PRIVATE CAPITAL FLOWS AND DEVELOPING COUNTRIES

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INTRODUCTION

The post-World War II period has experienced significant expansion of private capital flows to developing countries. Private capital flows consist of two major sources: non-debt-creating flows (foreign investment) and external borrowing. Foreign investment takes a variety of forms, including direct investment, portfolio investment, contractual arrangement, turn-key plant, compensation trade, and buy-back. Foreign direct investment (FDI) has comprised the bulk of foreign investment in developing countries in the post-war period. Similarly, private bank lending has been the major source of external borrowing for these countries since the late 1950s. Therefore, the paper will be focusing on FDI and private bank lending in the total private capital flows to developing countries.

The post-World War II expansion of private capital flows to developing countries may be viewed in terms of a significant expansion of FDI and a return to private bank lending,

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largely because of a renewed confidence of the international banking system in these countries. Prior to 1973, the share of FDI was greater than that of private bank lending in private capital flows. After 1973, however, the share of private bank lending surpassed that of FDI. In the 1980s, especially after 1982, the trend was once again reversed in favor of FDI. In particular, during this period the total private capital flows to developing countries have been declining and the share of FDI has been increasing. This trend is better understood in terms of an absolute *decline* in the volume of private bank lending and the more or less *sustained* flows of FDI.

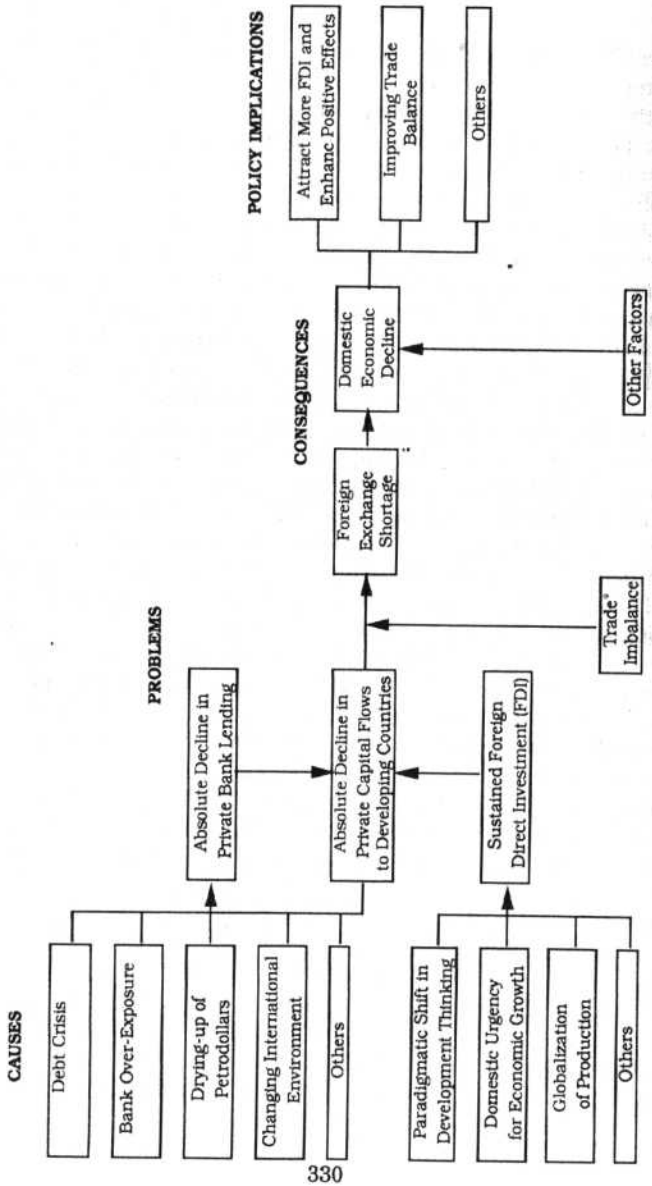
The purpose of this paper is to document these trends in private capital flows to developing countries since 1982 and provide a comprehensive explanation of the underlying causes. We will show that different sets of inter-related factors are responsible for the decline in private bank lending and the more or less sustained flows of FDI. The paper also evaluates the individual and combined effect of these factors and anticipates the possible impact of such recent world events as the Persian Gulf war and the restructuring in the East. Finally, we will discuss the consequences of these trends, including the foreign exchange shortage and domestic economic decline, and offer some policy implications for developing countries. Our largely empirical arguments are supported by a longitudinal series of data on external financing for non-oil developing countries between 1973 and 1990. The data are primarily from documents published by the International Monetary Fund (IMF) and the United Nations Center on Transnational Corporations (UNCTC). Additional support is drawn from the scholarly literature.

