Chapter 14
Foreign Finance, Investment, Conflict, and Aid: Controversies and Opportunities

■ Key Concepts

This chapter examines the international flow of financial resources to LDCs and weights the pros and cons of the different forms.

- Private foreign direct investment (FDI) and portfolio investment: Direct investment by multinational corporations and the purchase of stocks and bonds in emerging credit and equity markets by foreign investors are discussed.
- Foreign aid: Both government and non-government aid is discussed.

After an introduction in section 14.1, section 14.2 deals with foreign direct investment (FDI) and the role of multinational corporations (MNCs) in economic development. Conflicts between the objectives of MNCs (profit maximization) and host countries are discussed. Figure 14.1 shows FDI inflows both global and by groups from 1980 to 2012. Figure 14.3 presents a breakdown of resource flows to LDCs by type: official flows, FDI, portfolio flows and commercial bank loans (the last three make up private flows to LDCs).

Section 14.3 discusses growth and remittance of developing economies. This section presents Figure 14.4 and Table 14.1, both of which highlight resource flow to developing countries from 1990–2008 and the top 20 remittance receipt countries in dollars and as a percentage of GDP for 2008. The importance and benefits associated with increasing remittances to recipient nations are also discussed.

Multinational corporations are firms that own or manage resources in more than one country. Potential benefits include filling gaps in savings, foreign exchange, government revenue, management skills, technology, and entrepreneurship, all of which may ultimately increase economic growth, this is discussed in 14.2.. The text shows that these contributions may be small because: (1) MNC capital is often raised locally, perhaps from the government at subsidized rates, (2) little of the profits may be reinvested in the local economy, (3) MNCs may import many of the intermediate and capital goods they use in production, (4) liberal tax concessions and transfer pricing (that avoids taxation), and (5) there may be negative effects on indigenous entrepreneurship. Moreover, MNCs may encourage dualism and inappropriate consumption of luxury goods, use excessively capital intensive techniques, and displace indigenous production. The net benefits of MNCs should be empirically determined on a case by case basis.

Private portfolio investment represents one-third of the net financial resource flow to developing countries. The pros and cons of investing in emerging country stock markets are mentioned, with reference to several crises (Mexico, Russia, Asia).

Foreign aid is defined as a flow of official capital to developing countries that has a noncommercial, nonmilitary purpose (from the point of view of the donor) and features favorable interest rates and/or repayment periods. Some measurement issues are mentioned and data are presented on the volume and source of foreign aid. It is noted that there is a fine line between commercial and noncommercial objectives, and tied aid is stressed. The chapter discusses donor country motives and cites political as well as economic objectives. The two-gap model is introduced to describe the role of aid in relieving the foreign exchange gap. Developing countries tend to accept aid to supplement scarce domestic resources and to help speed up the development process. The growing role of non-governmental organizations is mentioned as a source of aid.

Section 14.5 focuses on conflict and development. The scope of conflict is discussed, as well as the consequences for armed conflict, including destruction of wealth, worsening poverty, loss of education and changes in social fabric. Figure 14.5 explains global trends in armed conflict from 1946 to 2008. Next, the section explains what the risk factors for armed conflict include, finishing with how such conflicts can best be prevented.

The case study on Costa Rica, Guatemala, and Honduras demonstrates the relevance of many of topics covered in chapter 14 (such as the ole of aid and remittances) as well we demonstrating the relevance of many of the other topics developed in the first thirteen chapters

■ Discussion Topics

- Have students brainstorm on how MNC and LDC goals can be reconciled in the short run and the long run. What policies might address some of the arguments against MNC investment?
- Weigh the costs and benefits of MNC investment against other alternative options, such as import substitution. What are the proposed short and long run differences for the economy? You might have students research Argentina and India.
- Discuss the feasibility of achieving the U.N. target for provision of foreign aid of 0.70% of GNI. An interesting angle is the current move by the entertainment industry towards putting pressure on governments to meet this target.
- Have students discuss news articles, essays and commentaries from the last decade on armed conflict and its impediment to development in Somalia, Sudan and other nations.

