

Foreign Investment & Capital Flows

9

Unit Highlights:

- ® Foreign investment.
- ® Capital Flows.
- ® Portfolio investment.
- ® Foreign Direct Investment.

Lesson-1: International Capital Flows

Lesson Objectives

After studying this lesson, you will be able to:

- ® understand the implications of capital flows among different countries;
- ® explain the nature of portfolio investment;
- ® explain the welfare effects of portfolio investment and
- ® understand how the transfer problem arises.

As we have seen earlier, a basis for mutually advantageous trade exists if the pre-trade prices differ between countries. And these prices may differ because (for instance) of differences in technology (Ricardo) or in factor-endowments (Heckscher-Ohlin). Suppose that prices of factor or goods reflect their (marginal) values to society. Then if the movement of goods between nations (prompted by price differences) can improve world welfare, so factor should have mobility (prompted by reward differentials). In the Heckscher-Ohlin model, free goods movement can lead to factor reward equality, despite international factor immobility. But for this to happen, it is necessary to assume that the trading countries share the same technology and that they differ little in the structure of factor endowments so that they produce similar goods. These are strong (though useful) assumptions. In the absence of international factor mobility, there is likely to be differences in factor returns. These will, however, be mitigated if the labour abundant country exports the labour-intensive good, while the capital abundant country exports the capital intensive good. Therefore, one could suggest that if factor could move from their abundant-locations to their scarce locations internationally, the world efficiency would have increased. In this sense, trade in goods and factor mobility would be substitutes. However, if the basis of trade is not resource-endowment differentials (as in H-O theory) but technology differences (as in Ricardo), then trade will tend to raise the return to the factor used intensively in the production of the export good of each country. If factors could move between countries in response to their factor price differentials, that could create a further basis for expanded commodity trade.

We know that in the real world, there is some mobility of factor (more so for capital than labour). This leads to some modifications of the conclusions of earlier models (based on the assumption of international factor immobility) and poses new problems for economic policy. In this section, we shall concentrate mainly on the issues raised by the international flow of capital.

It is clear from our discussion of the structure of the balance of payments that trade in international financial assets is the hallmark of capital accounts transactions. These trades involve movement of capital between countries. Note that capital here does not refer to physical capital (i.e. the produced means of production like buildings, machinery and equipment, roads etc.); trade in these items is recorded in the current account, being trade in goods (but keep in mind that some capital goods like roads are not tradable). The trade in financial assets (or, the movement of capital) means borrowing and lending between countries. (and so, they are appropriately recorded in the capital account of the balance of payments). International investments take place through these borrowings and lending.

International factor mobility can contribute towards raising world efficiency, by creating a new basis for expanded commodity trade.

In the present context, capital flows mean flows of financial, not physical, assets.

International Investments take two major forms: portfolio investments and direct foreign investments.

Direct vs. Portfolio Investment

As noted earlier, international investments can take two major forms—portfolio investments and foreign direct investments (FDIs). When a domestic resident buys shares, stocks, bonds issued by a foreign enterprise or government, he acquires claims on earnings from these financial assets. The purchase of these claims is an instance of portfolio investment. The distinguishing mark of portfolio investment is that the act of investing by itself does not give the investor any control over the use of funds the investor is lending. When the resident buys a bond issued by a foreign company or lends to a foreign government, there is no question of acquiring voting rights (there are none) and hence of control. Equity holdings carry voting rights, but for having a say in the affairs of the foreign enterprise, the domestic investor must own a high proportion of total equity capital (but not necessarily a majority holding). In short, portfolio investments are those which do not give (nor are intended to give) the investor any control over the use of funds so lent.

Direct investments stand at the opposite pole. The very intention of making a direct investment is to have a control over the affairs of the foreign enterprise in which the investment is made. The principal vehicles of such foreign direct investments since 1950 have been the multinational companies which invest by creating and operating subsidiary companies in other countries.

Historically, the proportion of direct to portfolio investments have shifted, sometimes dramatically. Until World War I, portfolio investments predominated, Britain being the principal lender. Net portfolio capital transfers nowadays are quite small, the annual flow rarely exceeding one percent of the gross national products of the major industrial nations. But between 1870 and 1913, British net foreign lending constituted 5.2 percent of its GNP, roughly coinciding with large flows of migration in these years. These investments did in fact earn higher rates of return than what domestic British securities offered. The recipients too were largely developed countries in Europe, America and Australia. The USA, on the other hand, was an exception to this trend of portfolio investment even before the first World War, its capital exports consisted mostly of direct investments.

Between the two World Wars, the flow of international investment declined substantially. But it grew very fast in the post-war period, dating roughly from the Korean war (1950-53) to the first oil shock (1973-74). In keeping with tradition, the USA led this revival with the US-based multinational companies occupying the predominant position. Since the early 1970's the growth of foreign direct investment has been rather slow, with the portfolio lending gaining some lost ground. In the mean time, changes in the direction of foreign direct investment have taken place. Prompted by resistance to, and expropriation of, FDI's in the developing countries, FDI's moved away from them towards Europe and other developed countries. Moreover, since the 1980's, the USA has been the favourite destination of direct investments from the Netherlands, Canada, Germany and even China. In recent times, the character of the DFI's have undergone a major change. Early multinationals were largely extractor of raw materials and other primary products, but now most of the FDI's are in manufacturing, much of which is concentrated in high technology areas.

In contrast to early multinationals, their present day counterparts favour manufacturing rather than extractive industries.

