International issues 2
(Chapters 13-14)

Introduction of definitions for Balance of Payments

Current Account Balance, Capital Account Balance, Cash Reserve Account (then errors and omissions).

Current Account: The portion of a country's balance of payments that portrays the market value of a country's visible and invisible exports and imports with the world.

The value of exports of goods and services
+ Investment income received from abroad
+Net remittances and transfers
–the value of imports of goods and services
–Debt service payments.

Capital account. A portion of a country's balance of payments that shows the volume of private foreign investments and public grants and loans that flow into and out of a country over a given period.

Direct private investment
+Foreign loans (public and private)
–Resident capital outflow
–Increase of foreign assets of domestic banking system.

Cash reserve account. The balancing portion of a country's balance of payments, showing how cash balances (foreign reserves) and short term financial claims have changed in response to current account and capital account transactions.

Change in cash reserve account:
Change in holdings of foreign hard currency
+Change in gold holdings
+Change in deposits at the IMF.

Special Drawing Rights: Claims on the IMF. Can be used as a type of international reserve.

Errors and Omissions =
Change in cash reserve account
– current account balance
– capital account balance.

Note there is also a measure of the trade balance you may see reported. Net value of exports minus imports of goods. (services left out).

http://www.imf.org/external/datamapper/datasets/BOP

Developing countries tend to have negative current accounts. Net importers. Historically, balanced by inflows of capital, both foreign investment and lending for a positive capital account.

The current account balance is expressed in value, and that value is in USD.

Devaluation can help address a persistent negative current account (although also impacts capital account). We don't worry as much about the capital account since it is seen as less under the control of the national decision makers than the current account.

If currency is overvalued, increasing the local cost of imports / increasing the competitiveness of exports could happen by adjusting the exchange rate.

Reduce the value of the domestic currency (as in declare that the official rate of exchange is no longer 2 kwacha per dollar, it is 5 kwacha per dollar; a kwacha that was worth $0.50 is now worth $0.20).

The wine that you import for $10 per bottle goes from 20 kwacha to 50 kwacha.

The farmers who sell a kilo of rice for 5 kwacha locally have the international price of their rice go from $2.50 to $1.00.

Depreciation is similar, but more gradual.

Freely fluctuating currency rates, where market forces determine exchange rate. Can lead to unpredictable movements and uncertainty. “Floating” a currency.

Managed float. Major currencies fluctuate freely, but are managed through monetary policy. (shift supply curve of currency buy increasing supply of money in the economy through lowered interest rates or decreasing supply of money by raising interest rates)

Ambiguous impact on current account balance due to inflationary aspect.

High inflation will mean the currency will need to be continually devalued against the world currencies.

Devaluation will also impact different segments of society differently.

Domestic producers who do not export, importers will be harmed. Exporters will be helped. Who are the exporters and who are the importers?

Balance of payments in action – Understanding the Debt crisis.

What happened in the 1980's?

Late 60's, early 70's rapid growth in developing countries. Many countries ran current account deficits, balanced with inflows of capital.

Then in the mid 70's, the oil crisis came along. Three main impacts.

1) Price of oil went up, leading to inflation.
2) World economy slowed down, decreasing market outlets for goods produced in developing countries.
3) Savings of OPEC countries put into banks, and banks wanted to lend this money out.

For the second half of the 70's, private banks made loans to developing countries to balance the current account deficit.

Faced with inflation and slowed growth, developing countries decided to borrow money to address these issues.

Many of these loans were on nonconcessional terms (more than tripling the lending of private capital markets over this period) compared to the previous loans which were from international institutions or developed country governments.

Second oil shock and macroeconomic adjustment in developed countries in late 70's / early 1980's. Interest rates went up rapidly as polices such as Volker's Fed (tight money supply to break inflation) were implemented in the developed countries. Particularly damaging if loans were flexible rate loans.

In addition, there was a huge outflow of capital from developing countries from the mid 70's to the mid 80's. "capital flight". Individuals were putting a lot of their savings into investments outside of the national economy.

Domestic inflation, high rates of interest in developed countries, low domestic growth.

Macroeconomic instability: high inflation, government budget and foreign payment deficits, reserves no longer adequate to balance negative current and capital account balances.

Two choices in such a situation.

1) Curtail imports (tariffs, quotas, reduce overvalued exchange rate), impose restrictive fiscal and monetary measures (reduce government spending, tighten money supply to reduce inflation).
2) Borrow more.