The existing literature may be organized into three groups regarding the underlying causes of these trends in private capital flows to developing countries. The first group focuses on external borrowing and is represented by Smith and Cuddington (1985), Root (1990), Blanchard et al (1989), Payer (1987), and MacEwan (1987).[1] They argue that the following factors have significantly contributed to the declining private bank lending: the debt crisis of developing countries; their inability to service their

international debts; the de facto moratorium announced by Mexico and Brazil; the instability and fragility of the international banking system; and competition from the U.S. for the world surplus. The second group concentrates on FDI and includes Cable and Persaud (1987), Rothgeb (1984), Page (1987), and UNCTC (1988).[2] They agree that a growing recognition of the need for FDI has more or less sustained its flows to developing countries. Several considerations lie behind this recognition: the adverse impact of private bank lending; advantage of FDI in providing both capital and technology; and changes in external economic situation, technology, multinational corporations (MNCs), and company-government relations. The third group also focuses on FDI and is represented by IMF (1985), Ramphal (1987) and Nixson (1989).[3] They point out the changing perceived role of FDI and marked liberalization of policies toward it in developing countries. This changing attitude toward FDI has been even more noticeable in developing countries with a socialist orientation.

Building upon this literature, we will offer a more integrating and comprehensive analysis. Figure 1 gives the conceptual framework of the paper. In particular, we argue that the major underlying causes of the declining private bank lending have to be sought in the debt crisis of developing countries, the over-exposure of private banks, the drying-up of Petrodollars, and the changing international environment. The effects of these factors have been the loss of creditworthiness of developing countries in general, increased instability and fragility of the international banking system, reduced funds available to developing countries, and more new competitors for the world surplus. We also maintain that the more or less sustained flows of FDI can be accounted for by three major causes: the paradigmatic shift in development thinking, the domestic urgency for economic growth in developing countries, and the globalization of production. These factors have contributed to a more market-oriented approach to economic development in many developing countries, increasingly positive attitude toward FDI as a panacea for economic decline, and the promotion of FDI by the spread of Western manufacturing industries to developing countries.

FIGURE 1. CONCEPTUAL FRAMEWORK



The combined effects of the decline in total private capital flows to developing countries and chronic trade imbalance have been a shortage of foreign exchange in many developing countries. This shortage, along with other contributing factors, has in turn led to domestic economic decline, resulting in domestic urgency for economic growth. However, there are some policy options available to developing countries that wish to attract more FDI. These include developing a positive attitude towards FDI, liberalizing economic policies, seeking different forms of foreign investment, and providing more favorable incentives. These countries can also enhance the positive contributions of FDI through skillfully balancing their bargaining power, carefully screening appropriate technologies brought in by FDI, and establishing better support and diffusion systems for technologies transferred by FDI. While these measures are taken, governments of developing countries shall also introduce policies that directly counter the negative impacts of FDI and do so in the start or in the process.

In the following pages, the second section will document the changing trends in private capital flows to developing countries, including the decline in private bank lending and the more or less sustained flows of FDI. The major body of the paper, sections three and four, will include indepth discussions of the underlying causes of the two sides of the decline in private capital flows to developing countries. In particular, section three will focus on the causes of the declining private bank lending, while section four provides an explanation for the more or less sustained flows of FDI. In the final section, we will discuss the consequences of these trends for developing countries and speculate on policy options for their governments, focusing on measures that can enhance the positive contributions of FDI.

THE CHANGING TRENDS IN PRIVATE FOREIGN CAPITAL FLOWS TO DEVELOPING COUNTRIES

In the immediate postwar years, private commercial banks were very cautious in involving themselves with developing countries mainly because of the lessons that they had drawn from the two world wars when a number of developing countries had defaulted on their debts. But the three post-war decades did witness a robust and stable international financial system and home governments in industrialized countries. Already in the 1960s a rapid expansion of private bank lending to developing countries was well under way.[4] This expansion accelerated after the oil shock of 1973-74. With the sudden increase of oil prices, the OPEC countries as a group witnessed enormous current account surpluses. These loanable funds were used as syndicated loans by commercial banks operating in Euromarkets. In 1973, private bank lending was only $5.7 billions per annum and it increased at an average rate of 49.3% per annum afterwards. It reached the peak of $76.8 billions per annum in 1981 (Table 1). During these years most of private capital flows were accounted for by medium and long-term private bank lending. However, the situation changed dramatically after 1982, when Mexico announced a *de facto* default on its debts. Thereafter the volume of private bank lending to non-oil developing countries declined sharply. By 1988, it dropped to a minimum of $0.7 billions per annum. The decline in private bank lending to developing countries in the 1970s has been more rapid than its expansion in the 1970s.

As a world-wide phenomenon, FDI began late in the 19th century and early this century but for decades it only made up a small portion of international private capital flows. In 1914, 90 percent of all foreign investment took the portfolio form.[5] Meanwhile the composition of foreign investment was gradually shifting. In the 1920s, about a quarter of such flows took the form of FDI. World War I and the Great Depression caused the collapse of the world monetary system in 1930, leading to the collapse of portfolio investment.[6] The inter-war

