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# IS FOREIGN CAPITAL A VIABLE OPTION FOR DEVELOPMENT IN DEVELOPING ECONOMIES?

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**Abstract**

Traditional economic theories and models have contested in favour of foreign capital for developing and less developing economies. Typically, low saving rate in the underdeveloped regions accumulating less capital generally inspires these theories and models. Hence, liberalisation of the capital account in order to attract foreign capital has become a dominant development strategy for developing countries. However, the inflow of foreign capital has its costs giving rise to a pertinent question: is foreign a viable option for development for the developing countries? The article seeks to address this query. To this end, it looks into a number of research works, empirical studies and investigation on the viability of foreign capital on the development front in less developed economies. The article concludes that foreign capital's role in development is quite contentious.

## 1. Introduction

In the 1990s, many developing economies opened up their capital account to ensure the free flow of foreign capital or foreign saving to attain growth. Prescribed by the developed nations and international financial institutions[1], the central message of this policy was simple and straightforward: liberalise the capital account to stimulate the development process.[2] This development strategy apparently looks quite justifiable for the capital-hungry developed nations.

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[1]Refer to the World Bank (WB) and the International Monetary Fund (IMF).

[2]See, Luiz Carlos Bresser-Pereira and Paulo Gala, "Why Foreign Savings Fail to Cause Growth?", final version (2007) of the paper presented at the Sao Paulo School of Economics of the Getulio on 23 May 2005, p. 2; Luiz Carlos Bresser-Pereira and Yoshiaki Nakano, "Economic growth with foreign savings?", *Brazilian Journal of Political Economy*, Vol. 23, No. 2, April-June 2003, pp. 3-4; Joshua Aizenman, Brian Pinto and Artur Radziwill, "Sources for Financing Domestic Capital-Is Foreign Saving a Viable Option for Developing Countries?", *SCCIE (Santa Cruz Center for International Economics) Working Paper*, No. 04-15, University of California, Santa Cruz, 2004, p. 3.

However, debates and arguments have encircled this policy ever since. Naturally, importance of foreign capital on the development front has become a heavily contested issue in economic literature. While conventional economic wisdoms make a strong case in favour of foreign capital, a number of empirical studies have revealed that foreign capital in many countries is not growth-enhancing; rather its role in development is controversial.[3] Inflow of foreign capital, among other things, channels into consumption activities, which in turn strains long-term growth. In many developing economies, foreign capital is employed to import consumption goods, thereby compelling their people to incur debt burden.

On the other hand, economists over the years have also argued for accumulating capital from domestic sources, such as household and business savings, government savings, budgetary savings and enterprise savings. Empirical evidences have supported this view. Against this backdrop, the main query of this paper is whether foreign capital a viable option for development. The article makes an attempt to address this question from the perspectives of developing and less developed nations. By reviewing a number of findings and evidences from some other empirical studies, it tries to argue that foreign capital is not quite beneficial in the developing countries.

This article is organized as follows. While section I takes up the introductory part, section 2 presents the economics behind foreign capital. The evidences relating to the effectiveness of foreign capital are provided in section 3. The last section, concluding remarks, summarizes the paper with its main points and presents a direction for future research.

## 2. The Economics of Foreign Capital

The benefits or importance of foreign capital and the rationale behind capital inflows especially in developing nations could be traced in the traditional macroeconomic theories and neo-classical growth models. Results from some empirical studies also champion the cause of foreign capital to stimulate development in the capital-poor nations.

It is widely perceived and acknowledged that the less developed as well as the developing economies are not well-equipped to finance their development activities from the domestic sources. Typically, low savings rate generating even lesser proportion of funds for investment caught these less developed nations in a trap of underdevelopment. Hence, they badly need capital, which Rostow dubbed

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[3] Pradumna B. Rana and J. Malcom Dowling, Jr., "The Impact of Foreign Capital on Growth: Evidences from Asian Developing Countries", *The Developing Economies*, XXVI-1, March 1988, p. 3.

the "missing component"[4] of development for the Least Developed Countries (LDCs). On the other hand, savings rate is relatively high in a capital-rich nation. But the savings usually find little profitable investment opportunity in these rich nations. As a result, the savings generated in the developed nations make way to the underdeveloped economies for investment purpose. However, there are pure economic arguments explaining such investment decision by the developed nations.

According to the neoclassical theory, the return from each unit of capital in a developed nation is lower in relation to the marginal return from capital in a less developed nation. As intensity of capital is quite high in a developed country, its marginal return tends to be diminishing.[5] Another simple neoclassical model—the Kemp-MacDougall model—implies that marginal return from capital in a poor nation is higher than that of in a rich nation in the absence of international trade. The poor nation will be benefited from the capital inflow, given that there is no restriction on capital movement, until equilibrium[6] is restored between both nations[7]. Frankel (1965)[8] also mentioned that a capital importing country benefited more than the capital exporting country; for the capital exporters only receive the direct benefits of their investment.[9] Indirect benefit like development effect, at the same time, is linked with the foreign capital inflow.