Welfare Effects of Portfolio Investment

The financial institutions of the world got a severe beating during the Great Depression of the 1930s. The wartime controls added to their troubles. As a result,

in the early post-war period, the international capital movements were reduced to a trickle. Instead of encouraging international capital flows, the Bretton Woods System proposed to regulate them in order not to allow them to disrupt the management of fixed exchange rates. Only gradually did capital become highly mobile internationally.

Here we shall occupy ourselves with private capital borrowings and lending. Portfolio investments can lead to more efficient allocations of world's financial wealth, thereby increasing aggregate world welfare. This proposition has been explained with the help of Fig. 9.1, on the assumption that there are no market imperfections. The fixed capital stock of country A is $O_A M$ and that of B is $O_B M$. The supply of labour in each country is assumed to be completely inelastic. The MPK_A and MPK_B curves represent the marginal physical productivities of (and hence the real returns to) capital in country A and B respectively. Needless to say, the marginal physical productivity curves represent the demand for capital services in each country. The interaction of demand and supply forces will establish the equilibrium returns to capital in a competitive market (as assumed here). This is shown to be r_A in country A and r_B in country B, when the countries cannot trade with each other.

Portfolio investments can increase aggregate world welfare by ensuring more efficient allocations of world's financial resources.

In the absence of capital movement between countries, each country has to match its financial wealth with its own stock of real capital. In isolation, the rate of return in country A (r_A) is higher than in country B (r_B). This reflects the fact that while A has an abundance of capital (relative to labour), the opposite holds for country B: it has ample opportunities for profitable

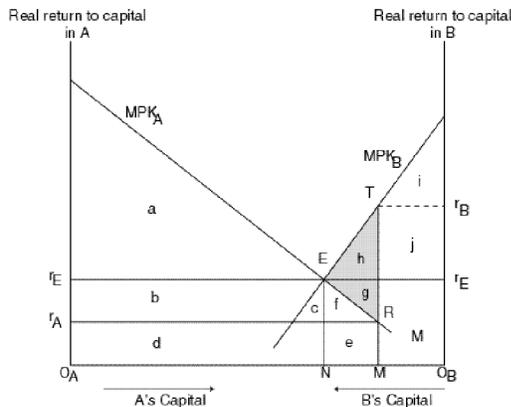


Fig 9.1 : The effects of portfolio investment

investments, but little wealth. Competition, therefore, forces the lenders in country A to accept a lower rate of return than in B.

Now suppose that it is possible to move capital from one country to the other. In the situation portrayed in Fig. 9.1, the direction of movement is clear : capital will move from country A (where the return is low) to country B (where the return is high). In the process, the rate of return will go up in country A and fall in country B. The movement of capital will continue until capital in both countries earn the same rate of return (r_E). This is given by the point of intersection (E) of the marginal productivity curves MPK_A and MPK_B , signifying that the marginal productivities have been equalized by capital movement between the two

countries. The total world stock of capital ($O_A O_B$) has been reallocated by capital movements : country A has $O_A N$ (lower than its endowment by MN), while B's share is $O_B N$ (higher than its endowment by MN). Obviously the loss of A (MN) has to be equal to the gain by B (MN) under the assumption of fixity total world stock.

The reallocation of world's capital stock has made the world as a whole better off than before, because the output in B has increased more than it has fallen in A. Let us take country A first. Its total output before capital export is given by the area under the curve MPK_A (i.e. the area $a+b+c+d+e+f$). In the absence of market imperfections, the share of capital in this output will equal the area $(d+e)$, with the rest (i.e. the area $a+b+c+f$) going to labour.

In the final international equilibrium, when country A has exported MN of its capital to B, the amount of capital employed in A ($=O_A N$) will earn a higher rate of return (r_E), the total earnings being equal to the area $(b+c+d)$. But the owners of exported capital would receive a total payment from B equal to the area $(c+f+g)$. Therefore, the combined total earnings of capital owned by country A (i.e. $O_A M$) is given by the area $(b+c+d+e+f+g)$. Country A's total earnings of capital exceeds the pre-trade return by the area $(b+c+f+g)$.

Free international mobility raises world welfare, but can hurt particular groups within the exporting and importing countries.

What has happened to the fortunes of workers in A? Before capital export, their total income was area $(a+b+c+f)$, but after trade it has dwindled to area 'a'. Therefore, the workers as a whole suffers an income loss measured by area $(b+c+f)$. When this is set off against the gain to capital owners in A (i.e. area $b+c+f+g$), we see that the net gain to country A is the area 'g'. Therefore, we conclude that the country which lends abroad gains by doing so.

We can also show that the capital importing country (country B) too is a net gainer. Because of capital import, B's total output has gone up by area $(e+f+g+h)$ of which $(e+f+g)$ is lost as payment to capital exporters in A. The net gain to country B is then area h. This consists of a loss to capital owners (area j) and gains to workers (area $h+j$).

The world as a whole makes a gain of area $(h+g)$ from the more efficient use of capital. There is nothing surprising in this result, since the welfare effects of international lending are analogous to those that arise when trades open or when workers move freely in response to wage differentials. Within each country, there are, however, gainers and losers. For example, the borrower in A are hurt, because they now pay more for the services of capital than before, while the borrower in B are better off for the opposite reason. The lenders in A gain, but those in B lose. The general lesson is that the freedom of international mobility will benefit the world as a whole and also the groups for which the freedom brings opportunity, but will hurt the groups for whom freedom only means tougher competition.

Losers in each country will try to lobby against free movement of portfolio capital.

