

**Unit Six:
Foreign Finance,
Investment,
and Aid: Controversies
and
Opportunities**

• The International Flow of Financial Resources

- In this chapter, we examine the international flow of financial resources, which takes three main forms:
 - (1) *private foreign direct and portfolio investment*, consisting of (a) foreign “direct” investment by large multinational (or transnational) corporations, usually with headquarters in the developed nations, and (b) foreign **portfolio investment** (e.g., stocks, bonds and notes) in developing countries’ credit and equity markets by private institutions (banks, mutual funds, corporations) and individuals;
 - (2) *remittances of earnings by international migrants*; and
 - (3) *public and private development assistance (foreign aid)*, from (a) individual national governments and multinational donor agencies and, increasingly, (b) private *nongovernmental organizations (NGOs)*, most working directly with developing nations at the local level.
- We also examine the nature, significance, and controversy regarding private direct and portfolio investment and foreign aid in the context of the changing world economy.

• Private Foreign Direct Investment and the Multinational Corporation

- The growth of private foreign direct investment (FDI) in the developing world has been extremely rapid—though volatile—in recent decades.
- Africa has usually received only a small fraction of inflows. In 2009, FDI in Africa totalled \$59 billion, but the share of global FDI going to Africa as a whole was just 5.3% (3.6% excluding North Africa).
- But even this was higher than recent years, largely driven by commodities investments. Most of the 34 least developed countries in Africa received very little foreign investment.
- This is not surprising given the fact that private capital gravitates toward countries and regions with the *highest financial returns and the greatest perceived safety*. Where debt problems are severe, governments are unstable, and economic reforms remain incomplete, the risks of capital loss can be high.
- We must recognize that multinational corporations are not in the development business; their objective is to maximize their return on capital. MNCs seek out the best profit opportunities and are largely unconcerned with issues such as poverty, inequality, employment conditions, and environmental problems.

- Two central characteristics of multinational corporations are their *large size* and the fact that their *worldwide operations* and activities tend to be centrally *controlled by parent companies*. They are the major force in the rapid globalization of world trade.
- Historically, multinational corporations, especially those operating in developing nations, focused on extractive and primary industries, mainly petroleum, nonfuel minerals, and plantation activities where a few “agribusiness” MNCs became involved in export-oriented agriculture and local food processing.
- Recently, however, manufacturing operations and services (banks, hotels, etc.) have occupied a dominant share of MNC production activities.

- **Private Foreign Investment: Some Pros and Cons for Development**

- **Traditional Economic Arguments in Support of Private Investment:**

- ✓ **Filling Savings,**

- the first and most often cited contribution of private foreign investment to national development is its role in *filling the resource gap* between targeted or desired investment and locally mobilized savings. (“savings-investment gap”)

- ✓ **Foreign-Exchange,**

- An inflow of private foreign capital can not only alleviate part or all of the deficit on the balance of payments current account but also function to remove that deficit over time *if* the foreign-owned enterprise can generate a net positive flow of export earnings.(foreign- exchange or trade gap)

- ✓ **Revenue, and**

- The third gap said to be filled by foreign investment is the gap between targeted governmental tax revenues and locally raised taxes. By taxing MNC profits and participating financially in their local operations, developing country governments are thought to be better able to mobilize public financial resources for development projects.

- ✓ **Management Gaps**

- Not only do multinationals provide financial resources and new factories to poor countries, but they also supply a “package” of needed resources, including management experience, entrepreneurial abilities, and technological skills that can then be transferred to their local counterparts by means of training programs and the process of learning by doing.

- **Arguments against Private Foreign Investment: Widening Gaps**

- There are **two** basic arguments against private foreign investment in general and the activities of MNCs in particular—the strictly economic and the more philosophical or ideological.
- On the **economic side**, the four gap-filling pro-foreign-investment positions just outlined are countered by the following arguments:
 1. Although MNCs provide capital, they may *lower domestic savings and investment rates* by substituting for private savings, stifling competition through exclusive production agreements with host governments, failing to reinvest much of their profits, generating domestic incomes for groups with lower savings propensities, and inhibiting the expansion of indigenous firms that might supply them with intermediate products by instead importing these goods from overseas affiliates. MNCs also raise a large fraction of their capital locally in the developing country itself, and this may lead to some *crowding out* of investment of local firms.