Some growth theories have also implied the need for foreign capital. The famous Solow growth model postulates that output or growth is a function of capital stock and labour, while the endogenous growth model augments the term capital by adding human capital and knowledge capital. Hence, these growth models implicitly inspired the capital-poor nations to import foreign capital. Much vaunted theories like the Harrod-Domar growth theory or the two-gap theory literally contested for the inflow of foreign capital to accelerate the development process of the less fortunate countries. These models explicitly indicated that when capital is imported, each monetary unit of it is invested and

[4] W. W. Rostow, *The Stages of Economic Growth: A Non-Communist Manifesto*, Cambridge: Cambridge University Press, 1960.
[5] Helmut Reisen and Marcelo Soto, "The Need for Foreign Savings in Post-Crisis Asia", p. 66, available at: http://www.adb.org/Documents/ Conference/ Sustainable_ Recovery_Asia/adb5.pdf accessed on 22 February 2010.
[6] Marginal product of capital is equal in both nations.
[7] Helmut Reisen and Marcelo Soto, *op. cit*., pp. 66-67.
[8] Frankel used a "development modifier of foreign capital" in his growth equation. This modifier is assumed to be taking value that is larger than unity. Hence, importation of capital is growth-enhancing. See, Seung Park, "Is Foreign Capital an Engine for Development?", *Journal of Economic Development*, p. 110, available at: http://www.jed.or.kr/full-text/2-1/5.pdf accessed on 27 February 2010.
[9] *Ibid*., p. 109.

nothing is expensed for consumption.[10] In other words, foreign capital merges with domestic savings converted into investment.

The celebrated two-gap model[11], due to Chenery and Bruno in the early 1960s, claimed that foreign saving along with local saving is a determining factor for development.[12] However, because of a few limitations associated with this model, a new one, namely, the "three gap model" emerged which included fiscal gap as the third gap.[13] This model points out that the lack of resources to finance the government expenditure is more critical than limited savings or foreign exchange. Thus, foreign capital could be the way forward in diminishing the budget deficit.

Even eminent economists, such as Arthur Lewis, Ragnar Nurkse and Rosenstein-Rodan, in the 1930s and 1940s had mentioned in their seminal contributions that foreign borrowing and investment "would be the way par excellence" to drive development and growth process.[14]

Various studies have also reported the favorable impacts of foreign capital on overall development. For instances, Gulati (1978), and Dowling and Hiemenz (1981) found a positive and significant impact of foreign capital on growth.[15] Gulati examined data on GDP growth rate, capital inflow and saving rate for 38 LDCs during the 1960s and regressed the GDP variable on the remaining ones. The model developed by Dowling and Hiemenz was better specified because it included a few policy variables for the period of 1968-1979 and covered 52 developing nations.

Another study by Gupta and Islam (1983) revealed that foreign capital during the 1970s played important role in speeding up growth compared to domestic savings.[16] The authors performed both Ordinary Least Squares (OLS) and Two Stage Least Squares (TSLS) methods in their study. Mosley (1980) applied TSLS procedure to find that foreign capital played significant role in development for

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[10] Riyad Momni, "Foreign Capital Inflow, Consumption, and Economic Growth: The Experience of Jordan, 1968-1987", *Journal of King Saud University*, Vol. 3, No. 2, 1991, p. 73.

[11] The two-gap indicates the difference between investment and the rate of desired savings. The foreign component of capital eventually bridges this gap.

[12] Helmut Reisen and Marcelo Soto, *op. cit*., p. 66.

[13] NH Bao, "Foreign Capital and Economic Growth: A Comparative Study of Malaysia, Thailand and Vietnam", 2003, p. 4 available at: www.hshimpo.com/jp/Bao-thesis.pdf accessed on 21 October 2010.

[14] Luiz Carlos Bresser-Pereira and Paulo Gala, *op. cit*., p. 1.

[15] Abdul Waheed, "Foreign Capital Inflows and Economic Growth of Developing Countries: A Critical Survey of Selected Empirical Studies", *Journal of Economic Cooperation* 25, 1, 2004, pp. 5-7.

[16] *Ibid*., p. 7.

