Today’s Plan

- Quiz 6
- Key Topics in Chapter 8:
  - Sovereign lending
  - Foreign Direct Investment (FDI)
  - International Monetary Fund (IMF)
- Discussion:
  - Is the IMF unfair? Apply your argument to the recent Greek crisis.
  - Should the U.S. keep contributing to the IMF?
Core of the Analysis

- Many actors value access to foreign funds, whereas others resent the burden.

- Both lenders and borrowers have a common interest in sustaining capital flows.
  - But they can disagree on how benefits are divided.

- Many powerful international institutions influence financial interactions.
How and Why Do People Invest Overseas?

- Two broad categories of foreign investment:
  - **Portfolio investments**: give the investor a claim on some income, but no role in managing the investment
  - **Direct investment**

- Portfolio investors’ interest is simply in the rate of return.
  - Some examples: loans, stocks, and bonds
How and Why Do People Invest Overseas?

- Most portfolio investment that goes into developing countries is **sovereign lending**:  
  - Loans from private financial institutions to sovereign governments

- **Foreign direct investment (FDI)**:  
  - Made by a company that owns and controls facilities that are located in another country
Investments overseas have a simple goal: to make money.
- Those with capital want to move their money to where profits are higher.

Capital is scarce in a poor country.
- The price of capital – measured in interest rates – is higher when it is in short supply (recall the Heckscher-Ohlin Theorem from last week!)
Why Invest Abroad? Why Borrow Abroad?

- However, about 90% of international investment flows to wealthy countries because the risks are lower.

- Industrialized countries are more economically and politically stable.
  - There is always a risk that poor countries may undertake policies that devalue an investment.
### Why Invest Abroad? Why Borrow Abroad?

<table>
<thead>
<tr>
<th>TABLE 7.1</th>
<th>INTERNATIONAL INVESTMENT FLOWS, 1980–2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>All Countries</strong> (billions of U.S. dollars)</td>
<td></td>
</tr>
<tr>
<td>Foreign direct investment</td>
<td>12.9%</td>
</tr>
<tr>
<td>Foreign portfolio investment</td>
<td>87.1%</td>
</tr>
<tr>
<td><strong>Advanced Economies</strong> (billions of U.S. dollars)</td>
<td></td>
</tr>
<tr>
<td>Foreign direct investment</td>
<td>12.3%</td>
</tr>
<tr>
<td>Foreign portfolio investment</td>
<td>87.7%</td>
</tr>
<tr>
<td><strong>Developing Countries and Emerging Markets</strong> (billions of U.S. dollars)</td>
<td></td>
</tr>
<tr>
<td>Foreign direct investment</td>
<td>15.3%</td>
</tr>
<tr>
<td>Foreign portfolio investment</td>
<td>84.7%</td>
</tr>
</tbody>
</table>

*Note: These are flows of new investments, not stocks of existing investments.*

What’s the Problem with Foreign Investment?

- Both investors and the countries they invest in have in interest not cooperating.
  - Yet, each side wants as much as possible from the other while giving as little as possible

- Making debt payments can require:
  - Raising taxes, reducing government services, importing less, restraining consumption and wages, etc.

- The benefits and costs of foreign investment do not equally affect every citizen.
  - No guarantee that the people who pay the cost of the investment will be the ones to benefit from it

- A financial crisis abroad may have negative effects domestically.
Concessional Finance

- **Concessional finance** is typically lent at below-market interest rates.
  - For example, the **World Bank** loans at no interest to the poorest nations

- Concessional finance is more a form of aid than finance.

- Debt forgiveness might alleviate some problems in very poor nations but would come at the expense of rich nations’ taxpayers.

- However, these issues do not have much impact on private international finance.
Who Wants to Borrow? Who Wants to Lend?

- It makes sense for a country to borrow if the borrowed funds are used productively.
  - The loans should increase the country’s output by more than the amount of the debt.

- As national output rises, tax revenue increases, making it easier to pay off debts.
Who Wants to Borrow? Who Wants to Lend?

- Governments often impose unpopular measures in an attempt to pay off loans.
  - Cut spending, raise taxes, hike interest rates (which restrains wages, profits, and consumption)

- This may cause a **recession** or even a **depression**.
Who Wants to Borrow? Who Wants to Lend?

- Debt difficulties can arise from international conditions.

- For example, from 1980 to 1982, American interest rates rose by 10%.
  - As American interest rates went up, so did the cost of outstanding loans
  - This was one of the causes of the debt crisis of the 1980s
Who Wants to Borrow? Who Wants to Lend?

- During the Great Depression, almost every debtor nation defaulted.

- After another Mexican crisis in 1994, the US provided billions of dollars to the Mexican government to help contain the crisis.
  - In response, Congress began to limit the authority of the President to use taxpayer money for such bailouts
Debtor-Creditor Interactions

- Foreign borrowing has contributed to the economic development of many countries.
  - In the 1800s, the US was the world’s largest borrower

- Concern about getting caught up in debt disputes helps explain why today’s private international finance flows to more advanced countries.
Debtor-Creditor Interactions

- Sovereign lending involves a commitment problem.
  - The possibility of default is a problem for the borrower who must reassure the creditor that it will honor its commitment.

- If a debt is defaulted, creditors can retaliate.
  - Cut off future lending
  - Freeze the debtor nation’s assets
  - Lobby to cut off aid
Debtor-Creditor Interactions

- Debtor-creditor interactions are characterized by incomplete information:
  - The debtor may claim that it cannot make its payments – but is it true?
  - The creditor may threaten to retaliate – but will the threat be carried out?
Institutions of International Finance

- The **Bank for International Settlements (BIS)** was established in 1930.
  - It oversaw relations between the debtor nation, Germany, and its international creditors

- Today, the **International Monetary Fund (IMF)** oversees many aspects of international financial affairs.
International Monetary Fund (IMF)

- The IMF was established at Bretton Woods to manage the international monetary system.