■ Sample Questions

Short Answer

1. Suppose an MNC subsidiary buys 100 input units from its parent at a price of $2 each. It has $300 in additional production costs, and sells its 100 units of output for $6 to the MNC. It pays a 25% local profit tax. The MNC sells the output at home for $8, and its cost of producing inputs is $1. It pays a profit tax of 20% at home on repatriated profits. What is the subsidiary net profit? Assume no selling costs at home. What is the MNC's total profit from the operation?

   Answer: $75; $360.

2. It has been argued that tied aid leads to inefficiencies in the recipient country's economy. Explain how this could occur.

   Answer: Discussed in the chapter.

3. State three major potential advantages of foreign direct investment for a developing country. State three major potential disadvantages.

   Answer: See Key Concepts.

4. Provide a concise statement on the relationship between multinational corporation investment and economic activity in developing countries with respect to: (a) the three gaps, (b) comparative advantage, (c) the debt crisis, (d) scale economies, and (e) pattern of consumption.

   Answer: The question may be asked as one long essay or selected parts for short essays. Discussed in the chapter.

5. Explain the motives of developed countries in providing foreign aid.

   Answer: Creation of markets, geopolitical influence, etc., discussed in the chapter.

6. Why does investment by multinational corporations not necessarily help to close the foreign exchange gap.

   Answer: Investment funds may be raised locally, and the subsidiary may not export its output.

7. Provide a concise statement about the relationship between multinational corporations and: (a) domestic employment, (b) foreign exchange, (c) taxes, (d) investment, (e) consumption, (f) industrialization, (g) inequality, and (h) technology.

   Answer: Depends on lecture coverage.

8. Explain what is meant by investment by MNCs encouraging inappropriate consumption.

   Answer: Discussed in the chapter.

9. Why does multinational corporation investment not necessarily offer the advantage of domestic employment expansion?

   Answer: Capital-intensive production coupled with crowding out of local borrowers when capital is raised locally.

10. Critically evaluate the following statement: "If no other assistance is available, tied aid should be accepted anyway, on the grounds that developing countries should accept any help they can get."

    Answer: Calls for a discussion of the costs and benefits of tied aid, which can lead to net positive or negative benefits.

11. State at least two major benefits of promoting non-governmental organizations in developing countries as sources and conduits of foreign assistance.

    Answer: Benefits: less constrained by political motivations, and able to avoid cynicism and suspicion by working directly with and for local people.

12. Discuss the pattern of allocation of foreign aid by members of the Development Assistance Committee (DAC) to developing countries in recent years. What are the priorities of the DAC members in allocating foreign aid among recipients?

    Answer: Amounts contributed by major donors are in Table 14.2. In terms of where the funds end up and priorities amongst geographic regions are in Table 14.3.

13. What are the main forms through which foreign capital flows into LDCs? Discuss the evolution of the various forms across the last decade.

Answer: Official and private flows. Private flows are made up of FDI, portfolio investment and commercial bank loans. Official flows are now much less important than they were at the beginning of the 1990s (see Figure 14.3). In recent years, bank loans represent net outflo for LDCs.

14. What role have remittances and direct foreign investment played in Guatemala, Costa Rica, and Honduras?

Answer: Discussed in the case study.

15. Discuss how remittances can help reduce poverty and meet other development objectives in recipient nations?

    Answer: Discussed in the section on "Role and Growth of Remittances."

16. What are the primary causes of armed conflict in developing countries and what increases the risk factor for these conflicts?

    Answer: inequalities in access to resources by culturally defined groups, political differences, inability to meet basic needs. And presence of mineral wealth all increase the risk factor for conflicts.

17. Is it possible to proactively prevent armed conflict in developing countries?

    Answer: Adequate investment in well-functioning institutions, both legal and economic; and, global and regional actors who can play an important role of facilitator of conflicts and can reduce the incentive to engage in conflict. Detailed discussion on page 757–766 of the text.

■ Multiple Choice

1. An argument in favor of foreign direct investment is that it tends to
   (a) reduce inequality.
   (b) promote rural development.
   (c) increase access to modern technology.
   (d) decrease local ownership.
   (e) none of the above.

   Answer: C

2. Which of the following is an argument against MNCs?
   (a) A reduction in inequality.
   (b) An increase in the use of labor intensive technology.
   (c) A deterioration of the balance of payments accounts.
   (d) An increase in government tax revenue.
   (e) None of the above.