TABLE 1. NON-OIL DEVELOPING COUNTRIES: EXTERNAL FINANCING, 1973-1990
(billions of current U.S. dollars)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990*
Non-debt-creating flows, net	**10.3**	**14.5**	**11.8**	**12.8**	**14.1**	**17.0**	**23.1**	**22.5**	**26.6**	**24.7**	**22.0**	**22.3**	**30.8**	**28.5**	**34.8**	**31.7**	**28.7**	**33.6**
Official transfers	5.5	8.8	7.1	7.4	8.2	8.2	11.5	12.3	13.3	13.0	13.7	13.9	16.9	17.6	18.0	17.3	17.2	14.4
SDR allocation, valuation adjustments, and gold monetization	0.6	0.6	-0.6	0.1	0.6	1.6	2.2	1.2	0.1	-0.5	-0.4	-1.3	4.7	2.0	5.5	1.8	-0.1	0.3
Net direct investment	4.2	5.1	5.3	5.3	5.3	7.2	9.4	9.0	13.2	12.2	8.7	9.7	9.2	8.9	11.3	12.6	11.6	18.9
External borrowing, net	**11.4**	**24.3**	**34.0**	**31.4**	**31.3**	**46.1**	**64.1**	**90.2**	**104.7**	**67.4**	**49.3**	**43.2**	**47.0**	**30.3**	**41.7**	**15.6**	**30.4**	**47.8**
From official creditors (long-term)	5.7	7.8	11.8	12.8	12.7	13.7	28.3	23.3	27.9	29.3	24.7	26.2	26.6	28.0	35.1	14.9	23.8	37.2
From private banks	5.7	16.5	22.2	18.6	18.6	32.4	35.8	66.9	76.8	38.1	24.6	17.0	20.4	2.3	6.6	0.7	6.6	10.6
Total	**21.7**	**38.8**	**45.8**	**44.2**	**45.4**	**63.1**	**87.2**	**112.7**	**131.3**	**92.1**	**71.3**	**65.5**	**77.8**	**58.8**	**76.5**	**47.3**	**59.1**	**81.4**

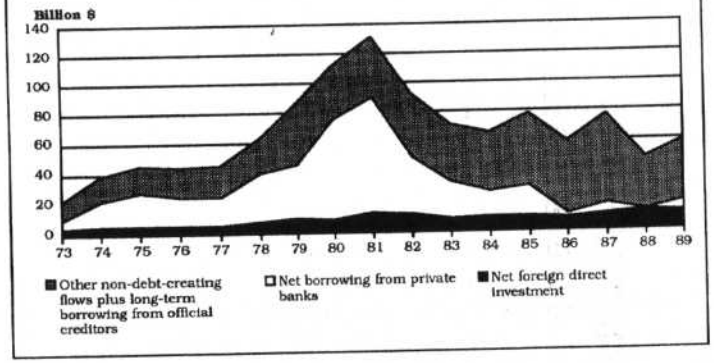
Sources: "World Economic Outlook", International Monetary Fund, various issues.
"Foreign Private Investment in Developing Countries", International Monetary Fund, January 1985.
"Determinants and Systemic Consequences of International Capital Flows", International Monetary Fund, March 1991.

*1990 data are for all developing countries.

years also experienced sharp decline in the magnitude of foreign investment. However, FDI proved more resilient and recovered slightly in the late 1930s. The post-World War II years witnessed a renewed expansion of FDI. The increase in net flows of FDI to non-oil developing countries was more prominent after the 1960s. They rose from an average of under $2 billions per annum in the early 1960s to an average of around $8 billions per annum from 1974 to 1982.[7] In 1973, net flows of FDI to non-oil developing countries were $4.2 billions per annum and by 1981 they reached a peak of $13.2 billions per annum (Table 1). In 1982, total net flows of FDI were $12.2 billions per annum. This figure remained more or less stable at an average of $10 billions per annum until 1989 when the actual net flows reached $11.6 billions per annum (Table 1). In contrast to the 1973-1982 period, when net flows of FDI to non-oil developing countries grew steadily, the 1982-1989 years witnessed more of less sustained flows of FDI.

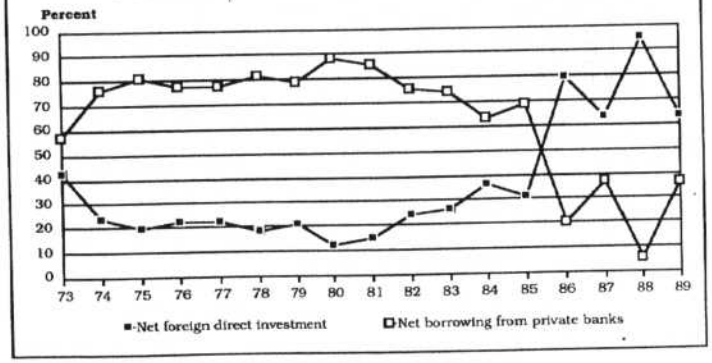
The share of FDI in total private capital flows has also increased significantly since 1982 (Table 2) while its absolute volume has remained more or less constant. In the 1973-1982 period, although net flows of FDI to non-oil developing countries grew steadily, private bank lending climbed up at a even higher rate (Figure 2). During the 1960s and up to 1973, FDI accounted for well over half of all private capital flows to non-oil developing countries.[8] In 1981, however, it represented barely 10.1 percent of a much larger volume of such flows. After 1982, the magnitude of private bank lending to non-oil developing countries declined sharply, whereas that of FDI remained more stable (Table 1). The end result has been an increasing share of FDI in private capital flows. In 1986, for the first time since 1973, FDI accounted for over half (79.5 percent) of private capital flows to non-oil developing countries (Figure 3). This figure has remained above 60 percent through 1990.

