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Foreign sources of finance & foreign debt

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THE MEANING OF FOREIGN SOURCES OF FINANCE

Foreign Sources Of Finance

- Foreign sources of finance help countries acquire foreign exchange, add to insufficient savings, and add to technical skills, management skills, and technology.

FOREIGN DIRECT INVESTMENT & MNCs

FDI And MNC

- Foreign direct investment is firm investments in a host country. Firms that undertake FDI are called multinational corporations because they operate in more than one country. Note that a corporation is a firm with a legal entity separate from the owning individuals.
- MNCs usually have headquarters in developed countries, and the world of them is still growing rapidly.
- FDI is different from local investment. The large size of MNCs and their superior power make FDI very important financial sources to developing countries.
- MNCs expand into less developed nations to boost sales and profits, get around trade restrictions, lower production costs, use locally produced raw materials, and extract more natural resources. About 19% of all FDI flows worldwide are received by
- Brazil, Russia, India, and China. Countries with lower incomes receive very little.
- MNCs usually choose countries that provide low-cost labor/natural resources. They also look for:
    - political stability
    - stable macroeconomic environment
    - institutions that favor FDI, such as freedom to repatriate, freedom to partake in foreign exchange, favorable tax, property rights, and minimal nationalization rules

- liberalized economy and trade policy
- large markets, rapid economic growth, good infrastructure and educated labor force

- Host developing countries can receive several benefits:
  - MNCs can supplement insufficient earnings
  - MNCs can supplement technical skills and technology
  - MNCs can supplement insufficient savings
  - MNCs can lead to greater tax revenues and promote local industry
  - MNCs can increase employment and lead to higher economic growth
- There are some downsides of MNCs
  - MNCs may not do the things from above
  - MNCs may cause environmental degradation
  - MNCs promote inappropriate consumption patterns
  - MNCs may use gov't resources for own benefit
  - MNCs may use their power to bring up their own policies
  - Competition between countries to host MNCs may cause the "race to the bottom" because each country will sacrifice resources that are necessary for developing to host MNC countries.

FOREIGN AID

- Foreign aid is the transfer of funds or goods and services to developing countries to bring improvements. They are concessional, which means that the transfers are more favorable than market or grants, and are non-commercial. Foreign aid is not military aid.
- Humanitarian aid is aid to areas with emergencies to ensure access to basic necessities, like food.
- Development aid is aid to help developing countries achieve development and growth objective:
  - Project aid – financial support for projects, like school-building
  - Program aid – financial support for sectors such as education
  - Technical assistance and debt relief

- Official Development Assistance (ODA) comes mostly from government funds, and takes the form of mainly grants. They reach developing countries via:
    - bilateral aid – funds go from the donor to the country
    - multilateral aid – from governments to international organizations which transfer the funds to recipients
    - through NGOs – donors send funds to NGOs which spend them in developing countries
- Donor countries provide aid through ODA for political and strategic reasons, economic motives, and for moral motives.
- Tied aid is the practice where donors tell recipients to spend a portion of the aid to buy from the donor country – only in bilateral aid
    - Recipients cannot seek lower priced alternatives
    - Recipients may have to buy specific goods that may be inappropriate
    - Large firms may be supported at the expense of other countries
- Non-governmental organizations (NGO) are the second type of aid. They are also concessional, but are all given in the form of grants. No repayment is necessary.
- NGOs are not part of any governmental structure, and include many different organizations, such as Amnesty International and the World Wildlife Fund.
- NGOs receive funds from voluntary contributions, and also from ODA funds.

Arguments in favor of ODA

- Poor societies are entangled in the cycle of poverty, and for people to break out, the government needs to intervene in some way and make the right investments. Foreign aid makes up the rest if the government is unable to do so.
- Investments that help raise incomes can be made possible with the help of foreign aid.
- Income distribution can be improved by concentrating on the most disadvantageous groups. Economic expansion can also come from aid.
- Aid is necessary for some MDGs to be achieved.
- Aid can provide debt relief for those in debt traps.

ODA limiting factors

- Tied aid and conditional aid

- Based on priorities and budgets, aid can fluctuate and be unpredictable.
- Uncoordinated activities can cause misuse and inefficiency in the use of resources.
- Aid may become a substitute for domestic resources instead of supplementing it.
- Aid may not reach those who are really in need of it, and aid can be misused due to corruption.
- On average, donors pledge 0.7% of their gross domestic product to ONA, but not all nations meet this goal.

NGO advantages

- Reaching the poor and assisting them in escaping poverty is a priority for NGOs.
- NGOs work closely with their beneficiaries Can participate with the local people and contribute to democratization.
- NGOs have a lot of experience which means they can offer advice.
- NGOs can be more creative and innovative.
- NGOs have a greater degree of freedom and don't have to conform to policies.
- Poor people trust NGOs more than government officials.
- NGOs can act as advocates of certain issues.