Capital Flows and the Transfer Problem

We have seen above that both countries (A and B) stand to benefit from international movement of portfolio capital. Of course, some groups within each country gain, while others lose. The losers may find reasons to lobby against free movement of portfolio capital. Apparently, there should be no national interest to oppose free flow of funds (not direct investments which are highly controversial). This, however, need not be the case. One can cite instances from recent monetary

history of countries trying to restrict the inflow or outflow of (portfolio) capital as part of the strategy of dealing with the balance of payments imbalance. The idea is to restrict capital exports, when there is an external deficit, and to discourage capital imports when there is a surplus. An apt example of this is the use of Interest Equalization Tax by the US in the 1960's to restrict capital outflows from the country. The fear that free flow of funds internationally may be undesirable from the point of view of the balance of payments is rooted in the so-called transfer problem.

Free capital flows have been opposed by some involving the so-called transfer problem.

The nature of the problem is explained below with the help of a simple model. Suppose that country A lowers its aggregate spending below its value of produced income by T in order to transfer it to country B. This transfer enables country B to raise its spending above its current aggregate value of production by this amount (T). Note that this assumption enables us to start from a position of balance in which the value of world (A+B) production equals the size of world expenditure.

Let us now ask: How is this transfer of purchasing power expected to affect the terms of trade (and to keep thing simple, assume that it is a one-way grant so that there is no question of a reverse transfer)? To answer this question, we need to know how this transfer is going to affect the world demand for one of the traded goods, say food. Food is imported by country A from B in exchange for its cloth.

The consequence on the terms of trade of the transferring country will depend on the relative magnitudes of marginal import propensities in the two countries.

One thing is clear. The transfer of (pure) purchasing power does not affect the world supply of food shown by the curve $(S_F^A + S_F^B)$ in Fig 9.2. The pre-transfer world demand curve is given by $D_F^A + D_F^B$, and the initial equilibrium terms of trade (P_F/P_C) is OA. The crucial question now is whether and how the aggregate demand for food will be affected by the transfer of purchasing power. Assuming that food is a normal good, the demand for food in the transferring country (A) will decrease (its demand curve will shift to the left). On the other hand, the increased purchasing power in the receiving country (B) will be spent on all commodities including food. This will cause the foreign demand curve for food to shift outward. Therefore, whether the world demand for food will shift to the right (a deterioration in the terms of trade for country A) or to the left (an improvement in its terms of trade) or will stay unchanged depends upon differences in the two countries' taste patterns. There is thus no clear-cut answer, because the terms of trade can move either way (or it may stay the same).

We can be more precise about the conditions under which an improvement or a deterioration is likely to come. Let ' m_a ' be the marginal property to import food for country A and m_b the marginal propensity to import cloth by B (from A). Now since the size of the transfer is T, country A's demand for food will be reduced (at the initial price) by $m_a \cdot T$, while that of country B will rise by $(1-m_b)T$, where $(1-m_b)$ is the marginal propensity to consume food in B. We can then say that the world demand curve for food will shift to the right $\left[\text{to } (D_F^A + D_F^B)' \text{ in Fig 9.2} \right]$ only if $T(1-m_b) > T \cdot m_a$ (i.e. of $m_a + m_b > 1$). Or, equivalently, the terms of trade (the relative price of food) will move against the transferor (A) if and only if the sum of the two countries' marginal propensities to import falls short of unity ($m_a + m_b < 1$). If this happens, the transfer is said to suffer a 'secondary burden'. This burden arises because of the fact that the relative price changes can cause an international

The possibility of relative price changes can cause international redistribution of income and thereby bring an secondary burden on the transferring country.

redistribution of income (unfavorable to A) which is additional to the one initially caused by the transfer. Of course, there is also the possibility that there will be an improvement in the terms of trade for the transferor. This could be called a 'secondary blessing'. But it can be shown that the size of this blessing could not be such as to make a country (like A) better off by giving (This will explain why Brazil is induced to burn a part of its bumper coffee crop rather than give it away!).

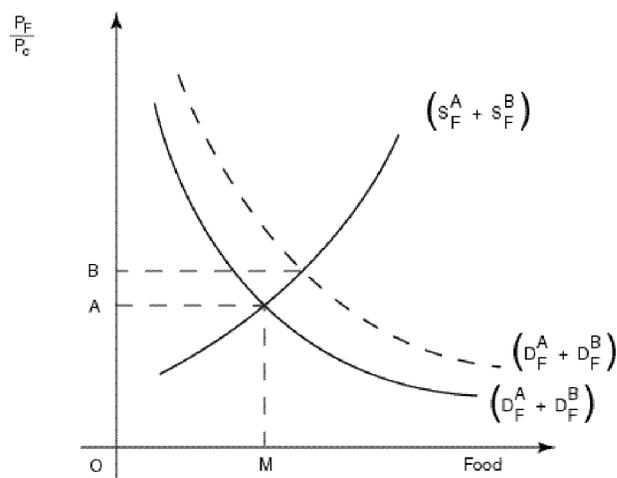


Fig. 9.2 : Transfer and the Terms of Trade

Note that even when the terms of trade don't deteriorate (no secondary burden), the lending country must free the necessary resources in order to export them to the other country which will import goods and services with the help of the transfer (loan). This means that if a transfer is not to create any problem (e.g. for the balance of payments), every financial transfer must be matched by an equal transfer of resources. This may require adjustments in the exchange rate, rate of interest or terms of trade both in the lending and borrowing countries. These adjustments may affect the short-term goals of the countries differently, triggering policy response by governments to restrict international lending and borrowing, perhaps using macroeconomic instruments.

In short, these and other related difficulties that arise when a country transfers purchasing power to another are said to constitute the transfer problem.