FIGURE 2. NON-OIL DEVELOPING COUNTRIES: EXTERNAL FINANCING, 1973-1989 (billions of current U.S. dollars)



Source: Based on Table 1.

FIGURE 3. NON-OIL DEVELOPING COUNTRIES: SHARES OF FDI AND BORROWING IN PRIVATE CAPITAL FLOWS, 1973-1989



Source: Based on Table 2.

TABLE 2. NON-OIL DEVELOPING COUNTRIES: SHARES OF FDI AND BORROWING IN PRIVATE CAPITAL FLOWs, 1973-1990 (Percent)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990*
Direct investment	42.4	23.6	19.3	22.2	22.2	18.2	20.8	11.9	14.7	24.3	26.1	36.3	31.1	79.5	63.1	94.8	63.7	64.1
Borrowing from private banks	57.6	76.4	80.7	77.8	77.8	81.8	79.2	88.1	85.3	75.7	73.9	63.7	68.9	20.5	36.9	5.2	36.3	35.9

Source: Based on Table 1.
*1990 data are for all developing countries.

THE DECLINING PRIVATE BANKING LENDING

The waxing and waning of private bank lending to developing countries are the result of many inter-related factors. We think four of them are very important in explaining its decline in the 1980s. They are the debt crisis of developing countries, the over-exposure of private commercial banks, the drying-up of Petrodollars, and the changing international environment. Each is in turn explained below.

1. The Debt Crisis of Developing Countries

In the period of 1973-1981, nearly three-fourths of the current account deficits of non-oil developing countries were financed by borrowing from private banks and short-term official flows.[9] This heavy reliance on external borrowing, especially on private bank lending, has confronted many developing countries with overwhelming debt burdens, increasing their vulnerability to the international banking system. As shown by Smith and Cudding, "more than eighty reschedulings in the 1975-1983 period, numerous arrears, moratoriums, and a rising number of non-performing loans demonstrate the inability of many countries to service their debts according to the terms originally contracted."[10] During the 1980s, developing countries have accumulated a total of $1.3 trillions in international debts. Most of the private commercial bank lending was made to middle- and upper-income developing countries because low-income developing countries were still considered unacceptable credit risks. Major debtor countries include Latin American, African and a few Asian countries. The five countries with the largest external debt among non-oil developing countries (Mexico, Brazil, Argentina, South Korea, and the Philippines) accounted for around two-fifths of total outstanding debt of all non-oil developing countries at the end of 1983.[11]

In August 1982, Mexico, suffering from a sharp drop in its oil export revenue, announced a de facto moratorium on its

payments to commercial banks.[12] This triggered a loss of confidence in the creditworthiness of developing countries in general. Banks immediately withdraw short-term credit lines and greatly restricted new medium- and long-term lending. The spring of 1987 brought another two events which marked a turning-point in the debt crisis.[13] The largest Third World debtor, Brazil, stopped paying interest on the commercial bank portion of its debt. In response to this, Citicorp, the largest U.S. commercial bank and the leader in lending to developing countries, announced that it would set aside $3 billions as a reserve against Third World debt. It thus completely demolished the early efforts of the IMF, as well as U.S. government, to moderate the debt crisis. Other American and British commercial banks quickly followed suit. With this debt crisis in the background, most governments of developing countries are now encountering greater difficulty in securing short- and long-term credits.

2. The Over-Exposure of Private Commercial Banks

In the immediate postwar years, private commercial banks had been very cautious in involving themselves with developing countries due to the lessons drawn from the two world wars when there were a number of debt defaults. But the three postwar decades witnessed a robust and stable international financial system; home governments in industrialized countries, especially in the U.S., had also injected more confidence by banking up the system with bail-outs in crises. On the side of developing countries, military coups, martial law declarations and less obvious changes of economic policies led commercial banks to believe that "the old, bad policies had been changed and that borrowing governments were now on the right track."[14] In addition, attractive borrowers were scarce at the time in the usual commercial bank markets because many corporate clients began to bypass banks and raise funds by issuing their own bonds. All of these contributed to the

regaining of confidence of commercial banks in developing countries and the sharp increase of private bank lending to these countries in the late 1960s and 1970s. The oil price hike in 1973-74 and the large OPEC surplus thereafter, made available through Euromarkets, gave commercial banks another boost.

The essential feature of the rising role of Euromarkets is its relative lack of regulations.[15] In many industrial countries, by requiring that commercial banks hold a certain percentage of all deposits in reserve, a government both places a limit on the expansion of loan activities and protects the banking system from putting itself in a position where it cannot meet demands of depositors for their funds. In addition, government regulations limit the degree of risk that can be undertaken by banks in extending new loans. However, in Euromarkets, such regulations are virtually absent. Competition among private commercial banks push the banks into making riskier loans while holding increasingly smaller percentage of their deposits as reserves. This over-exposure problem has resulted in increased instability and fragility of the international banking system, which in turn led to the difficulty of commercial banks to issue more long-term loans. The problem became exacerbated when the Western hemisphere began to experience economic recession since the early 1980s.

