The effects of foreign capital on the economical system

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Abstract: *Foreign capital plays an important role in the importance of the economic growth. It has gained importance in the recent years because of the curios, pattern of global imbalances, whereby capital seems to be flowing "uphill" from poorer to richer countries. In the next article we examine the effects of foreign capital on the economical system.*

Key Words: foreign capital, domestic capital, economic growth, economic system, financial system

Capital should flow from rich countries to poor countries — because in the neoclassical model, the marginal product of a unit of capital is much higher in poor countries that are typically labor abundant and capital poor. Second, more productive poor countries should attract more foreign capital because they have the ability to use it better. And third, because it adds investible resources, and because of the collateral benefits of foreign capital such as bringing in new technologies of production and control, greater use of foreign capital should be associated with more growth.

Capital does not flow from rich to poor countries in the relative quantities it used to — surprising given that financial markets have been getting better. Moreover, it is not also true that amongst non-industrial countries, the most productive get the most capital inflows. Finally, for non-industrial countries, there does not seem to be a positive association between growth and reliance on foreign capital. In fact, there is generally a negative correlation suggesting that non-industrial countries that are more reliant on foreign capital grow less. For industrial countries, though, there is a positive association.

Correlation is not causation, and indeed there are both benign and malign explanations of these correlations. What seems to be clear is that non-industrial countries do not have tremendous absorptive capacity for foreign capital in general, though particular forms of foreign capital such as FDI may be useful. Put differently, the relatively low use of foreign capital by successful developing countries may have more to do with their

low demand for foreign capital than with a willingness of developed country creditors to supply it.

One reason for the low demand may be their financial system is underdeveloped so that when they have growth opportunities, the extra domestic savings they generate are largely adequate to cover the investment that can profitably be financed. This is a benign explanation for the limited role of foreign capital in development. More malign is if foreign capital inflows cause overvaluation of the exchange rate, thus reducing the competitiveness of the economy, and thus reducing manufacturing exports and undermining a traditional stepping stone to growth. There are also concerns about foreign capital we do not address, such as its potentially higher volatility, which may make countries other than the really needy stay away from it.

Our conclusion is therefore that in the long run, capital account opening is unlikely to help poor countries grow by providing resources in excess of what is available in the domestic economy — notwithstanding examples of foreign capital led booms and busts -- though it may help in other ways. Foreign capital is no panacea for capital-poor countries. Put differently, the current patterns of flow of capital in the global economy, though seemingly perverse, may not be so, at least given the financial and institutional constraints non-industrial countries have. That does not mean these flows are optimal, safe, or sustainable in the long run.

We observed that foreign capital helps indirectly—by disciplining policymakers or by promoting reforms that improve the financial system. The authors say it is possible to make the opposite argument and find indirect costs. Plausibly, lifting restrictions on capital flows could undermine the domestic financial system because spendthrift governments can tap a larger pool of funds abroad. Also, the well-off have less incentive to lobby for reforms at home if they are free to store their wealth overseas.

Perhaps, then, the gains from globalised finance are latent and will be unleashed once catalyzing reforms are in place? Maybe they will. But the wish list of complementary measures is difficult to tick off. Economies might reap the benefits of foreign capital more fully if property rights were stronger, contracts were more enforceable, and if there were less corruption and financial cronyism. But the authors point out that if poor countries could carry out such ambitious reforms "they would no longer be poor" and financial globalization would be "a clearly dispensable sideshow". With so much else to do first, liberalizing capital flows would not be an obvious policy priority.

Foreign capital ought to be good for countries that have profitable ventures that lack funding because of low savings at home. But Messrs Rodrik and Subramanian argue that for many countries, it is not low savings but a shortage of good investments that is the binding constraint. Weak property rights, poorly enforced contracts and the fear that profits will be siphoned away make it hard to conceive of ventures that might generate a reliable return. When investment opportunities are scarce, capital inflows simply displace domestic savings and encourage consumption.

The Effects of Foreign Capital on State Economic Growth

U.S. Bureau of Economic Analysis data show that the nation's rate of yearly output growth between 1995 and 1999 was more than 50% higher than for the period 1987 to 1994. Using state-level data, this study examines foreign capital's contribution to this upturn in growth. Pooling data for the 50 states in a regression framework showed that foreign capital accounted for 2.6% of overall state output growth for the full period. Foreign capital made no contribution between

1987 and 1994 but accounted for 3.7% of output growth between 1995 and 1999. Furthermore, estimates show that foreign capital had a much larger impact on the manufacturing sector, accounting for more than 16.7% of state manufacturing output growth between 1995 and 1999 so taking the case of U.S. policy we can se the effects of the foreign capital upon the Economic Growth.