Questions for Review

MCQ's (tick the right answer)

1. Foreign Direct Investments
 - a) do not give the investors any control over the use of funds invested.
 - b) do give the investors total control over the use of funds invested.
 - c) do give at least some control over the use of funds invested.
 - d) have nothing to do with controls.
2. Investors of portfolio capital have
 - a) no control over the use of funds
 - b) some control over the use of funds
 - c) total control over the use of funds
 - d) none of the above.
3. Since capital movement can benefit both the borrowing country and the lending country,
 - a) all citizens are equally benefited in the lending country
 - b) all citizens are not equally benefited in the lending country
 - c) all citizens are equally benefited in the borrowing
 - d) some lose and some gain in the borrowing country as well as the lending country.
4. The welfare effects of international lending are analogues to
 - a) those which arise when trade for goods open
 - b) those which arise when worker move freely in response to wage differentials
 - c) these which arise when the gap between export and export duties is narrowed.
 - d) both (a) & (b)
5. The problem that may arise when a country transfers purchasing power to another is known as
 - a) interest parity problem
 - b) wage parity problem
 - c) income parity problem
 - d) transfer problem.

Short Questions

1. Why is it claimed that international capital mobility can be a further basis for expanded commodity trade?
2. Which are the principle vehicles of Foreign Direct Investment (FDI)? Can you guess why these are preferred to other forms?
3. While portfolio investment can raise aggregate welfare, they can also hurt specific groups in the leading as well as the receiving country. Is this surprising? Isn't it the consequence of all trades (including commodity trade)?
4. What is the transfer problem? How is it related to the welfare of the transferring country?
5. Diagrammatically show the consequences of transfers on the terms of trade?

Essay Type

1. Distinguish between direct and portfolio investment and highlight their distinguishing features.
2. Diagrammatically examine the welfare effects of portfolio investments.
3. Discuss how international capital flows might lead to a transfer problem.

Lesson-2: Debt Crisis

Lesson Objectives

After studying this lesson, you will be able to:

- ® what the nature of the debt crisis was;
- ® how the debt crisis arose and might arise again and
- ® the role of short term capital movement in the recent East Asian financial crisis.

The Debt Crisis

The benign effects of capital movement explained with help of Fig. 9.1 rest on the assumption that the debtors can pay the interest and repay the principal on time. But the experiences of international lending and borrowings in the 1970's and early 1980s did not support this assumption. This was the period in which the richer LDC's borrowed heavily from the industrialized countries or their large private banks. In absolute terms most of the loans were concentrated in two regions: Asia and Latin America. The developing countries also borrowed from international institutions (such as the World Bank). By the beginning of 1983, the total overseas debt of the 21 largest LDC borrowers stood at \$514.5 billion, including a short-term borrowing of \$132.5 billion. These sovereign debts brought international headlines in 1982 and 1983, when the borrowers seemed to be facing troubles in meeting their debt service obligations.

Why was there a surge in international lending (and borrowing) in the period 1974-'81? And why did the sovereign borrowers face difficulties in keeping their commitments?

Willingness to lend : Major Factor

(a) *Increase in Private Bank Reserves*

The huge oil-revenues of the OPEC countries gave big boost to the reserve bases of major international private bank in early 1970s.

The OPEC oil cartel managed to hike the price of oil to dizzy heights during 1973-74 and again in 1979-80. These oil shocks sent the world economy into a recession. But oddly, these also dramatically increased the supply of investible funds. The huge oil revenues of the OPEC countries were held in liquid form by acquiring bonds, bills and bank deposits in the US and other established financial centres. The big boost in the reserve bases of major international private bank (like chase Manhattan, Citibank and Morgan Guaranty) made them bold enough to pursue a policy of aggressive lending.

This eagerness to lending was further fuelled by the inflationary monetary policies which the industrialized countries followed in order to fight the unemployment caused by recession (these countries feared that a tight monetary policy would exacerbate the already high unemployment rate).

It must be noted that these two factors (possession of petro dollar as additional reserves and the favourable environment for lending used by the inflationary monetary policies) only explain why the lenders were more capable and willing to lend. But they do not explain why a large chunk of the investible funds was channelled to the developing countries.

(b) *Unfavorable Investment Climate in the Industrialized Countries*

The petro-dollars which inflated the reserves of most western banks could have been invested in domestic capital formation, perhaps in energy-saving projects. As it turned out, the climate of recession bred a general feeling of pessimism about the profitability of investment in the developed countries. There were not enough takers of loans at attractive rates of interest. So, the banks and lenders naturally turned towards borrowers in the developing countries which promised higher rates of return.

(c) ***Hostility to Foreign Direct Investments***

The poor investment climate in the industrialized countries and the consequent relative lack of demand for funds in these countries do not explain why the investments took the form of loans and enterprises over which the lenders had no control. Or, in other words, why did they not take the form of foreign direct investment (FDI) in which the investors keep a controlling ownership? In fact, the latter option was not readily available. In this period, there was a rising tide of resentment and hostility in the developing countries towards FDI's, particularly against the multinational companies, the principal carriers of FDI's. This mood of hostility was at least in part encouraged by the successful overthrow of the power of international oil companies by the OPEC in the early 1970's. The result was a continually declining share of FDI's in net financial flows to the developing countries. This share which was 25% in 1960 and 20% in 1970 came down to a mere 10% by 1980.

Unfavourable investment climate in the richer countries, combined with some hostility to direct investment, prompted international banks to lead heavily and sometimes indirectly, to the developing countries.

(d) ***Competitive lending***

Once lending at interest to the developing countries had become an established form of doing business and gained some momentum, it acquired a life of its own. Private banks vied with one another to get ahead of its rivals in leading. This herd instinct seemed to have driven many lenders to throw caution to the wind while granting large loans against which there were no collaterals to be seized when the borrower faltered in meeting their repayment obligations.