3. The Drying-Up of Petrodollars

In the 1970s and early 1980s, most private bank lending to developing countries was from the OPEC countries' Petrodollars recycled through Euromarkets. The large current account surplus of the oil-exporting countries in the 1970s led to the replacement of funds in bank deposits and short-term government securities in industrial countries and off-shore markets.[16] Following the oil crisis of 1973-74, about $80 billions were recycled this way.[17] This fund enabled developing countries to borrow heavily from private banks in developed

countries to finance their growing capital needs and to pay for sky-rocketing oil bills.

However, since 1980, a number of developments have reduced the funds available through Euromarkets to non-oil developing countries. These include: (1) A soaring of domestic expenditures in all OPEC countries, which has greatly reduced their current account surplus; (2) Exploration of oil in the North Sea which decreased the demand for OPEC oil; and (3) The drastic downturn of crude oil prices in 1986 which had a devastating impact on the OPEC countries' current account surplus (Table 3). Meanwhile, demands for oil in the West decreased, putting even more pressure on OPEC countries.

In addition, recent world events may also have a significant impact on future fund availability and private bank lending to developing countries.[18] First, the Persian Gulf war became a big world surplus consumer, in contrast to the situation before when OPEC countries were suppliers of the world surplus. It is estimated that the war has cost some $70 billions, almost all of which was financed by surplus from Japan, Germany, the Arab Gulf states and a few other nations. The restoration of the Kuwaiti economy will require additional funds that would have to be drawn from the world surplus again (Kuwaiti surplus in particular). Iraq must also be rebuilt and countries like Jordan, Turkey and Egypt have already received large sums for economic setbacks they suffered during the Persian Gulf crisis. Second, the restructuring of Eastern European countries and the former Soviet Union has already imposed a large demand on the world surplus through aid from the World Bank, IMF, and European Bank for Reconstruction, which is mainly funded by Germany's surplus. Demand for the world surplus from these countries will continue to increase in the foreseeable future.

TABLE 3. TWELVE MAJOR OIL EXPORTING COUNTRIES: BALANCE ON CURRENT ACCOUNT, 1973-1990
(Millions of current U.S. dollars)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Exports	39.0	117.9	109.6	133.2	146.7	143.4	211.3	296.5	274.3	218.6	178.8	173.1	154.6	100.9	122.1	119.3	146.4	171.5
Imports	20.2	35.8	56.2	68.1	83.7	97.4	100.7	126.2	150.0	150.6	131.8	115.5	97.5	85.8	85.0	93.8	97.2	106.3
Merchandise Trade Balance	18.8	82.2	53.4	65.1	63.0	46.0	110.6	170.2	124.3	67.9	47.0	57.6	57.0	15.1	37.2	25.5	49.2	65.2
Net Services & Private Transfers	-12.2	-13.9	-18.0	-24.8	-33.6	-40.4	-48.3	-59.8	-70.8	-74.3	-67.1	-62.8	-54.9	-41.8	-42.4	-41.2	-47.9	-48.1
Current Account Balance	**6.7**	**68.3**	**35.4**	**40.3**	**29.4**	**5.7**	**62.3**	**110.4**	**53.5**	**-8.4**	**-20.0**	**-5.2**	**-2.1**	**-26.7**	**-5.1**	**-15.7**	**1.4**	**17.1**

Sources: "World Economic Outlook", International Monetary Fund, May 1983, September 1984, and October 1990.
Note: Twelve major oil exporting countries include: Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Oman, Qatar, Saudi Arabia, United Arab Emirates, and Venezuela.

TABLE 4. DEVELOPING COUNTRIES: GROWTH OF REAL PER CAPITA GDP, 1973-1990
(Annual change, percent)

Region	Average 1973-82	1983	1984	1985	1986	1987	1988	1989	1990
Africa	2.9	1.1	0.7	4.0	1.7	1.3	2.9	3.5	1.9
Asia*	5.7	8.1	8.4	6.8	6.9	8.1	9.0	5.5	5.3
Europe	4.0	2.4	4.9	2.7	4.4	2.6	1.6	-0.7	-4.7
Middle East	4.9	1.1	-	1.7	0.7	0.1	4.7	3.2	-1.5
Western Hemisphere	4.3	-2.8	3.6	3.4	4.7	2.4	0.2	1.5	1.0

Source: "World Economic Outlook", International Monetary Fund, May 1991.
*Excludes Japan.