But why is the attracting of foreign capital unsuccessful sometimes?

Without inviting foreign investors in some developing countries, foreign companies have not responded to their invitations. The reason can be the political and economical instability in the host country. The one reason is that objectives and organizational characteristics of state-owned enterprises' differ greatly, but it is possible to identify common factors. The main reason in many less developed countries was a distrust of private enterprise, combined with the socialist ideological beliefs. The Indian government explicitly stated its intention to retain control over the 'commanding heights'. A related factor was the desire to decolonize the country's commercial sector. Many Latin-American countries strove to avoid dependency or the dominance of foreign economic powers.

Other characteristics of state-owned enterprises also influence the content of their investment promotion materials. They have a much broader coalition of members than most private enterprises, including their managers, boards of directors, government ministers, civil servants, parliament and politicians. Their managers must take into account the expectations and various interest groups. They are expected to balance the social as well as the commercial costs and benefits of their projects with a much greater emphasis on the social side than in private companies. Their goals and objectives tend to be broader more than in private companies.

The characteristics of less developed countries are the high rates of unemployment, huge disparities between rich and poor, the relative inefficiency and low purchasing power of domestic market, the low levels of technology, and so on. In addition, many governments are influenced by the 'ideology of development', a belief that the government has to take a very active role in the country's economy in order to hasten the pace of development.

At the personal level many managers in state corporations face career environment more similar to civil service than to the result-oriented competition of American companies. The environment may reward them for caution rather than risk-taking. There is a difference concerning subordinates as well, in the American companies there is an assigned real and limited responsibility to quite junior trainees, in the large organizations in developing countries often practice a kind of 'training by hanging around', in which junior managers are supposed to learn their jobs mainly by observation. Often they are given only small tasks under close supervision until they have been with the organization for several years. It also makes top managers overloaded as they have to spend too much of their time reviewing on minor matters. They may not be able to rely on their subordinates, so they may not be able to devote sufficient effort and attention to the difficult and strategically important tasks of planning their organizations' futures.

An important difference between American executives and state corporation managers in LDCs is that the former tend to strive to increase their own and their organizations' power and independence, while the latter often deliberately subject their organizations to the guidance and control of government ministries or boards. The managers of American companies assume the bigger risk in the hope of bigger result, but managers of state owned enterprises do not, because they want to avoid the possibility of any failure being attributed to their own errors.

These cultural and environmental characteristics strongly affect the language of documents drafted by state corporation managers to attract and influence foreign companies. They are afraid of foreign companies. Managers of the state owned companies often do not understand the competitive atmosphere and the pressure for financial results that confronts executives at all levels in American companies.

It would be a long, slow and difficult process to try to change the ingrained attitudes and practices of the State owned enterprises to make their investment literature more marketing-oriented. However, they know the way how to introduce news without great changes in the organizational culture. They see only the following: 'what you must do for us', rather than 'what we can do for you'. The least developed country has to be concerned primarily with its own welfare, with obtaining the coming foreign capital. But that country should be more effective in attracting desirable capital.

Another problem is that the corporations owned by the state do not understand prospective investors' needs, and leave the saying out of consideration: 'You catch more flies with honey than with vinegar.' They would be better to welcome to all proposals. It should communicate its eagerness to make it easy as possible for foreign companies to follow through on their plans. This does not mean that hospitality of the corporation or the country should allow itself to be exploited or abused by foreign companies. The question is, whether state rules make good policy, as rules are intended to guard against financial and other abuses which the country may have suffered in the past, while on the other hand they may well be less necessary as the local economy becomes more developed and the government's regulatory powers grow more sophisticated.

Corporation personnel would not be involved in the formative stages of the project, but would only see the completed documents. They would consider only one proposal at a time if several were to be submitted. They need to understand the competitive bidding so it is quite possible that confidence comes from the state owned corporations' managers.

For several reason this is not the best way. Proposal evaluation is too important to be slighted in this way and careful attention should produce some good rewards. They could have much more confidence in a feasibility study. Finally they would want to have some of their own people working with the prospective investor while the study is being carried out. Otherwise, it is too easy for the investor to manipulate the study so as to make the proposal look better for the host country than it really is. If the management were overloaded, they could assign more junior people to work intensively with the foreign company.

Having submitted one investment proposal at a time also has many disadvantages. Maybe the state owned enterprises' people would be better able to recognize the strengths and weaknesses of a given proposal if they took the time to work through several of them and could compare them. They can increase their ability to bargain for better terms if they had proposals from several competing foreign companies.

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