Causes of Borrowers' Failure

This supply of international lending dropped off in 1982 and dozens of debtor countries expressed the possibility of their default on debt service. Why did this happen? Were LDC's taking advantage of their sovereign status - that they cannot be sued or compelled to pay like ordinary debtors? or, did their capacity to pay sufficiently and unexpectedly decline? Most observers agree that the latter was the plausible explanation. On that assumption, the significant erosion of the ability to repay is usually attributed to three factors:

(a) ***Rising interest burden***

Many developing countries, particularly those of Latin America, borrowed from international banks on the basis of floating (ie, adjustable) interest rates. The interest rate is called floating when the loan contract allows the lender to adjust the interest rate charged in keeping with changes in the current international market rate. In most cases, the loans to these countries were tied to the LIBOR (London Inter Bank Offered Rate) which is adjusted every six months. This feature of the loan contract turned out to be an important contributor to the world debt crisis.

Developing countries' failure to repay has been attributed to their diminished ability to do so.

The phase of accommodating monetary policy of the early 1970's in the industrialized countries (in order to avoid increasing unemployment) gave place to a phase of tight money policy in the late 1970's (in order to curb accelerating inflation). The resulting sharp rise in interest rates (including the LIBOR) put the developing countries in a double squeeze. Not only that new borrowings became more expensive, but the interest payments on old loans escalated, because of the floating rate provision in the loan contracts.

Interest burden rose sharply, because many loans carried floating interest rates. On the other hand, the world recession eroded the capacity to repay the loans and interest.

(b) World Recession

Following the second oil price hike in 1979-80, the world economy moved into the worst recession since the 1930's. By 1981 the average rate of unemployment in seven major industrialized countries exceeded 8% , while their GDP growth rates became negative in real terms. This unexpected development hit the developing countries in two ways. First, the demand for LDC export declined because the incomes in richer countries fell and also because developed country markets became less accessible to LDC exports owing to the rise of protectionist tendencies. Secondly, the developing countries suffered declines in their terms of trade. In fact, the terms of trade of oil-importing developing countries declined by 13% during 1978-81. Until then, the export of principal LDC borrowers grew roughly as fast as their external debt (22% vs. 25% during 1975-79). But in 1980-81, while debt had been growing at about the same rate, the growth in real exports came to a virtual halt. As a result, the capacity of LDCs to service their growing external debt was severely eroded.

(c) Appreciation of the dollar

The tight monetary policy referred to above not only led to a sharp rise in interest rates, but also to a considerable appreciation of the US dollar. As explained earlier, the interest- arbitrage mechanism ensures a close link between the interest rate and the external value of the currency. The tight monetary policy in US took US interest rates above those in Britain, France, Germany and Japan. The massive flow of funds into the US induced the rise of the external value of the dollar. Consequently, the real value of loans denominated in dollar soared, making the debt service costlier.

Appreciation of the US dollar raised the real value of dollar-denominated loans. Capital flights from some countries further complicated the debt problem.

(d) Capital Flight

The unsettled economic and political conditions in many LDC's led to capital flights, especially from Latin American (debtor) countries. These were primarily motivated by concerns to seek safe haven for funds owned by private individuals and firms, and led to increased indebtedness of the countries concerned. Empirical evidence seems to suggest that but for these capital flights, Argentina and Brazil would have faced little indebtedness, while Venezuela could have become a creditor country. The difficulties noted above do not explain why the debt problem turned into a debt crisis. Loans to sovereign entities may not be backed by collaterals, but they nevertheless have the backing of the governments' taxing powers. Why was this power not exercised in full? The main reason was, no doubt, political : asking the citizens to pay for loans from foreign lenders has never been popular with the taxpayers. But there is another reason. In order to meet debt service obligations, a country must shift resources to the export sector and limit imports (of both). Many LDC economies cannot exercise this option easily because of severe rigidities in intersectoral reallocation of resources. For example, governments may raise sufficient local currency funds to meet debt service

obligations. But this is not enough. There must be reallocations of production and consumption to generate necessary international purchasing power (the relevance of the transfer problem involved should be clear).

Repudiation of loans : Not an Easy Option

A sovereign debt is one which cannot be enforced in the case of non-payment. But the sovereign borrowers have to pay a price in case of default or non-payment in other ways. This explains why they earnestly request debt rescheduling and provision of new credit to bail them out. Debt rescheduling involves postponement of the repayment of principal, but not of interest payment. Bank finance in the form of new loans is usually supplemented by loans from some governments and the IMF.

While the developing country governments enjoy sovereign immunity, it is never total. For instance, the creditor country can seize assets of the debtor located in the creditor country or even the debtor country's export. But when the value of debts is much higher than the value of assets or exports, seizure is not an effective deterrent. Similarly, imposing trade sanctions or breaking trade links may go some way, but may not always work. However, the possibility that is most dreaded by the defaulter is exclusion from new borrowings that default could bring. No formal sanction or organization is necessary for this, because the international capital market will regard default as a bad risk which may lead to drying up of the future credit flow.

It is not easy to refuse to pay sovereign debts, even in the absence of formal sanctions. Loss of credibility may dry up the further credit flow.

Short-term capital Movement & the East Asian Crisis

We have thus far dealt with movement of long-term portfolio capital. Historically, these have no doubt been important, but in recent years, the phenomenon of short-term capital movements has become the subject of intense controversy among economists, politicians and policy-makers. The East Asian financial crisis of recent years has brought to the fore the question of whether (and how) short-term capital flows significantly contribute to destabilization of economies which follow a pegged exchange regime of one sort or another and also have gone quite far in the direction of financial liberalization.