Most borrowed more, leading to huge debts and huge debt service bills. By the 1990's, we entered the phase of IMF stabilization programs, where option one was arguably no longer possible to evade.

Restructuring of debt with private institutions conditional upon adoption of an IMF sponsored stabilization program.

1) Abolish foreign exchange and import controls.
2) Devalue overvalued currencies.
3) Anti-inflation fiscal and monetary policies (raise interest rates and reserve requirements, cut government spending, control wage increases, free markets and remove price controls).
4) Open up and encourage FDI.

If you follow the stabilization steps, you get some SDR to help balance reserve account.

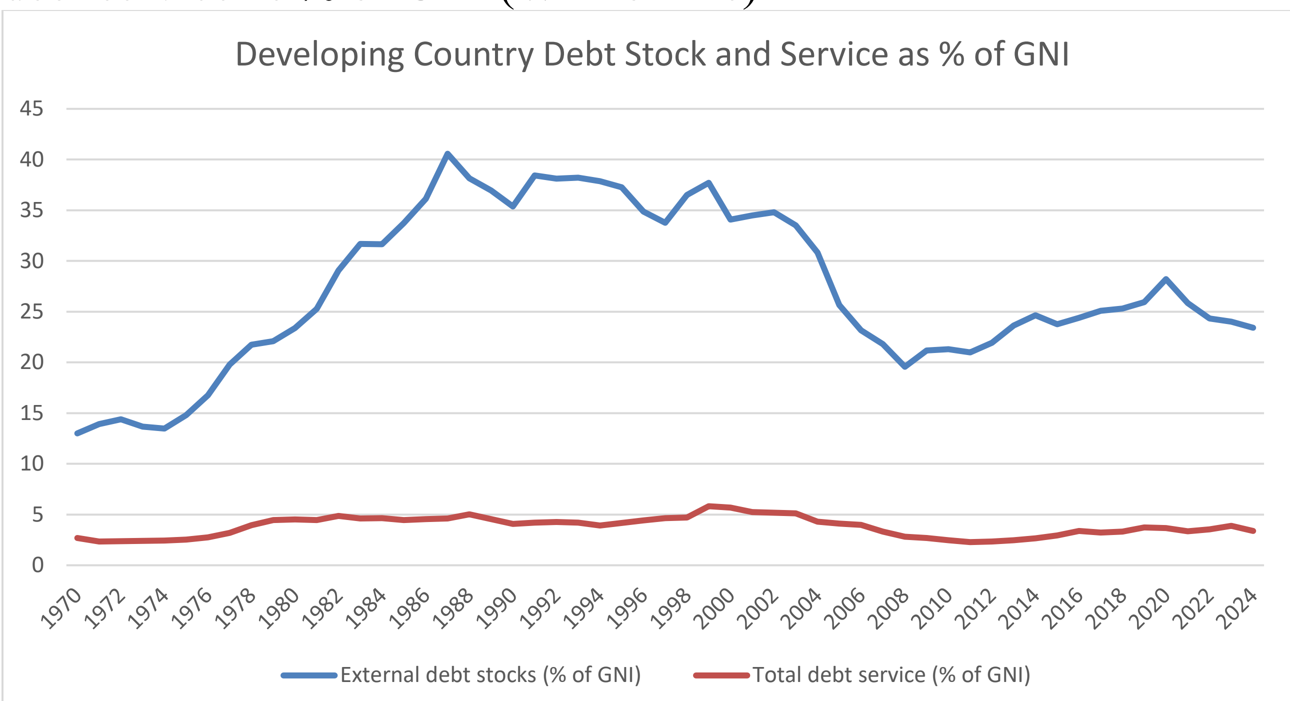
Did not lead to growth in the majority of places it was implemented.

However, it did allow for debt restructuring. Reduce interest rates, extend payment period, cancel some of the principal due. Private banks get guarantee from WB and IMF if they restructure that loan will not fail. Debt for equity (buy debt at 50 cents on the dollar, use the money to buy the state owned telephone system), debt for nature swaps (buy at a discount, use money for natural resource conservation projects).

Worked out well for banks and for international financial system. Crisis was avoided, major defaults were avoided.

Did not work out so well for developing countries. Debt service as percent of GNP remains very high, and the burden of debt did not go away, just got spread out over time. Need capital for growth, need growth to pay off debt, but with outflows to service existing debt they end up in a trap.