NGO Criticisms

- NGOs are usually too small, and have limited resources, so effectiveness is limited.
- NGOs are usually free of government constraints, but rely on governments and thus independence can be lost.
- NGOs may deprive governments of quality personnel.
- Governments don't like NGOs advocating things that may conflict with public policy.
- Overall, NGOs are favorable, but must work with the government.

Trade, Not Aid

- Development should be based on trade expansion and increasing exports.
    - The failures of aid do not address the main issues of growth and development.
        - Corruption, replacement rather than supplement, aid don’t reach those in need
    - Trade has the potential to contribute to development and growth.
        - Help with poverty alleviation, shown by East Asian countries.
        - Protective policies should be eliminated in developed nations.

Trade And Aid

- asserts that trade is significant, but not sufficient for extremely poor developing nations. There are places where trade is ineffective and aid is sometimes required.
    - Rich agricultural subsidies prevent developing countries from exporting as much.
    - Poverty cycle
    - Developing countries depend on commodity exports and are hurt by volatility
    - Some poor countries cannot export goods and have limited access to credit
    - Some extreme locations are hard for trade to reach
    - At the same time, aid also has weaknesses.

Aid For Trade

- Extension of trade and aid. Aid and trade should be linked together so some of the aid is used to help develop export institutions.
- Constraints: high transport costs, bad transport networks, costs of production, etc.
- ODA funds are not replaced by aid for trade.

- Middle-income developing nations that do not qualify for ODA funds should also be addressed in order to address trade constraints.

MULTILATERAL DEVELOPMENT ASSISTANCE

- Multilateral development assistance – non-concessional lending to developing countries

The World Bank

- World Bank – development assistance group that gives long-term loans to developing country governments to promote development and change. Established to reconstruct Europe after WW2.
- Consists of the Int'l Bank for Reconstruction and Development and the Int'l Development Association.
- The World Bank gave structural adjustment loans to change the course of policy-making, such as removing price controls or liberalizing trade.
- Now they focus towards poverty and alleviation.
- criticized for environmentally unsustainable and socially unsound projects that could force people to move. They've been trying to change this recently.
- The size of financial contributions determines the World Bank; richer nations can contribute more, so poorer nations are less represented.
- Conditional lending and interference with domestic policies are provided by the World Bank.
- SALs have been criticized for making inequality in income and other problems worse. Poverty occasionally rises.
- Not doing enough to alleviate poverty.

International Monetary Fund

- IMF established along with World Bank to lend to countries with balance of payments deficits.
- Lent to developed countries for the first two decades, and slowly lent to developing countries as the debt crisis began.

- IMF loans come with stabilization policies that are conditions for receiving the loan, such as tight monetary and fiscal policies, devaluation/depreciation, wage cuts, and liberalization policies.
- Like the World Bank, the IMF is dominated by rich countries.
- Conditionality and excessive interference.
- Stabilization policies can lower economic growth, increasing poverty.
- Something wrong with stabilization policies – which are usually short lived, and IMF loans don't resolve the problems.

THE ROLE OF INTERNATIONAL DEBT

- Foreign debt – level of external debt from borrowing from foreign lenders. Comes from government borrowing from multilateral organizations, foreign commercial banks, and government sales of bonds.
- Countries borrow to pay for deficits in the current account. Developing countries, however, suffer from high debt levels and still have little growth.
- Some countries became indebted during the oil shock, when OPEC increased oil price, causing stagflation.
- Countries with commercial banks compete to lend to developing countries, and believe losses on loans would be cared for by the public sector.
- Loans were not used wisely to invest in developing nations. Later, a different shock to the price of oil slowed exports, and developing nations got worse. Numerous of these nations borrowed more money.
- Debt rescheduling – new loans by commercial banks to developing countries on better terms. New loans over longer time periods at lower IR to pay for older debts.
- IMF lending and stabilization policies – IMF conditional loans
- World Bank lending and SALs – World Bank conditional loans
- Debt-for-equity swaps – when a country with debt trades some debt for equity. The government provides a foreign corporation with some assets and assumes responsibility for the debt of the government.

Debt Consequences

- Balance of payments problem
- Debt trap – unsustainable debt which requires even more debt to repay.
- Opportunity costs: countries that are in debt have fewer resources to invest.
- Lower private investment
- Lower economic growth

HICP Initiative

- Difficulties from high debt levels pressure creditors to cancel debts.
- The Heavily Indebted Poor Countries Initiative provided debt relief by canceling some debt. Countries have to have a per capita GNI below a level and in a debt trap.
- Countries need to show evidence that they are changing.
- HICP criticized for:
    - debt reduction level insufficient, countries risk returning to debt trap
    - program too slow to take effect
    - severe conditions, such as payments for schools and hospitals
    - countries with high debt levels are unable to benefit from debt relief because they are “manageable”.

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