4. The Changing International Environment

There have been several changes in the international environment in the 1980s that contribute significantly to the declining private bank lending to developing countries.[19] First, because of its twin deficits (current account and budget), U.S. became a large contender against developing countries for the world surplus. For the first time since 1914, U.S. changed its position from a net creditor to a net debtor in 1985. In 1988, the current account deficit of U.S. was $135 billions and the IMF projects it to increase continuously in the near future.[20] This current account deficit is in large part the result of the U.S. budget deficit and the reduced level of domestic savings in the economy. The U.S. twin deficits have already become the major global macroeconomic problem and threaten the short-term stability of the world economy. U.S. is now borrowing at an unsustainable level and absorbing capital that would otherwise be used to finance investment in other parts of the world, especially developing countries.[21] The combined effect of the reduced level of current account surplus of OPEC countries mentioned above and the new competition from U.S. for the world surplus has resulted in a large unexpected increase in world real interest rates. This has in turn created a very unfavorable situation for debtor developing countries to service their debts and to receive more finance in the future.

Second is the changing international politics. The 1980s was a decade of revived conservative neoclassical policies forged mainly by Reagan and Thatcher administrations in Western developed countries.[22] Of these policies, one important aspect was the renewed militarist policy, particularly in U.S., which had overcome the "Vietnam syndrome" to reimpose the U.S. hegemony and expand the control of the West over world markets and raw material supplies. In addition, new national economic control policies had focused on investment planning and import controls. These greatly reduced the magnitude of available funds from the Western developed countries to developing countries.

THE MORE OF LESS SUSTAINED FLOWS OF FOREIGN DIRECT INVESTMENT

While many factors may be identified as underlying the trend toward the more or less sustained flows of FDI since 1982, we believe three are the most critical. They are the paradigmatic shift in development thinking in recent years, the domestic urgency for economic growth in developing countries, and the globalization of production. In the following pages, we discuss these factors and indicate their specific causes and consequences.

1. The Paradigmatic Shift in Development Thinking

For quite a while in the 1960s and 1970s, development studies were dominated by the *dependencia* theory.[23] This school of thought treats the social and economic development of underdeveloped countries as being conditioned and dominated by external forces, namely, developed imperialistic countries. It is also argued that the penetrating of MNCs into economies of developing countries, especially into their potentially most dynamic sectors, leads these countries toward further "maldevelopment." The dependency school greatly affected policy discussions in the 1960s and 1970s and rendered increasingly tightened control over FDI by governments of developing countries; in some cases, policy options led to complete nationalization of foreign capital and autarky. The dependency theory began losing its grip over development thinking in the late 1970s when the rival interdependence theory emerged.[24] The latter asserts that developing countries are becoming increasingly important to the advanced industrialized countries because of the latter's growing dependence upon products of developing countries. This interdependence has also created a collective decision-making environment in the global economy. The whole context of policy debate has gradually shifted away from the confrontational approach to FDI

and MNCs. There is now a growing recognition that foreign investors can contribute to development by foreign exchange earnings, sharing large project risk and technology transfer.[25]

A second paradigmatic shift is reflected in a growing tendency for privatization in many developing countries.[26] This covers a range of policies from those of governmental disengagement and deregulation to the sale of public-owned assets. Just as the 1960s and 1970s were characterized by the rapid expansion of public sectors, the 1980s witnessed wide-spread attempts to curtail the economic role of the state. This tendency renders a return to market mechanism in many developing countries. Private enterprises are also becoming the major moving force of these economies and they are given more freedom and assistance in seeking economic cooperation with MNCs. This cooperation becomes more appealing to developing countries because FDI is a means of obtaining not only capital but also technology, management skills, marketing know-how, and export outlets.[27]

The paradigmatic shift has also been influenced by demonstration effects of certain successful strategies followed in a few developing countries, the so-called NICs in particular.[28] During the past two decades, Taiwan, South Korea, Singapore and Hong Kong have witnessed the most rapid economic growth among developing countries. Their export-oriented development strategy, particularly the emphasis on foreign investment and trade, is considered the main cause of their success. Singapore, among the four, has relied most on FDI. One-third of all firms in Singapore are either wholly or majority foreign-owned. South Korea, instead, is more receptive to other forms of foreign capital, including foreign aid, loans, and minority-owned investment. Taiwan and Hong Kong lie somewhere in the middle of the spectrum. It must be noted, however, that these countries took a "command capitalism" approach and were fortunate to have largely unrestricted access to Western markets.

2. The Domestic Urgency for Economic Growth in Developing Countries

The late 1970s and 1980s witnessed a declining level of economic activity in most developing countries. As shown in the IMF report of *World Economic Outlook*,[29] developing countries in Africa, Middle East, Western Hemisphere and Europe experienced stagnant growth of per capita GDP (Table 4). Asia as a whole is the only exception. On average, countries of the sub-Saharan Africa and Latin America suffered an absolute decline in the standard of living during the 1980s. Given the deteriorating economic situation, many developing countries feel the need for revitalizing their economies. This urgency has also been the product of massive grass-roots pressure and the changing political environment. The extreme poverty and high unemployment rates in many developing nations, especially the low-income ones, have continuously caused political upheavals. Indeed, economic downturn has begun to threaten political regimes as exemplified in Panama, the Philippines, Turkey, Kenya, Tunisia, Nigeria, and East European countries. In other developing countries, the political manifestation of declining economic situations is less severe mainly because of dictatorships. This changing political economy, together with the debt crisis and austerity requirements from the IMF and World Bank, urges these states to normalize their economies and put them on a growth path in order to maintain political stability.