Low and middle income country debt stock, as % of GNI, debt service as % of GNI (WDI online)



This package of policies that go with the structural adjustment period has been termed the "Washington Consensus". Williamson (1990), see Williamson in the reader (2000).

Largely developed in response to the experience of Latin American countries in the 1980's.

High budget deficits, borrowing (debt crisis), high inflation.

Based on our theories that markets work, and that market based solutions and policies would help solve these problems that were experienced.

- Fiscal discipline, balanced budgets, control inflation.
- Redirect public expenditure to fields with high economic return and potential to improve income distribution.
- Tax reform (lower and broaden)
- Interest rate liberalization
- Competitive exchange rates
- Trade liberalization
- Liberalize FDI inflows

- Privatization of state owned assets.
- Deregulate to abolish barriers to entry and exit
- Secure property rights.

One main finding from countries that adopted these policies is that liberalization without supervision can be problematic.

The financial crises of the late 1990's made clear that capital market and exchange rate liberalization could lead to instability.

Privatization did often lead to increased efficiency, but not always increased equity.

Privatization often led to short term benefits in the government's budget status only.

Privatization was also found to be of questionable benefit if there is not a competitive market to replace the previous system.

What about foreign investment, finance, and aid? Since we saw that the current account balance is usually negative, what can be done with the capital account?

Part of the goal of liberalizing according to the "Washington consensus" was to encourage private flows of capital.

Multinational corporation – corporation or enterprise that conducts and controls productive activities in more than one country.

Foreign direct investment flows tend to places with highest returns and highest security. Over 90% of international FDI flows go to other industrial countries and the fastest growing LDC's.

Link to UNCTAD stats on FDI
https://unctad.org/publication/world-investment-report-2025

https://unctad.org/publication/world-investment-report-2024
https://unctad.org/system/files/official-document/wir2024_en.pdf
https://unctad.org/topic/investment/world-investment-report

Historically, extractive industries. Increasingly, manufacturing and services (but often aimed at manufacturing for export back to the MNC's home country).

What are the arguments in favor of MNC's?

1) Fill savings gap. Developing countries need capital, MNC's have it.
2) Fill foreign exchange gap. Developing countries need dollars, MNC's have them.
3) Fill government revenue gap. Coffers filled by taxing MNC's, use money for development projects.
4) Transfer of skills, knowledge, and technology.

Arguments against?

1) Capital invested in MNC may stifle local competition, may not lead to reinvestment in local economy, may not lead to linkages in country as forward and backward linkages may be international.
2) Can worsen foreign exchange position, as MNC's import products and capital goods, and repatriate profits.
3) Tax concessions may dampen any direct impact.
4) Skills may not be transferred as expat staff in charge, and may not be all that applicable to local conditions.

Another issue of MNC management is the practice of transfer pricing. As MNC's have a global production chain, you set the price of an intermediate good sold from one branch in one country to the next branch in another country to get the lowest tax burden.

Portfolio investment. Foreign purchases of stocks, bonds, CD's and commercial paper of LDC's. Diversification of investment portfolios of developed country investors has led to a large jump in these funds over the past decade.

The good news is that they provide a lot of capital for enterprise development in developing countries.

However, this tends to be in the fastest growing, most secure countries.

The bad news is that it is a highly volatile source of capital. Sudden, dramatic, outflows of capital possible. Not long run investment in all cases.

Asian currency crisis in 1997,
Russia in 1998,
Brazil in 1999,
Argentina in 2001…

Sudden flows out can lead to a crisis.

Foreign aid.

Bilateral and multilateral.

Public and private (NGO).

Explicit (counted) and implicit (usually not counted).

Not commercial flows, and not military aid.

As governments move out of the way of markets, idea was that aid would flow more efficiently.

Foreign aid meets two criteria:

1) Objective should be non-commercial from the point of view of the donor.
2) It should be characterized by concessional terms (interest and repayment period less stringent than commercial terms).

Issues with figuring out the amount of aid:

1) Discounting to distinguish real from nominal
2) Accounting for the parts of aid being given as a loan, not a gift
3) Aid can be tied by source (must buy inputs from donors) or by project (must use aid in a specific way).