- A country facing debt difficulties can turn to the IMF to negotiate a program of economic policies.
  - Once these policies are enacted, the IMF will give inexpensive loans to the country

- The IMF can also “certify” a debtor country as being in compliance with IMF norms.
  - The country is then more attractive to creditors
International Monetary Fund (IMF)

- The IMF negotiates agreements directly with an individual country’s government.
  - This allows it to play a major part in negotiations between sovereign governments and private financiers.

- However, critics of the IMF believe it is a tool of international financiers, doing little to assist poor nations in achieving economic growth and development.
What Do We Know? What Motivates the IMF?

- Some believe IMF behavior reflects the geopolitical concerns of the US, its largest member.

- Studies suggest that political alignment with the US made governments more likely to get funding.

- Studies also show that various factors made Congressmen more likely to support more American money for the IMF:
  - Campaign contributions from large banks
  - Districts with many college-educated workers

- The IMF helps address debtors’ economic problems, but it is also motivated by the interests of the major powers.

- Both economic and political considerations are central to understanding the IMF.
Recent Borrowing and Debt Crises

- Since the mid-1960s, international finance has been an important part of the international economy.
  - First crisis: the Mexican default in 1982

- Most debtor economies remained depressed for years – the crises were not fully resolved until 1990.
Recent Borrowing and Debt Crises

- In 1997-1998, combined debt and currency crises hit a series of East Asian countries.
  - The nations had been seen as models of developmental success

  - The IMF and creditor governments had to step in
Sopo sing utang?
Mosok rakyat kaya ya raya.

- In 1997, East Asia was crippled by an international financial crisis.

- The root of the crisis was the revival of capital flows in the 1990s. Two main worries:
  - The value of investments were dependent on the value of domestic currencies
  - Concern about the debtor governments’ involvement in domestic economies

- The panic started in 1997 when Thailand’s largest bank was declared insolvent.
  - Its liabilities exceeded its assets

- The results:
  - A reevaluation of the IMF
  - Vigorous debate about the costs and benefits of international financial integration
International Direct Investment: What Role Do Multinational Corporations Play?

- Foreign direct investment (FDI) is another important form of international capital movement.
  - Carried out by corporations that maintain control over the facilities they establish overseas

- These corporations are known as **multinational corporations (MNCs)**.

- Corporations go multinational to gain access:
  - To the local market
  - To local resources

- What ties FDI together?
  - FDI investors believe that overseas direct investment is profitable
Why Do Corporations Go Multinational?

- Governments typically act to promote and protect the interests of their corporations abroad.

- Some fault MNCs for:
  - Not investing at home
  - “Outsourcing” jobs to countries with lower wages
  - Looking for pollution-friendly regimes
  - Seeking ethically relaxed governments
Why Do Countries Let Foreign Multinationals In?

- MNCs bring in managerial, technological, and marketing skills as well as investment capital.
  - For example: Intel opened facilities in Costa Rica in 1997, transforming the country’s economy

- Yet, some host countries complain about:
  - MNCs that pay too little in taxes
  - Insensitivity to social, cultural, and political norms
  - MNC dominance of domestic markets
Host Country Interactions with MNCs

- Each side has strong incentives to bargain for a greater share of benefits from FDI.

- A host country’s weapons include:
  - The ability to regulate and tax companies
  - Threats to nationalize MNCs (forcing them to sell to local investors or the government itself)

- An MNC’s weapons include:
  - Withholding capital, technology or expertise
  - Pulling out of the local economy
Host Country Interactions with MNCs

- In the 1960s, LDC governments took a dim view of MNCs’ impact on local politics.
  - Many countries began to restrict and regulate MNCs
  - The turn away from MNCs in the 1960s and 1970s was associated with the increase of foreign borrowing.
  - Borrowing brought in foreign capital without permitting foreign ownership

- Why did MNCs regain popularity in the 1980s?
  - Debt crises increased the need for capital
  - MNCs became less politically sensitive
Why Aren’t There International Institutions Related to FDI?

- International lending has the IMF, the World Bank, the Inter-American Development Bank.
  - But there are few widely accepted global concerns associated with FDI

- In the case of FDI, each investment has different characteristics.
  - Host governments are often well equipped to supervise foreign companies
Why Aren’t There International Institutions Related to FDI?

- **Bilateral investment treaties** provide protection for each other’s investments.
  - But nothing analogous to the IMF has emerged
  - Incentives for global FDI regulation are few

- FDI is largely seen as a positive factor in economic development.
In the 1800s and early 1900s, international labor migration rates were much higher than they are today.

- Yet immigration remains very controversial

Applying the Heckscher-Ohlin theorem:

- An inflow of unskilled labor from abroad will tend to reduce the wages of local unskilled workers
- Likewise, immigration of skilled labor will reduce the wages of local skilled workers.

Benefits of immigration:

- Employers gain from lower wages
- A larger labor force and lower cost of production
Policies on immigration have varied over time:
• The political economy of immigration involves economic and noneconomic considerations

Economic considerations:
• Immigrants tend to be poorer than natives and often use social programs
• But they also usually pay taxes

Noneconomic issues:
• Some may see immigrants as a cultural threat
• Others welcome the diversity
Conclusion: The Politics of International Investment

- There are many advantages to having access to international capital.
  
  - However, foreign loans and investment may become a burden, impose constraints, and create conflicting interests.

- While many people benefit from international finance, it can also negatively impact the lives of billions.
IMF and the Greek Crisis


- Is the IMF unfair? Apply your argument to the recent Greek crisis.
- Should the U.S. keep contributing to the IMF?