As discussed earlier, international capital movements are induced by differences in yields expected on financial investments between countries. Large enough changes in the composition of portfolios will, however, eliminate the differences in expected yields. In the last three decades, short-term capital has become more mobile internationally. This increased mobility has important consequence on macroeconomic policy and welfare, as the East Asian crisis has demonstrated so dramatically. In an earlier unit we have explained how the Euro-currency market provides for both depositors and borrowers a competitive alternative to domestic banking systems. This can offer better terms at little or no increase in risks. Therefore, whenever the national interest rate goes out of line with the Euro-currency rates, large international flows can take place to take advantage of the differential.

The East Asian financial crisis is alleged to have been caused to a large extent by short-term capital flows.

In the late 1980's and early 1990's, the East Asian countries began to liberalize their financial sector which led to a change in the composition of capital flows into the region. The share of FDI's in the total capital inflow declined markedly as that of liquid portfolio-capital (so-called 'hot-flows') surged forward. As is well-known,

the short-term capital can go out of the country as easily as it can flow in, the movement in either direction being determined by the perceptions and activities of speculators in the foreign currency market.

As the rate of inflation in the East Asian countries was higher than that in the developed countries (which were not much out of line with Euro-rates for reasons of arbitrage), the interest rates in the developed countries were lower. This created an incentive for East Asian financial institutions to borrow short in foreign currency, convert the currency (assuming the exchange risk) and lend long in the domestic currency. Behaving in these 'courageous' ways, these institutions made themselves vulnerable from two directions. **First**, a currency depreciation could mean losses in foreign exchange (more domestic currency will be needed to repay a given loan denominated in foreign currency). **Secondly**, the bank faced the risk of a run, if doubts were to arise in their ability to honour commitments.

Both the borrowers and the lenders had strong incentives to engage in heavy borrowing and lending, while the watch-dog institutions watched complacently.

The East Asian financial institutions were not very careful about their lending operations, nor did the 'watch-dog' institutions do their surveillance effectingly, As a result, credit flowed mostly into non-manufacturing and non-productive sector of the economy. The values of collaterals were highly inflated and artificial. Soon it became clear to observers that a substantial part of the credit was not recoverable. This set off alarm among the investors. The capacity of the monetary authorities was stretched to the limit to sustain capital account convertibility as the stability of the currency became suspect in the currency market.

In the environment of deregulated financial market (with no capital control) the only option for monetary authorities was to use the interest rate to arrest the downward slide in the exchange rates. Both, however, were subject to expectations shaped by uncertainty in the market. Ultimately the monetary authorities were forced to give up defending the exchange rate and floated the currency. This resulted in drastic depreciation of the national currencies. The crisis that started in Thailand soon engulfed the entire East Asian region.

With no capital control, interest rate manipulation proved ineffective.

Who is to be blamed for this financial mess? The speculative investors who are ever ready to come in and go out ? The East Asian financial institutions which wished to ride the speculative tide, never caring to see what had been happening in the real sector of the economy? The financial authorities which failed to do the job they were expected to do? There seems to be no agreement on these issues. But then, the allocation of blame is less important than the lesson the episode has to teach: a deregulated financial market in the climate of unhindered short-term capital mobility could be a potent force for instability in the financial sector and appropriate precautionary steps are to be taken in advance (especially because no one could correctly foresee that the East Asian crisis was looming on the horizon.)

Questions for Review

MCQ's (tick the right answer)

1. The huge oil-revenues of the OPEC countries
 - a) were deposited in the world bank
 - b) were deposited in the banks owned by OPEC
 - c) were deposited in large international private banks
 - d) were used to buy gold only.
2. Banks are found to lend more, when
 - a) they have additional reserves, and hence are more willing to lend
 - b) they are able, but not willing to lend
 - c) they are able and willing, but there are no borrowers
 - d) they are able and willing, and the borrowers are eager to borrow.
3. For the debt crisis,
 - a) the borrowing countries were totally responsible
 - b) the leading institutions were totally responsible
 - c) both the borrowers and the lender were partly responsible
 - d) none of the above.
4. It is not easy to repudiate sovereign loans, because
 - a) the lenders might organize formal sanctions
 - b) it is impolite to say not to the lender
 - c) the bad name earned may choke off future flow of credit
 - d) all of the above.
5. In the environment of deregulated financial market,
 - a) it is quite easy to use interest rate to arrest the downslide of the exchange rate
 - b) it is not at all easy
 - c) it is always ineffective whether the market is deregulated or not
 - d) none of the above hold.

Short questions

1. Why was there a surge in international lending and borrowing in the period 1974-1981?
2. Why did the sovereign borrowers face difficulties in keeping their commitments?
3. Many have alleged that while the borrowers were reckless about their borrowing, the lending banks too were less cautious than they should have been. Do you think this view has merits?
4. To what extent were the financial authorities (e.g. the central bank) relatively lax in imposing discipline on the financial sector in the run up to the financial crisis in East Asia?
5. "Repudiation of sovereign loans is not a very viable option for the defaulters." Do you agree? Why?

Essay type Questions

1. Discuss in general terms the nature of the debt problem faced by many developing countries from time to time.
2. Examine several debt crises of the recent past and try to locate their origins.
3. Examine the East Asian Financial crisis and highlight the role of short-term capital flows in its genesis and aggravation.

Lesson-3 : Foreign Direct Investment (FDI)

Lesson Objectives

After studying this lesson, you will be able to:

- Ⓜ define foreign direct investment (FDI);
- Ⓜ explain the nature of FDI; and
- Ⓜ explain why a firm chooses to invest in a foreign country.

