Lecture 17
Foreign Financing

Introduction
Developing economies’ financial linkages with the global economy have risen significantly in recent decades.
- Theoretical models identify channels through which international financial integration can promote growth
- However, no clear and robust empirical proof

Potential benefits have often been counterbalanced by increased vulnerability to crisis (Debt crisis and Asian financial crisis). An intense debate has emerged in both academic and policy circles on the effects of financial integration for developing economies.

Need to differentiate between the various financial flows
Debt, Portfolio flows and Aid flows. Since there are different benefits/costs and different countries of destination.

Lecture Outline
Introduction
I-Theoretical background
A-Types of financing source
   1- Balance of Payments
   2- Pros and Cons of various resources
B-Two-gap model
II Capital account liberalization
   A-Stylized facts on financial openness
   B-Impact of financial globalization on performance

Conclusion

I-Theoretical background
A-Types of financing sources

How to finance an economy’s needs?

International  Domestic

Private Funds  Public Funds
FDI  Loans  Loans

Portfolio Investments
  - Bonds - Stocks
AID
1-Balance of Payments

Current transactions
- Goods and Services
- Income
  - Wages of expatriates, Returns of Investment, Profits of Firms
  - Interest payment (debt servicing)
- Transfers
  - Development aid
  - Transfers of migrants

Capital and Financial transactions
- Capital: debt cancellation
- Financial operations
  - FDI
  - Portfolio investment
  - Others: essentially debt

Change in Official Reserves

Errors and Omissions (Parallel Markets, Illegal trade (not reported flow of capital, smuggling, etc.)

1-Balance of Payments
The balance of payments should be always in equilibrium: BOP = 0
A deficit in Current Account has to be covered by a Surplus in the K account.

HOW?
Attracting direct foreign investment into the economy
Running down official reserves of foreign currency
Attracting short term banking flows into the financial system by offering an attractive rate of interest
Foreign capital is typically seen as a way of filling in gaps between the domestically available supplies of savings/foreign exchange and the desired level of these resources necessary to achieve growth and development targets.
But additional benefits/costs depending on the types of flows.

2-Pros and Cons of various financial sources

Debt
Pros: no loss of sovereignty

Danger emerges when:
Debt service and reimbursement > capacity of payment (income growth)
More than the size the structure of the debt matters:
  - short versus long term
  - currency: local or foreign (risk in case of devaluation)
  - foreign or domestic owners of the debt: less risk averse

Official Aid: Grants or Loans to poor countries
(a) undertaken by the official sector;
(b) with promotion of economic development and welfare as the main objective;
(c) at concessional financial terms [grant element > 25%]

Pros: cheaper, contra-cyclical, and less volatile
Cons: limited funds, subject to conditionality and strategic games

2-Provisions and Cons of various financial sources

FDI (investment to own 10 per cent or more of the ordinary shares)

Pros:
- Transfer of technological and managerial know-how
- Increase in fiscal revenues through taxes on MNC profits
- Long term investment: less volatile (less sensitive to devaluation)

Cons:
- **worsening of balance of payments** (importation of capital equipment and intermediate products and outflow of foreign exchange in the form of repatriated profits)
- **reduce savings and investment:**
  - increased competition (under protection) inhibits expansion of domestic firms
  - profits go to richest with lower savings propensity
  - crowding out of investment of local firms
- management, entrepreneurial skills, ideas, technology may be inappropriate (too capital intensive and not absorbed: idea gap)

2-Provisions and Cons of various financial sources

Cons:
- MNC produce **inappropriate products** (for elite) and use **inappropriate (capital-intensive) technologies** of production.

reinforce dualistic economic structures and exacerbate income inequalities: rich/poor, urban/rural

influence government policies to extract sizable economic and political concessions unfavorable to development

Portfolio flows: foreign purchases of the stocks (equity), bonds, certificates of deposit, and commercial paper of LDC