2. Although the initial impact of MNC investment is to improve the foreign- exchange position of the recipient nation, its long-run impact may be to reduce foreign-exchange earnings or at least make the net increase smaller than it appeared, as a result of substantial importation of intermediate products and capital goods and because of the overseas repatriation of profits, interest, royalties, management fees, and other funds.

3. Although MNCs do contribute to public revenue in the form of corporate taxes, their contribution is considerably less than it might appear as a result of liberal tax concessions, the practice of **transfer pricing**, excessive investment allowances, disguised public subsidies, and tariff protection provided by the host government.

4. The management, entrepreneurial skills, ideas, technology, and overseas contacts provided by MNCs may have little impact on developing local sources of these scarce skills and resources and may in fact inhibit their development by stifling the growth of indigenous entrepreneurship as a result of the MNCs' dominance of local markets.

- Government policies in developing countries may be directed toward mitigating some of these concerns. Many academic and political thought leaders in developing countries have commonly raised a number of more fundamental objections.
- **First**, the impact of MNCs on development is very uneven, and in many situations, MNC activities reinforce dualistic economic structures and exacerbate income inequalities.
- **Second**, it is argued that multinationals typically produce inappropriate products (those demanded by a small, rich minority of the local population), stimulate inappropriate consumption patterns through advertising and their monopolistic market power, and do this all with inappropriate (capital-intensive) technologies of production that as a result create comparatively little employment. This is perhaps the major criticism of MNCs in light of the substantial employment problems of developing nations.

- **Third**, as a result of the first two points, local resources tend to be allocated for socially undesirable projects. This in turn tends to aggravate the already sizable inequality between rich and poor and the serious imbalance between urban and rural economic opportunities.
- **Fourth**, multinationals use their economic power to influence government policies in directions unfavorable to development. They are able to extract sizable economic and political concessions from competing governments of other developing countries in the form of excessive protection, tax rebates, investment allowances, and the cheap provision of factory sites and essential social services. This phenomenon is often referred to as a “race to the bottom.” As a result, the private profits of MNCs may exceed social benefits

- **Fifth**, MNCs may damage host economies by suppressing domestic entrepreneurship and using their superior knowledge, worldwide contacts, advertising skills, and range of essential support services to drive out local competitors and inhibit the emergence of small-scale local enterprises.
- **Finally**, at the political level, the fear is often expressed that powerful multinational corporations can gain control over local assets and jobs and can then exert considerable influence on political decisions at all levels.

• **Private Portfolio Investment: Benefits and Risks**

- In addition to foreign direct investment, the most significant component of private capital flows has been in the area of portfolio investment.
- With the increased liberalization of domestic financial markets in most developing countries and the opening up of these markets to foreign investors, private portfolio investment now accounts for a significant and currently rising share of overall net resource flows to developing countries.
- Basically, portfolio investment consists of foreign purchases of stocks (equity), bonds, certificates of deposit, and commercial paper. As usual, the middle-income countries have been the favored destination of these flows, with sub-Saharan Africa all but neglected.

- As in the case of the FDIs of multinational corporations, the benefits and costs of private portfolio investment flows to both the investor and the developing country recipient have been subjects of vigorous debate.
- From the investor's point of view, investing in the stock markets of middle-income countries with relatively more developed financial markets permits them to increase their returns while diversifying their risks.
- From the perspective of recipient developing countries, private portfolio flows in local stock and bond markets are a potentially welcome vehicle for raising capital for domestic firms.
- But from the macro policy perspective of developing-country governments, a key issue is whether large and volatile private portfolio flows into both local stock and short-term bond markets can be a destabilizing force for both the financial market and the overall economy

• **The Role and Growth of Remittances**

- Remittances have increased dramatically in this century, exceeding 5% of GDP of low-income countries, outpacing FDI and approaching inflows from aid.
- However, remittance flows are very uneven across developing countries.
- Migrants often build houses for their families and send money vital for keeping children in school and better-fed. Thus remittances now provide a significant pathway out of poverty.
- Indeed, the World Bank reports that based on household surveys, remittances have substantially reduced poverty in such countries as Guatemala, Uganda, Ghana, and Bangladesh.