We have mentioned before that foreign direct investments are those in which the investor attains controlling interest in the affairs of the entity or enterprise in which the capital is invested. The large multinational corporations are the principal carriers of FDI. Multinationals are essentially those companies which own or control production facilities in more than one country. In some cases, the capital invested in a foreign subsidiary is raised entirely in the capital market of the foreign subsidiary and its subsequent growth depends on investments of internally generated profit. The fact that the investor has substantial control over the foreign subsidiary enterprise makes the analysis of direct investment more complex and controversial than portfolio investment.

The Nature of FDI

Direct investment is not just an ordinary form of international capital flow, because it affects the nations' stock of productive factor as well as the degree of market competition in the industry into which the investment flows. The FDI's are marked by two prominent features:

1. The capital movement that accompanies an FDI is not of the ordinary variety: it is of the entrepreneurial or risk-bearing type. Of course, it finances the construction of plants and production facilities. But more importantly, the transfer of technology and managerial skills are necessary accompaniments of an FDI. Usually a direct investment by a multinational takes place through establishing and expanding a subsidiary in the foreign country.
2. The direct investment is highly industry-specific. What this means is that a multinational usually builds up production or marketing facilities in the host country in the very industry in which it has established itself in the home country. Direct investments can take two major forms: horizontal and vertical. Horizontal investment occurs when the subsidiary is established to produce the same product as the parent was producing in the home country. Vertical investments (of which petroleum refining and metal processing are typical examples) are different. Here the job of the subsidiary is to perform the next stage forward or the next stage backward for the sale or fabrication of the parent's product. Many small subsidiaries are mere distributors of parent's product in the host country. They are examples of forward vertical integration. But more important in respect of size of investment and complexity of operation is the backward vertical integration wherein a subsidiary provides a raw material or an input to the source country for further processing or fabrication. One obvious reason for vertical integration is, of course, the reduction of risk.

Foreign direct investment brings technology and managerial skills and is also highly industry specific. It usually takes two forms: horizontal and

Why Invest Abroad?

Why would a firm choose to invest in a foreign country, usually in competition with local entrepreneurs? A number of disadvantages are ranged against a foreign investor. The language laws, customs, and market conditions may all be different, or at least imperfectly known. Therefore, there must be a general explanation of why a profit maximizing investor would prefer to defy all these odds and invest in a foreign subsidiary. The issue becomes all the more intriguing if we remember that the investing firm has several sound alternatives to foreign investment, namely producing domestically and exporting abroad; or licensing foreign firms to produce the product in question. The obvious answer that comes to mind is that the firm finds the FDI option more profitable than other options. But this leads to the question : why should it be so, and not otherwise?

The following are the major explanations for the existence of the multinational company.

1. Vernon's Product Cycle Hypothesis

According to this hypothesis, a firm tends to be multinational at one stage of its growth. In the early stage, the production technique is new and requires large inputs of specialized labour. At this stages mass production is unsuitable because of small markets and technological uncertainties. Therefore, the market to be served first is the innovator's home market. But as the product matures, the production method becomes standardized and consumer acceptance spreads. Rival products emerge and the pull of cost advantage on the location of production grows stronger. At that stage, the firm may decide to develop production facilities at low-cost locations abroad.

The hypothesis is consistent with observed concentration of innovations in the developed countries. It can also explain why the newly industrializing countries (like Korea, Thailand) have been successful in exporting manufactured goods to the developed countries.

According to the product cycle hypothesis, a firm would prefer to acquire production facilities abroad at a stage when its product is mature.

2. Market Imperfections

The explanation provided by the product cycle hypothesis for the existence of the multinationals is incomplete. It does not say why a national firm would go for FDI rather than license or sell its technology to a foreign firm. The answer to this question has been sought in the imperfections of the market. According to this, the parent firm enjoys certain advantage such as patented and generally unavailable technology, team-specific management skills, economies of scale and a brand name, to mention just a prominent few. These give the national firm a monopolistic hold and enable it to capture monopoly rents in foreign markets.

The desire to capture monopoly rents may drive a firm to go multinational.

The alternative of licensing or selling the technology to existing foreign firms may appear less attractive than the FDI. The investing firm may perceive that the license faces or the sum of discounted rents (from the sale of technology) would not be as high as profits from the FDI. This would be the case when the license holder or the technology buying firm fails to apply the technology as efficiently as the parent firm for lack of requisite managerial skills (often management and technology are complementary).

The need for internalization through backward and forward integration may lead to direct investment abroad.

Stephen Hymer (1976) provides a different explanation for foreign direct investment by a parent company. The explanation, like the above, is still based on market imperfection. Hymer does not agree with the view that a multinational company simply appropriates the rents that it can earn by virtue of its firm's specific advantages noted above. In his view, a FDI is an instrument of suppressing competition to preserve existing rents in an existing market or to preempt the possibility of a rival in a new market, even when the foreign enterprise may look only marginally profitable. Under these instincts Kodak may set up a foreign branch because it fears that Fuji will do, if it does not. Examples of General Motor and Ford have been cited in corroboration of Hymer's thesis of "defensive investment". They are alleged to have set up plants in many developing countries to keep others (and each other) out of the race.

Another variant of market imperfection based explanation stresses the need for internalization through backward and forward integration. This consideration is said to weigh heavily in the case of development of a new process or a product, because here success crucially depends on complex coordination, rapid exchange of information and detailed planning. Integration tends to increase the efficiency of all these activities. And when integration calls for operations across national frontiers, direct investment in a foreign subsidiary is the appropriate answer.

