestic investment

S_d = domestic saving

- sustainable borrowing:

- if a country’s economy is growing, the country can maximize its consumption by continually borrowing from abroad; a country can continue to borrow from abroad if growth is high enough to pay off the interest on the amount borrowed

- page 539, equation 14-4 – in the long-run, the debt to GNP ratio is given by:

$$\frac{D}{Y} = (v - s)/(g_Y - i)$$

D = total stock of debt

Y = GNP

v = proportion of GNP that is investment

s = saving rate

g_Y = growth rate

i = interest rate on debt

if domestic investment equals domestic saving for the country, then $v = s$ and D settles at zero; however, if domestic investment is greater than domestic saving, then $v - s > 0$ and the debt can only be sustained if the growth rate is greater than the interest rate

- page 539, equation 14-2 – the long-term debt can also be expressed in terms of exports:

$$\frac{D}{E} = \frac{a}{(g_E - i)}$$

D = total stock of debt

E = exports

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M = imports

$a = (M - E) / E$ (the export imbalance normalized by exports)

g_E = growth rate of exports

i = interest rate on debt

the size of the debt is determined by the deficit in the current account, the interest rate, and the growth rate of exports; if the growth rate of exports is greater than the interest rate on the debt, then the debt is sustainable

- these models suggest that continually borrowing to finance growth is possible, but if the growth rate of either income or exports is too low, then growth cannot continue to be supported through foreign borrowing; a problem for some developing countries is that the interest rate increased and led to an unsustainable debt
- debt crisis of the 1980s:
 - borrowing from commercial banks by developing countries increased after 1970 or so; in the early 1980s major borrowers defaulted on their debt that had accumulated over the past 10 years; this was not the first time some countries had defaulted – Latin American banks had defaulted before but it was believed that, if necessary, the international financial system would help them pay their debt

the demand for borrowing: the debt crisis followed the implementation of import substitution industrialization (ISI), where countries tried to protect domestic industries with tariffs, overvalued exchange rates, etc.; overvalued exchange rates, however, discouraged exports and encouraged imports – because prices are generally determined by world markets, this hurt primary product and mineral exports, such as coffee, aluminum, cocoa, etc.; thus due to ISI, the supply of foreign currency (earned by exports) was low; although both domestic saving (for reasons discussed earlier) and foreign currency were low in developing countries, the demand for investment funds by government and private industry was high – as a result, there was a temptation to borrow from abroad

the supply of lending: during the 1970s, the high price of oil led to a large increase in oil revenue and the producers of oil in the Middle-East put the earnings into Western bank accounts; these banks were willing to lend to developing countries, and it was believed that the loans would be repaid because the debt was sovereign and the IMF, etc. could bail countries out

increased oil prices and increasing the money supply led to inflation in developed countries; inflation and reduced growth rates led to tighter monetary policy and restructured spending, which resulted in recession and caused interest rates to increase

because the interest rates charged by banks in developed countries increased, developing countries that rolled-over their debt (borrowed to pay off previous debt) took out loans at higher interest rates than before; also, world economic conditions had lowered developing countries' exports and their ability to earn foreign currency; as a result, some developing countries became unable to service their debt

- page 541, table 14-5 – debt ratios for developing countries:

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for all developing countries, the debt to GNP ratio increased from 14% in 1970 to a maximum of 43% after 1980

the debt to export ratio is significant because most of debt is owed to foreign banks and must be repaid in foreign currency (which is earned through exports); the debt to export ratio for all developing countries increased from 115% in 1970 to 203% after 1980, but decreased to 116% by 1997

the debt service to exports is the proportion of earnings through exports that is used to pay off the debt (the rest is available for imports); several Latin American countries have a debt service to export ratio near 100% which severely impairs their ability to import

- by 1982/1983, countries that had borrowed were in crisis because they were unable to pay off their debt service and banks in developed countries were unwilling to lend to them; negotiations between banks, governments, and international financial institutions led to different solutions for each country; large middle-income countries (those in Latin America) were allowed to swap debt for equity, the debt period for payback was adjusted, and they agreed to certain conditions (such as reducing government deficit)

the net flow of funds from developed countries and multilateral organizations to developing countries dropped from US\$36 billion in 1981 to -US\$35 billion in 1987 (the net flow reversed)

because affected countries could not continue borrowing and had to pay off the debt (through dissaving and generating foreign exchange), per capita income in these countries declined; also, social spending (education, etc.) was cut in the affected countries and there was some indication of increased infant mortality, decreased school enrollment, and other harmful social consequences

the economies of affected developing countries had grown during the 1970s, but contracted during the 1980s; real per capita income decreased overall 6% in Brazil, 7% in Mexico, 16% in Venezuela, and 20% in Argentina; for Latin America as a whole, the percent of urban people in poverty increased from 17% to 22% and the percent of rural people in poverty increased from 45% to 53%

less attention was devoted to solving the debt crisis of sub-Saharan African countries perhaps because their economies' relative importance to the world economy is less (in absolute terms, they participate less in international trade, have smaller loans, and receive less aid) than that of Latin American economies; for sub-Saharan African countries, some debt was negotiated or forgiven, but some countries are still heavily indebted (the ratio of debt service to exports is still high)

in 1996 the ratio of total debt to GNP averaged 27% for Asia, 36% for Latin America, and 42% for sub-Saharan Africa

in Latin America, most debt is privately held by firms, but in sub-Saharan Africa, debt is held mostly by governments and banks

in 1996, the World Bank and IMF launched the “HIPC Initiative” (HIPC = highly indebted poor country, and refers to a country that meets certain criteria regarding debt and poverty) to relieve the debt burden of HIPCs; HIPC was expanded in 1999 when governments of developed countries offered \$100 billion in debt cancellation; some economists and policymakers argue that debt cancellation should accompany additional funding to reduce poverty and ensure economic growth; although foreign saving is not a large proportion of investment in most developing countries, in sub-Saharan African countries it is a significant fraction of total investment (up to one-half in some countries), and reduced availability of foreign saving is harmful to growth

- Asian financial crisis of 1997:
 - this financial crisis is attributed to a loss of trust in banks

in the immediate aftermath of the crisis, the East Asian model of economic development, where government has an active role in the economy, was reconsidered, and it was believed that overly close relationships between government officials and businesses could have been responsible for the financial crisis

however, the financial crisis was not so much due to government-business relations, but mainly due to an unsophisticated financial system, over-reliance on short-term loans, and the sort of dynamics that can cause a crisis of confidence in any financial system (see pp. 506-9 of Chapter 13).