- **Foreign Aid: The Development Assistance Debate**
- **Conceptual and Measurement Problems:**
- In addition to export earnings and private foreign direct and portfolio investment, developing countries receive two other major sources of foreign exchange: *public (official) bilateral and multilateral development assistance* and *private (unofficial) assistance provided by nongovernmental organizations*. Both of these activities are forms of **foreign aid**.
- In principle, all governmental resource transfers from one country to another should be included in the definition of foreign aid.

- Economists have defined foreign aid, therefore, as any flow of capital to a developing country that meets two criteria:
 - (1) Its objective should be noncommercial from the point of view of the donor, and
 - (2) it should be characterized by **concessional terms**; that is, the interest rate and repayment period for borrowed capital should be softer (less stringent) than commercial terms.

- Even this definition can be inappropriate, for it could include military aid, which is both noncommercial and concessional. Normally, however, military aid is excluded from international economic measurements of foreign-aid flows.
- **The concept of foreign aid that is now widely used and accepted, therefore, is one that encompasses all official grants and concessional loans, in currency or in kind, that are broadly aimed at transferring resources from developed to less developed nations on development, poverty, or income distribution grounds.**

- Just as there are conceptual problems associated with the definition of foreign aid, there are measurement and conceptual problems in the calculation of actual development assistance flows. In particular, **three** major problems arise in measuring aid.
- **First**, we cannot simply add up the dollar values of grants and loans; each has a different significance to both donor and recipient countries. Loans must be repaid and therefore cost the donor and benefit the recipient less than the nominal value of the loan itself.
- **Second**, aid can be tied either by **source** (loans or grants have to be spent on the purchase of donor-country goods and services) or by **project** (funds can only be used for a specific project, such as a road or a steel mill). In either case, the real value of the aid is reduced because the specified source is likely to be an expensive supplier or the project is not of the highest priority (otherwise, there would be no need to tie the aid).
- **Finally**, we always need to distinguish between the nominal and real value of foreign assistance. Aid flows are usually calculated at nominal levels and tend to show a steady rise over time. However, when deflated for rising prices, the actual real volume of aid from most donor countries declined substantially in recent decades.

- **Amounts and Allocations: Public Aid:**

- The money volume of **official development assistance (ODA)**, which includes bilateral grants, concessional loans, and technical assistance as well as multilateral flows, has grown from an annual rate of under \$5 billion in 1960 to \$50 billion in 2000 and to over \$128 billion in 2008.
- However, the percentage of developed-country GNI allocated to official development assistance declined from 0.51% in 1960 to 0.23% in 2002 before improving to 0.33% by 2005 and to 0.45% in 2008 as part of a campaign to increase assistance in the wake of the continued lag in human development in sub-Saharan Africa—a major initiative at the G8 meetings in Britain in 2005.

- ODA is allocated in some strange and arbitrary ways. South Asia, where nearly 50% of the world's poorest people live, receives \$8 per person in aid. The Middle East and North Africa, with well over triple South Asia's per capita income, receives *nine times* the per capita aid!
- It is clear that the allocation of foreign aid is only partly determined by the relative needs of developing countries. Much bilateral aid seems to be based largely on political and military considerations.
- Multilateral aid (e.g., from the World Bank and various UN agencies) is somewhat more economically rational, although here too, the rich often seem to attract more resources per capita than the poor.

- Because foreign aid is seen differently by donor and recipient countries, we must analyze the giving and receiving process from these two often contradictory viewpoints.
 - **Why Donors Give Aid:**
 - Donor-country governments give aid because it is in their political, strategic, or economic self-interest to do so. Some development assistance may be motivated by moral and humanitarian desires to assist the less fortunate (e.g., emergency food relief and medical programs).
1. **Political Motivations** Political motivations have been by far the more important for aid-granting nations, especially for the largest donor country, the United States. The United States has viewed foreign aid from its beginnings in the late 1940s under the Marshall Plan, which aimed at reconstructing the war-torn economies of western Europe, as a means of containing the international spread of communism.