Cons: Volatility: hot money (herding behavior with overreaction)
Pros: For investors: increase in returns and diversification of risks
B-Model of the financing gap
Recall from Harrod Domar Growth Model (1947)
National income is made of consumption and savings
\[ Y(t) = C(t) + S(t) \]
Output equals the demand of consumer and investment goods
\[ Y(t) = C(t) + I(t) \]
\[ S(t) = I(t) \]
Investment increases the domestic capital stock
\[ K(t+1) = (1-d)K(t) + I(t) = (1-d)K(t) + S(t) \]
with \( s \), the saving rate and \( \theta \) the capital-output ratio (ICOR)
\[ S(t) / Y(t) = s \]
\[ K(t) / Y(t) = q \]
So we get the famous: *Harrod-Domar equation*:
\[ \frac{s}{\theta} = g + \delta \]
B-Model of the financing gap

*Harrod-Domar equation:* \( \frac{s}{\theta} = g + \delta \)

Simplicity in terms of description and prediction
- if one has a target for output growth: \( g \)
- simple deduction of necessary investment rate knowing \( \theta, \delta \) “required” investment rate for a target growth rate

**What if domestic savings rate is insufficient, i.e. Positive savings gap?**

**Solution is simple**
- import foreign financial resources

Elaboration into the two-gap model: savings and foreign exchange

Two potential constraints on investment
- availability of domestic savings: \( I < sY + \text{capital flows} \)
- availability of foreign exchange to import necessary machines:
  - \( m1 I + m2 (C+G) < \text{capital flows + Exports} \)

With \( m1 \) and \( m2 \) the marginal import share of \( I \) and \( (C+G) \) respectively

B-Model of the financing gap

**Message is thus:** Economic growth is proportional to investment, which in turn is financed by domestic savings plus foreign capital

**Typical limitations of the Harrod Domar model**
- exogeneity of parameters: \( \theta \) and \( s \)
- not verified empirically: no robust relationship between investment rate and growth rate (cf. Easterly)
- overestimation of quantitative role of investment

**Additional limitations of the two-gap model**
- no increase one for one of investment with foreign capital flows (increase in consumption, corruption...)
- exogeneity of Exports, \( m1 \) and \( m2 \) (not influenced by \( Y \), capital flows)

II Capital account liberalization

A-Stylized facts on financial openness

Financial openness is typically based on the estimated gross stocks of foreign assets and liabilities as a share of GDP.

Also indicators of restrictions to capital flow

1-Stark difference between industrial and developing countries
- Enormous increase in Industrial economies in the 1990s
- Increase also in developing economies in that decade but still low level
2-Financial integration in terms of increased capital flows have been spread very unevenly across developing countries

**Several phases**
- 1970s: Bank loan increase leads to the debt crisis
- 1980s: Retrenchment
- 1990s: Abundant portfolio flows lead to financial crisis
- Over the last 20 years: surge in FDI

**Great differentiation**
- Integrated countries (MFI, 22) have access to most of and all types of financial sources
- Less integrated countries (LFI, 33): more bank loans, no portfolio flows

3-Private capital flows only marginally flow to developing countries

4-Private capital flows to developing countries are concentrated among a few emerging countries
5-Foreign flows still small relative to domestic investment

II Capital account liberalization
B-Impact of financial globalization on performance
1-Potential Benefits of Financial Globalization in Theory
Empirical Evidence

No apparent systematic relationship between growth and financial integration

1- financial integration is not a necessary condition for achieving a high growth rate.
2- financial integration is not a sufficient condition for a fast economic growth rate either.

Conclusion

2-Empirical Evidence: After accounting for important potential omitted variables, still no significant correlation between growth and financial integration
Most empirical studies find no strong and robust effect of financial integration on economic growth for developing countries

Why divergence from apparently so strong theoretical basis

1. Potential benefits far outweighed by costly banking/financial crises experienced in the process of financial integration.
2. Main source of income/growth difference is difference in TFP and not physical accumulation:
   - unless foreign financial flows affect the determinants of TFP (mostly “soft” factors or “social infrastructure” like governance, rule of law, and respect for property rights
   - they are unlikely to offer a major boost to growth by itself.