FDI and Trade Barriers

If the exchange rate potentially affects a firm's choice between exporting and direct investment, so should the trade barriers imposed by the foreign country. These barriers tend to raise prices and profitability of investment within the protected market which provides the foreign firm a clear incentive to enter the sheltered market. This it can do in several ways: by establishing a new subsidiary, by buying an existing firm, or by entering into a partnership agreement with an existing firm. On the other hand, a firm may choose the FDI option, if its exports have been adversely affected by the import barriers. Japanese direct investments in U.K. and US are said to have been motivated by this consideration. Surveys of foreign subsidiaries in host countries tend to support this observation. Countries have often used tariffs to attract direct investment.

Transfer Pricing

The tax policies in the host and source countries do affect the flow of foreign direct investment. The higher the rates of tax, the greater the incentive, in general, to search for (legal or illegal) ways of avoiding taxes. For a firm the obvious way of doing this is to shift its operations to location offering lower tax rates. The FDI's can accomplish this in two ways. First, it is profitable for a multinational to create a subsidiary in a low tax country. Secondly, the multinational can resort to what is called 'transfer pricing' or other devices to report as much of its total profit as possible in the low- tax country. It is a kind of profit transfer by manipulation of the books of accounts. But what is transfer pricing?

A multinational company can resort to transfer pricing to lighten its overall tax burden.

Transfer pricing has to do with the pricing of goods and services exchanged between units of a multinational in different locations. Suppose that a multinational company wants to report lower profits in the parent country where the corporate tax rate is higher than in the host country. This can be done in either one or both ways: (i) change the subsidiary lower prices for goods and services sold to it;

(ii) ask the subsidiary to charge higher prices for goods and services sold to the parent. The former keeps the total revenue of the parent down, while the latter pushes up the unit's costs; and both help to keep profits down. Perhaps an example will be helpful. Suppose that an American subsidiary in Japan (the low-tax country) produces car engines to be shipped to USA for final assembly. The subsidiary buys some of its inputs for engine making from the parent company in USA. Now if the Japanese subsidiary is charged less for whatever it buys from the parent, the book profit of the parent will be lower. The profits go down further if the Japanese unit charges a higher price for the engine sold to the parent. In other words, by charging more for what it sells to the parent and being charged less for what it buys, the subsidiary can help lower the parent's profits (and, at the same time, it can keep its profits higher). Since the inter-branch exchanges are internal transfers, the transfer prices are mere accounting prices. Because of this property, profit can be secretly transferred from the branch in the high-tax country to one in the low tax country in order to lower the overall tax burden (and so to raise overall post-tax profits)

The Question of Restricting FDI

It is extremely difficult to measure the full impact and the real cost of multinationals both in the host and source countries using economic calculus alone. Direct investment in the most sensitive area is international economics today. Historically both developed and developing countries have voiced their concerns about the FDI's. Canada, Japan and Western European countries at various times have expressed the fear that foreign ownership would dilute their control over domestic resources. The developing countries are willing to welcome the capital, technology and management skills that come with FDI's, but, at the same time, are afraid that these will lead to exploitation and waste. The LCD's, therefore have generally preferred to avoid FDI in certain activities which are thought to be vulnerable to foreign influence, wasteful and inimical to (perceived) long-run national interest. They have thus tried to impose conditions on the entry and operation of the multinationals (such as local participation, domestic research and export). Multinationals are also accused of political manipulation in the host as well as the source country.

There are concerns about FDI in the source country too. If capital is invested abroad, less is available at home to be used with labor. Wages are likely to fall while the return to capital goes up; but these tendencies have not been confirmed by careful empirical studies. The source country may lose tax revenues if the multinational uses transfer pricing policies to avoid tax.

The most contentious issue surrounding FDI's seem to be more political than economic: the political clout that multinationals carry and its potential abuse in manipulating political decisions concerning economic issues. But then one has to take account of the fact that there is no perfect sovereignty in today's world, except in a state of complete isolation. The new world order must cope with the opportunities as well as the constraints thrown up by FDI's.

FDI's need be restricted is a root issue.

Questions for Review

MCS's (tick the right answers)

1. Multinationals usually have production or distribution facilities
 - a) in the parent country alone
 - b) in several countries
 - c) in countries with which the parent country government has no diplomatic link.
 - d) in the least developed countries only.
2. Alternative to foreign direct investment is
 - a) to sell technology to a foreign firm
 - b) to license technology to a foreign firm
 - c) both (a) & (b)
 - d) none of the above
3. In Hymer's view, a multinational is an instrument of
 - a) suppressing competition
 - b) fostering competition
 - c) enhancing a country's prestige
 - d) none of the above.
4. Vernon's product cycle hypothesis is
 - a) consistent with observed concentrations of innovations in developing countries
 - b) inconsistent with this evidence
 - c) a possible explanation of why a firm would like to be a multinational
 - d) both (a) & (b)

Short Questions

1. "The capital movement that accompanies an FDI is of the entrepreneurial or risk bearing type." Explain.
2. In what sense, direct investment is industry-specific? Elaborate.
3. How are multinationals associated with vertical forward and vertical backward integration? Discuss.
4. One obvious reason for vertical integration is the reduction of risk. How can vertical integration reduce risk?
5. "A firm tends to be multinational at one stage of its growth." Explain in terms of the product cycle hypothesis.
6. How can trade barriers lead to foreign direct investment? Explain with examples.

Essay type Questions

1. Examine the nature of FDI's and explain the forms they usually take.
2. Discuss the major explanations for the existence of the multinational companies.
3. What is transfer pricing? Is it harmful to the host country alone? Give reasons.

Answer key for MCQ's

Lesson-1: 1.c, 2.a, 3.d, 4.d, 5.d

Lesson-2: 1.c, 2.d, 3.c, 4.d, 5.b

Lesson-3: 1.b, 2.c, 3.a, 4.d