2. Economic Motivations: Two-Gap Models and Other Criteria

Within the broad context of political and strategic priorities, foreign-aid programs of the developed nations have had a strong **economic** rationale. This is especially true for Japan, which directs most of its aid to neighboring Asian countries where it has substantial private investments and expanding trade.

- Let us examine the principal economic arguments advanced in support of foreign aid.

- **Foreign-Exchange Constraints** : *External finance (both loans and grants)* can play a critical role in supplementing domestic resources in order to relieve savings or foreign-exchange bottlenecks. This is the so-called two-gap analysis of foreign assistance. The basic argument of the **two-gap model** is that most developing countries face either a shortage of domestic savings to match investment opportunities or a shortage of foreign exchange to finance needed imports of capital and intermediate goods. Basic two-gap and similar models assume that the **savings gap** (domestic real resources) and the **foreign-exchange gap** are unequal in magnitude and that they are essentially independent.

- **Why Recipient Countries Accept Aid:**

- The reasons why developing nations have usually been eager to accept aid, even in its most stringent and restrictive forms, have been given much less attention than the reasons why donors provide aid.
- The major reason is probably economic. Developing countries have often tended to accept the proposition—typically advanced by developed-country economists—that *aid is a crucial and essential ingredient in the development process. It supplements scarce domestic resources, it helps transform the economy structurally, and it contributes to economic growth.*
- Thus the economic rationale for aid is based in part on their acceptance of the donor's perceptions of what the poor countries require to promote economic development.
- In sum, while there is no doubt that the least developed countries will need more assistance to escape from the vicious circle of poverty, fresh approaches are needed to ensure effectiveness.

- **The Role of Nongovernmental Organizations in Aid:**

- One of the fastest-growing and most significant forces in the field of development assistance is that provided through private **nongovernmental organizations (NGOs)**.
- NGOs include religious groups, private foundations and charities, research organizations, and federations of dedicated doctors, nurses, engineers, agricultural scientists, and economists. Many work directly on grassroots rural development projects; others focus on relief efforts for starving or displaced peoples.

- NGOs have *two* important advantages.
- **First**, being less constrained by political imperatives, most NGOs are able to work much more effectively at the local level with the people they are trying to assist than massive bilateral and multilateral aid programs could.
- **Second**, by working directly with local people's organizations, many NGOs are better able to avoid the suspicion and cynicism on the part of the mostly poor people that they serve that their help is insincere or likely to be short-lived.

- **The Effects of Aid:**

- The issue of the economic effects of aid, especially public aid, like that of the effects of private foreign investment, is fraught with disagreement.
- On one side are the economic traditionalists, who argue that aid has indeed promoted growth and structural transformation in many developing countries.
- On the other side are critics who argue that aid does not promote faster growth but may in fact retard it by substituting for, rather than supplementing, domestic savings and investment and by exacerbating balance of payments deficits as a result of rising debt repayment obligations (when aid takes the form of loans, even if at reduced interest rates) and the linking of aid to donor-country exports.

- Official aid is further criticized for focusing on and stimulating the growth of the modern sector, thereby increasing the gap in living standards between the rich and the poor in developing countries.
- Rather than relieving economic bottlenecks and filling gaps, aid—and for that matter private foreign investment—not only widens existing savings and foreign-exchange resource gaps but may even create new ones (e.g., urban-rural or modern-sector-traditional-sector gaps).
- The attention to improved assistance to reduce extreme poverty, particularly in its increased focus on the 49 least developed countries at the United Nations' 2010 Millennium Development Goals summit, the improvements in accountability and evaluation of aid that have taken more shape since the Paris Declaration, and some enhancement of resources are hopeful signs that aid will become more effective and more targeted toward people living in poverty.