30 poorest nations during 1969-1977.[17] In a research work focusing on the nexus between foreign aid and per capita real GDP of 56 nations from 1974 to 1993, Hansen and Trap (2001) identified a positive correlation between the two variables.[18] Another empirical research, by pulling cross section and time series data from 1965 to 1982, suggested that foreign capital's contribution to the growth of nine Asian developing nations was quite considerable.[19] Especially Foreign Direct Investment (FDI) increased the available resources and efficiency in investment sectors in those nations.[20] This particular empirical work employed a simultaneous equations model which included variables, such as domestic saving, foreign aid, export, labour force, etc.[21]

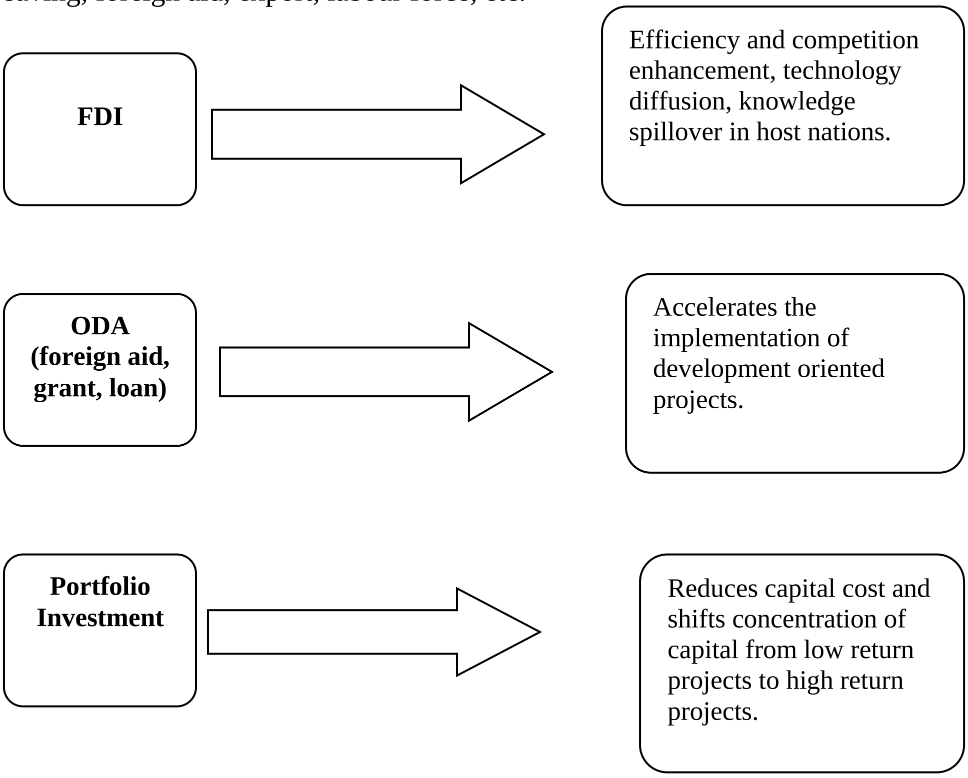


**Figure 1: Impacts of Foreign Capital**

[17] *Ibid*., p. 6.
[18] *Ibid*., p. 12.
[19]Pradumna B. Rana and J. Malcom Dowling, Jr., *op. cit*., p. 9.
[20]These Asian nations were: China, India, South Korea, Myanmar, Nepal, Philippines, Singapore, Sri Lanka and Thailand.
[21] For a detailed discussion, see, Pradumna B. Rana and J. Malcom Dowling, Jr., *op. cit*., pp. 4-9.

The potentials of foreign capital can also be tapped by a labour-abundant economy. A study in this regard revealed that foreign capital's affect on development is quite significant in a labour-surplus nation. On the other hand, the effectiveness of foreign capital is not linked with the abundance of natural resources. Even the importation of foreign capital by a non-labour-surplus nation can hinder its industrial process.[22] Although the findings are questionable, they have implicitly recommended the developing nations, which are generally labour-surplus economies, to import foreign capital.

Now, it is worth mentioning the types of foreign capital. Inflows of foreign capital or foreign savings are usually disaggregated into various components like FDI, portfolio investment, bond finance, Overseas Development Assistance (ODA) and external loans and credit. They are quite beneficial in a number of ways for the capital-starved LDCs.

One can take the example of FDI. As widely recognised, it enhances investment and competition between local and foreign firms, raises local efficiency in production and helps to transfer technology, knowledge and know-how. Further evidences show that FDI smoothes consumption over time and assists to accelerate the growth of export oriented industries.[23] Desai *et al*[24] find that FDI does not crowd out domestic investment as common perception suggests and it helps lowering the cost of production in the host nations. FDI, in fact, has a much stronger impact on growth than other components of foreign capital for it is usually received by the private and the traded-goods sectors and therefore, increases private investment in the recipient country.[25]

Portfolio investment is also regarded as an important source to finance the local firms and enterprises. Studies suggested that inflow of portfolio investment has put downward pressure on capital cost and shifted the concentration of capital from the low return projects to the relatively higher return projects.[26] However, inflow of foreign capital is not without risks as its effectiveness, reported by various empirical studies, is often found questionable.