   Answer: C

3. One of the significant criticisms of MNCs is
   (a) the relatively low wages they pay.
   (b) on balance they bring in more capital than officially registered.
   (c) increased monetary policy effectiveness.
   (d) all of the above.
   (e) none of the above.

   Answer: E

4. The amount of foreign aid in proportion to developed countries' GNP has
   (a) increased over time.
   (b) remained fairly stable over time.
   (c) decreased over time.
   (d) fluctuated widely but has shown no clear trend.

   Answer: C

5. MNCs can often decrease their tax liability through
   (a) use of more capital-intensive techniques.
   (b) use of transfer pricing.
   (c) use of more foreign input sources.
   (d) bargaining with the host country.
   (e) none of the above.

   Answer: B

6. A motivation of developed countries in providing development assistance is
   (a) the creation of markets.
   (b) geopolitical influence.
   (c) genuine humanitarian concern.
   (d) all of the above.
   (e) none of the above.

   Answer: D

7. With tied aid
   (a) MNC investment depends on tax concessions.
   (b) aid recipients must use the aid to purchase goods and services from the donor.
   (c) aid recipients must follow World Bank/IMF conditionality.
   (d) all of the above.

   Answer: B

8. The developing area receiving the largest share of direct foreign investment is
   (a) Africa.
   (b) Asia.
   (c) Latin America.
   (d) Transition economies.

   Answer: B

9. Which of the following is *not* a type of portfolio investment?
   (a) Investment in stocks.
   (b) Multinational corporation investment.
   (c) Investment in commercial paper.
   (d) All are types of portfolio investment.
   (e) None are types of portfolio investment.

   Answer: B

10. The best explanation for the late 1994/early 1995 collapse of the Mexican peso and stock market is
   (a) free movement of capital internationally is destabilizing for a developing country.
   (b) portfolio investments were camouflaging overvalued exchange rates.
   (c) debt for equity swaps had created imbalances in the ownership structure of the economy.
   (d) the potential benefits of NAFTA had been oversold.

   Answer: B

11. In the two-gap model, which of the following gaps, when binding, leads to foreign aid having the largest impact on GNP?
   (a) Fiscal gap.
   (b) Savings gap.
   (c) Foreign exchange gap.
   (d) None of the above.

   Answer: C

12. Voluntary organizations that work with and on behalf of mostly local grassroots organizations in developing countries are termed
   (a) international organizations.
   (b) nongovernmental organizations.
   (c) multilateral institutions.
   (d) equity organizations.
   (e) none of the above.

   Answer: B

13. A model comparing savings and foreign exchange constraints to see which is binding for economic growth is known as a
   (a) project appraisal.
   (b) two gap model.
   (c) computable general equilibrium.
   (d) trickle down model.
   (e) none of the above.

   Answer: B

14. Which of the following countries meets regularly the UN target for the provision of foreign aid (as a percent of GNI)?
    (a) Japan.
    (b) United States.
    (c) Denmark.
    (d) France.

    Answer: C

15. During 1990–2003, as a percentage of total resource flows to developing countries, the share of official flows has
    (a) remained relatively constant.
    (b) increased by a relatively small percentage.
    (c) increased by a relatively large percentage.
    (d) decreased by a relatively small percentage.
    (e) decreased by a relatively large percentage.

    Answer: E

16. As a percentage of GNI, which of the following countries provides the greatest amount of foreign aid?
    (a) United Kingdom.
    (b) United States.
    (c) Italy.
    (d) Sweden.

    Answer: D

17. As an absolute amount (billions of dollars), which of the following countries provides the greatest amount of foreign aid?
    (a) United Kingdom.
    (b) United States.
    (c) Italy.
    (d) Sweden.

    Answer: B

18. The direct benefits of out-migration to a developing nation include:
    (a) Loss of skilled workers.
    (b) Increased remittances.
    (c) Job growth.
    (d) Larger capital formation.

    Answer: B

19. The largest recipient of remittances in dollars in the year 2008 was:
    (a) India.
    (b) Mexico.
    (c) Pakistan.
    (d) Philippines.

    Answer: A