Official development assistance (ODA): bilateral and contributions to multilateral grants, loans, and technical assistance. (note OA) “Official Development Assistance (ODA) is defined as those flows to developing countries and multilateral institutions provided by official agencies, including state and local governments, or by their executive agencies, each transaction of which meets the following tests: i) it is administered with the promotion of the economic development and welfare of developing countries as its main objective; and ii) it is concessional in character and conveys a grant element of at least 25 per cent.”

https://www.oecd.org/en/data/dashboards/official-development-assistance-at-a-glance.html

https://www.oecd.org/en/publications/cuts-in-official-development-assistance_8c530629-en/full-report.html

Also from the OECD database
Can find country specific information by recipient:
https://www.oecd.org/en/publications/geographical-distribution-of-financial-flows-to-developing-countries-2024_fbd9569c-en-fr.html

http://www.oecd.org/dac/stats/aid-at-a-glance.htm

Patterns over time
https://www.oecd.org/en/publications/development-co-operation-profiles_2dcf1367-en/full-report.html

Looking at the longer-term history, a large share of US ODA went to two countries: Egypt and Israel. Percents don't total to 100% as only top 15 on the list: Again, from OECD.

United States					
1983-84		1993-94		2003-04	
Israel	14.1	Israel	10.9	Iraq	11.8
Egypt	13.0	Egypt	7.1	Congo, Dem. Rep.	4.1
El Salvador	2.5	El Salvador	4.1	Egypt	3.9
Bangladesh	2.3	Somalia	3.6	Jordan	3.4
Turkey	2.2	Haiti	2.7	Afghanistan	3.3
Costa Rica	2.1	Philippines	1.8	Pakistan	3.0
India	1.9	Colombia	1.4	Colombia	2.8
Northern Marianas	1.7	Jordan	1.3	Ethiopia	2.6
Philippines	1.6	Jamaica	1.3	Sudan	1.4
Sudan	1.6	Bolivia	1.2	Palestinian Adm. Areas	1.2
Indonesia	1.3	India	1.2	Peru	1.1
Pakistan	1.3	Ethiopia	1.1	Bolivia	1.1
Jamaica	1.2	Bangladesh	1.0	Serbia & Montenegro	1.0
Peru	1.2	Peru	0.9	Uganda	1.0
Honduras	1.1	Rwanda	0.9	Indonesia	1.0

TOTAL DAC COUNTRIES					
1983-84		1993-94		2003-04	
Egypt	5.2	Egypt	5.0	Iraq	3.8
Israel	4.7	China	3.8	Congo, Dem. Rep.	3.7
India	3.3	Indonesia	3.6	China	2.7
Indonesia	2.7	India	2.5	India	2.0
Bangladesh	2.2	Philippines	2.2	Indonesia	1.8
China	1.7	Israel	2.2	Afghanistan	1.7
Tanzania	1.4	Ex-Yugoslavia. Unsp.	1.4	Egypt	1.5
Philippines	1.4	Bangladesh	1.4	Pakistan	1.5
Thailand	1.3	Côte d'Ivoire	1.3	Ghana	1.4
Pakistan	1.3	Pakistan	1.2	Viet Nam	1.3
Sudan	1.3	Mozambique	1.2	Philippines	1.3
Turkey	1.2	Thailand	1.2	Tanzania	1.3
Sri Lanka	1.2	Tanzania	1.1	Ethiopia	1.2
Kenya	1.1	El Salvador	0.9	Bangladesh	1.1
Papua New Guinea	1.0	Zambia	0.9	Nicaragua	1.0

What influences aid flows?

Economic motivations.

Two gaps that aid can fill: domestic savings gap (shortage of domestic savings to be used for investment) and a foreign exchange gap (shortage of hard currency to finance needed capital imports).

As noted in growth theory, beyond the 'savings gap' model, there have long been political motivations for giving aid.

Marshall Plan and cold war aid. Contain the spread of communism.