However, this need for economic revitalization is hampered by several obstacles.[30] Among these are the dependence of domestic production on foreign markets for such production inputs as raw materials, intermediate goods and capital goods including machinery, equipments, technology, and managerial skills. This dependence is particularly critical because more developing countries have chosen industrialization as the route to development. The situation worsened because of the import-substitution strategy implemented by many developing countries in the 1960s and 1970s. The reliance of these countries on

imported oil is also significant, as indicated by the poor performance of these economies in the early 1970s and 1980s when oil prices sky-rocketed. The demand for imported production inputs triggers a large demand for foreign currencies, which can be raised through export earning, external borrowing and FDI, to name the three main channels.

The export earning situation for many developing countries has not been favorable in the 1980s because of undesirable demand and supply conditions.[31] These countries can not compete in international markets and where they do enjoy a comparative advantage, markets in industrial countries are closed to them. External borrowing has also proved to be unpredictable and inflexible in its obligations, and unobtainable for many developing countries.[32] These unfavorable situations in export earnings and external borrowing have rendered it necessary for a major shift in the composition of private capital flows to developing countries toward an increasing use of FDI. Many Third World leaders now often see FDI as a panacea when confronted with economies that are plagued by severe difficulties.[33] In particular, they turn to developed countries for FDI which they hope will lead to growth and prosperity.

3. The Globalization of Production

Beginning in the late 1970s, many industries in Western developed countries, particularly manufacturing industries, started to experience declining profit rates. This was the result of a complex set of social, political and economic factors emerging in these countries, including the stagnation in productivity growth, breakdown of the capital-labor accord, and intensification of inter-capitalist competition, both domestically and internationally. Many firms were forced to rationalize their production process through relocating to places where production costs are lower or access to potential markets is greater. Development of modern communication and transportation technologies further made it possible for production to expand geographically. Thus many developing countries became hosts to branch plants of MNCs as well as to small and medium-size firms from developed countries.

However, these firms tend to locate only in those developing countries which offer favorable economic prospects and investment climate. Depressed economic situations that have prevailed in many developing countries became a major factor for the uneven distribution of FDI in the developing world. In addition, investment decisions of MNCs are generally based on their global strategies. South-East and East Asian countries have been the more favored locations because of their large potential domestic markets (China, Indonesia and Thailand), low labor costs (China, India, Malaysia and Thailand), availability of skilled labor force and well developed infrastructure (Hong Kong, Taiwan and Singapore), and abundance of natural resources (Indonesia and Malaysia). This so-called "globalization of production" or "new international division of labor" is most prominent in manufacturing sectors and has significantly promoted FDI in developing countries.[34]

In addition, some recent world political events may influence future flows of FDI to developing countries. The Gorbachev "revolution" in the Eastern Europe and former Soviet Union gradually eliminated the East-West tension, replacing it with a new world order in which the North (U.S. in particular) has become a predominant actor in world politics. Meanwhile, the Persian Gulf war has increased the fear of developing countries to possible intervention of the North. Any possible antagonistic action against the developed world can translate into a disaster for the respective developing country. As a result, firms in developed countries now feel more protected by their governments. Under these conditions, developing countries may have to choose to minimize risks by unifying with the developed world. Hosting FDI from the North is one important way of achieving this goal. But how much the new international politics will affect future FDI flows to developing countries is not certain at this point.

POLICY IMPLICATIONS FOR DEVELOPING COUNTRIES

As discussed above, the absolute decline in total private capital flows to developing countries can be viewed in terms of two developments. First, there has been a decline in the absolute volume of private bank lending. It went down from a peak of $76.8 billions per annum in 1981 to a minimum of $0.7 billions in 1988. Commercial bank loans have become unobtainable for many developing countries. This is particularly true for those countries with heavy debts, including most Latin American and African countries. Second, the absolute magnitude of FDI in developing countries has remained more or less constant in the 1980s, at an average of about $10 billions per annum. However, these flows of FDI are unevenly distributed across regions, as well as sectors. In the first half of the 1980s, 18 countries and territories accounted for 86 percent of flows of FDI to developing countries as a whole.[35] South-East and East Asian countries as a group have been exceptional in attracting FDI. Flows of FDI to these countries have been steadily growing in nominal terms in the 1980s. On the other hand, the volume of FDI in Latin America and Africa is of an entirely different dimension. Largely because of mounting debt burdens and lagging economic growth. Latin American and African countries experienced drastic decline in inflows of FDI.

The combined effects of the decline in total private capital flows to developing countries and chronic trade imbalance have been a shortage of foreign exchange in many developing countries. This shortage, along with other contributing factors, has in turn led to domestic economic decline because of the dependence of domestic production on imported raw materials, intermediate as well as capital goods, including equipments and technology. Coupled with massive grass-roots pressure and austerity requirements from the IMF and World Bank, domestic urgency for economic growth in these countries will persist. According to an IMF projection (1990), assuming that debtor developing countries will gradually fulfill their debt services

and regain creditworthiness, commercial bank lending would still remain substantially below the levels of the late 1980s and early 1980s.[36] The relative importance of FDI may increase in the foreseeable future under this circumstance.