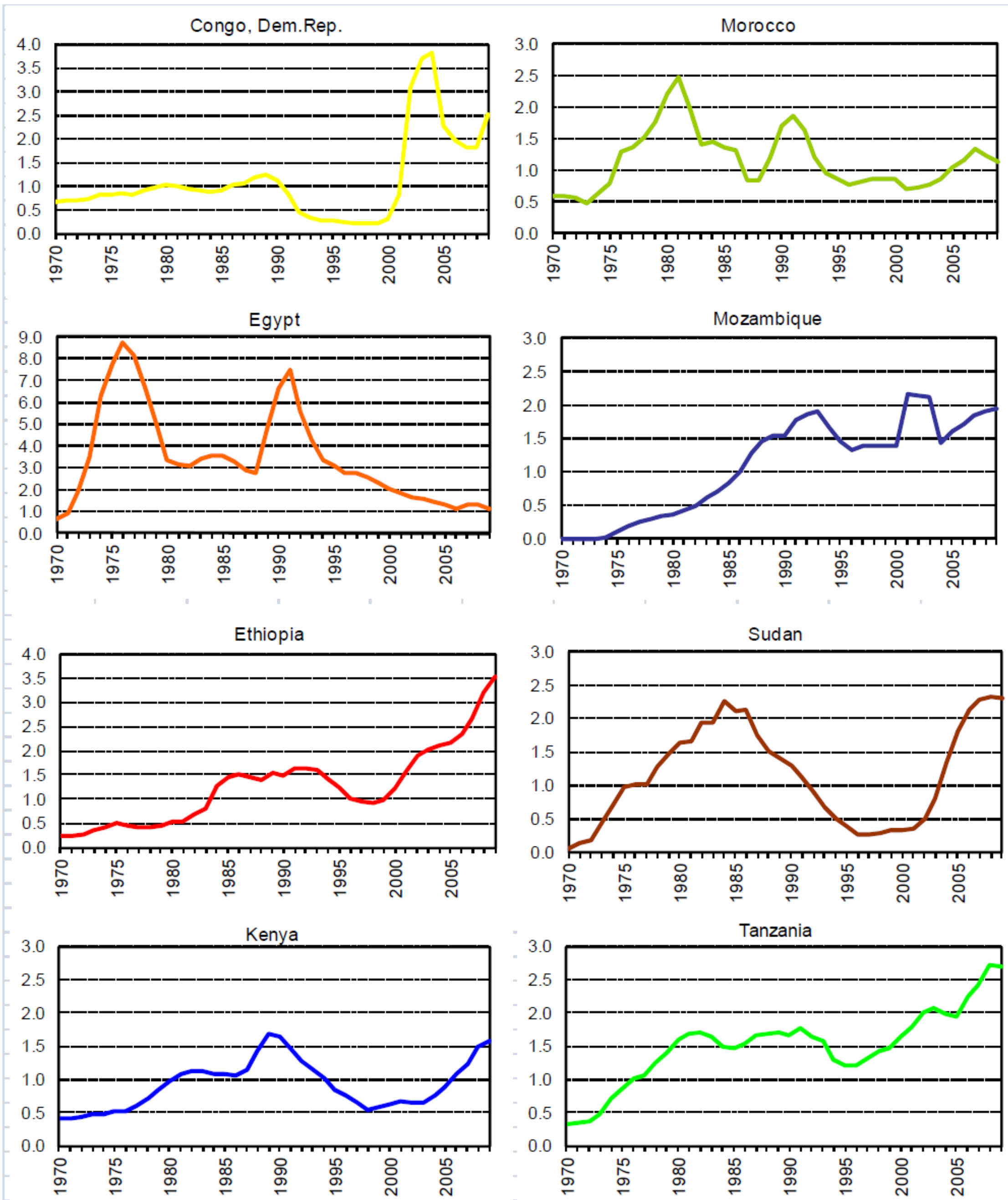
Bilateral aid flows often are influenced by former colonial status.

Flow of aid changes in response to donor's political assessment of changing international situations, not necessarily with the relative need of potential recipients.

Flows can be unpredictable and sporadic.

2.2.10. Trends in aid to largest African recipients since 1970

USD billion, 2009 prices and exchange rates, 3-year average net ODA receipts



Africa region OECD report page 9

Note that just because aid is given, does not mean development will happen. Aid money can be used in ways that have little impact or are in fact harmful.

Burnside and Dollar (2000). Aid has little impact on growth in and of itself. Conditional on 'good policy' it has an impact. ***https://www.aeaweb.org/articles?id=10.1257/aer.90.4.847***
2004 update
https://documents1.worldbank.org/curated/en/992381468780325835/pdf/wps3251Aid.pdf

Do donors target 'good policy'? Alesina and Weder (2002) find no evidence that aid is less likely to go to corrupt governments overall.

Some evidence that aid flows are targeted at "good governance" in a 2014 study in World Development.
https://doi-org.libezproxy2.syr.edu/10.1016/j.worlddev.2014.09.020

Arguments that aid leads to dysfunction (anti-politics machine, it can be a kind of a 'resource curse', a variant on 'Dutch disease')