There are certain policy options available to developing countries that wish to attract more FDI. The most important step is to develop a positive view of FDI. The states can accommodate the paradigmatic shift in development thinking by liberalizing their national economic policies. Countries with large potential domestic markets will in particular benefit from liberalized policies because of the attraction of their markets for MNCs. The states can also relax tight control on domestic enterprises, freeing them to negotiate with foreign investors on their own behalf. The states need to loosen control over ownership, that is, they have to accept different forms of FDI including wholly foreign-owned subsidiaries, majority as well as minority foreign ownership, contractual joint-ventures, and buy-back arrangements. As demonstrated by previous experiences, control over ownership does not necessarily lead to control over production and profits. Developing countries with depressed economies, relatively small domestic markets, or scarce natural resources may be able to attract FDI by providing favorable investment climates through liberalizing macroeconomic policies and stabilizing the political situation. In addition, they can attract foreign investors by granting them incentives such as commodity protection, tax holidays, investment allowance, and subsidies for the training of local labor. Minimizing restrictions on sectoral investment, permitting remittances of profits and dividends are among other helpful policies. However, even with these incentives in place, there is no guarantee that FDI will flow to these developing countries.

We feel that FDI has some positive impacts on the development process in developing countries. It presents an opportunity for these countries to finance their economic growth. A developing country can also get access to the technological and managerial assets of foreign investors through FDI, the diffusion of which can have substantial impacts on produc-

tivity growth. Although licensing agreement and turnkey plant can also provide a similar access, FDI bounds foreign investors to the operation of the investment project and enhances their willingness for technology transfer and job training. Moreover, the introduction of efficient and internationally competitive enterprises into an economy can stimulate local entrepreneurship by providing increased competition and opportunities for subcontracting with local firms. In an era of high unemployment and debt crisis, FDI can also be used to create jobs and generate export earnings to help relieve pressures of debt services. FDI may provide the initial capital and future opportunities for profits needed for industrial investment. There are also more dynamic gains from this industrial development, including a better trained labor force; a higher national income, more innovations, and better competitiveness for a developing country's exports.

However, these positive impacts have to be viewed against a number of negative aspects related to FDI. First, with no significant backward or forward linkages with other economic sectors, FDI, particularly in certain manufacture industries, is unlikely to have the same multiplier effect as in developed and articulated economies. This negative impact is even aggravated by the tendency of MNCs to internalize production and distribution in order to minimize transaction costs. Thus, growth under FDI could lead to sectoral disarticulation in some developing countries. Second, although foreign investors often tend to re-invest their earnings locally during periods of economic growth in the host country, during economic downturns they may actually increase repatriation of funds, further depressing the economy. In addition, they often compete with local firms for domestic as well as external sources of funding and displace the possible development of local firms. Third, some developing countries may have to confront the increasing control exercised by large MNCs over certain sectors of their economies because of many firm-specific advantages. Their advantages include brand names, patented superior technology, marketing and management skills, control of a

large section of world markets, and economies of scale. Last, FDI could cause segmentation or dualism in the labor market of host countries. While a small portion of the labor force is employed by foreign investors, enjoying better working conditions and salaries, the majority is left with insecure and low paid jobs.

There are several measures that can be adopted by developing countries to enhance the positive contributions of FDI. First, with the increasing use of FDI, developing countries will be faced with the increasingly important role of MNCs as intermediaries on both the input side (such as technology, management, and equipments) and output side (world export markets) of production processes. The relative bargaining power of developing countries in negotiating investment projects will be jeopardized if optional locations exist, given investment decisions of MNCs which are based on their global strategies. The rational solution would be for a host government to grant an agreement that is steeply favorable to the investor at the outset. But as the country moves up the learning curve of technology and management skills, it can forge a better bargaining power. The initially favorable investment agreement for the MNC is likely to be subsequently renegotiated in favor of the host country in the long term.

Second, by carefully screening appropriate technology brought in by FDI, the large supply of semi-skilled and unskilled labor in developing countries can be absorbed into the production of matured and standardized manufactures which in turn may be exported to world markets. In this way, the large supply of labor can in fact be turned into assets for these countries. Even though there is no standard method to determine the appropriateness of a technology, developing countries can adopt more labor-intensive ones in their early stage of development. Through learning by doing, they can gradually become better prepared for more sophisticated technologies. These countries could also choose to cooperate with Third World MNCs because the latter may offer not only more appropriate technology but also smaller and more efficient

operations.

Finally, major recipients of FDI flows to the developing world can accelerate their economic growth through establishing better support and diffusion systems for technologies to be transferred by FDI, as exemplified by the successful stories of South Korea and Taiwan. Banks, government offices, and business institutions are in many cases important sources of financing, counsel, and aid for a local subsidiary in technological development. Diffusion systems link different parts of the technological infrastructure. The turnover of trained and experienced managerial and technical personnel from foreign subsidiaries can facilitate starting new domestic enterprises or modernizing domestic organizations. This entire process of technology diffusion can bring significant long-term benefits to economies of developing countries.

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