### 3. Role of Foreign Capital in Development: The Evidences so far

Most of the theories and models supporting capital account liberalisation or importation of foreign capital suffer from flawed assumption. A common assumption that all imported capital is invested but not consumed is itself

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[22] Seung Park, *op. cit.*, pp. 121-122.
[23] Helmut Reisen and Marcelo Soto, *op. cit.*, pp. 74 and 76.
[24] Mihir A. Desai, C. Fritz Foley and James R. Hines Jr., "Foreign Direct Investment and the Domestic Capital Stock", *Michigan Ross School of Business Working Paper Series*, Working Paper No. 1023, University of Michigan, 2005, p. 8.
[25] NH Bao, *op. cit.*, p. 6.
[26] Helmut Reisen and Marcelo Soto, *op. cit.*, p. 75.

problematic. In fact, one of the main criticisms against foreign capital is that it could spur domestic consumption by crowding out local savings and impact the budgetary balance adversely.[27] Griffin (1970) argued almost in the same vein.[28] He explained that foreign capital is actually a substitute for local savings, not necessarily added up with the domestic savings.

Particularly, foreign aid and credit are prone to stimulating consumption on the part of the government and household. An investigation by Cohen (1993) on 34 less developed debtor countries revealed that much of the foreign credit inflow in these nations had turned into consumption, thereby hindering the process of capital accumulation.[29] Economists have also argued that even if every unit of foreign capital is invested in an underdeveloped economy, it might pay-off in the short run but not in the long run due to technological backwardness.[30]

If foreign capital contributes more to consumption activities, then a country, even with a low current account deficit, might not reap much dividend from capital inflow.[31] The experience of Jordan from 1968-1987 further solidifies the argument. A study shows that inflow of capital in Jordan during that period reduced local saving by increasing the consumption level.[32] The study employed the classical OLS technique to examine how foreign capital inflow was correlated with consumption and investment. In the process of analysis the study found that a bulk of foreign capital was utilised to import consumer products in Jordan during the aforementioned period. A portion of the capital converted into local currency was also used for labor and raw materials. All these had boosted the consumption activities in Jordan. The Latin American economies had a similar experience in the 1990s with a large share of foreign saving was used for consumption leading to short run growth, but in the long run growth rate slowed down quite considerably.[33] One option for countering the foreign capital induced consumption is to generate a higher domestic saving rate which would eventually create a surplus in the current account to facilitate debt servicing.[34]

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[27] See, Jan Priewe, and Hansjorg Herr, *The Macroeconomics of Development and Poverty Reduction: Strategies Beyond the Washington Consensus*, Baden-Baden: Nomos, 2005, p. 80 and Pradumna B. Rana and J. Malcom Dowling, Jr., *op. cit*., p. 1.
[28] NH Bao, *op. cit*., p. 4 and Seung Park, *op. cit*., p. 110.
[29] Helmut Reisen and Marcelo Soto, *op. cit*., p. 73.
[30] Josef T. Yap, "Managing Capital Flows to Developing Economies: Issues and Policies", *Discussion Paper Series No. 2000-41*, Philippine Institute for Development Studies, November 2000, p. 7.
[31] Luiz Carlos Bresser-Pereira and Paulo Gala, *op. cit*., p. 4.
[32] Riyad Momni, *op. cit*., p. 75.
[33] Luiz Carlos Bresser-Pereira and Yoshiaki Nakano, *op. cit*., p. 22.
[34] Josef T. Yap, *op. cit*., pp. 6-7.

**Table: Findings of Various Studies on Foreign Capital**

| Authors | Data/Observations | Findings |
|---|---|---|
| Dowling and Hiemenz (1981) | 52 developing countries (1968-1979) | Foreign capital has positive and significant impact on growth |
| Hansen and Trap (2001) | 56 countries (1974-1993) | Positive correlation between foreign capital in form of aid and GDP growth rate |
| Mosley (1980) | 30 poorest countries (1969-1977) | Foreign capital stimulates growth |
| Rana and Dowling (1988) | 9 Asian developing economies | Foreign capital has considerable impact on growth |
| Momni (1991) | Jordan (1968-1987) | Foreign capital reduced domestic saving by increasing consumption |
| Kabir (2007) | Bangladesh (1972-2005) | FDI does not cause economic growth |
| Crakovic and Levine (2002) | 72 developing and developed economies (1960-1995) | FDI does not explain growth |
| Bresser-Pereira and Nakano (2003) | 51 countries (1979-1998) | Only a meager rise in GDP due to increase in foreign capital inflow |

Source: Compiled by the author from various sources

In addition to that balance of payment crisis and heavy external indebtedness are linked with foreign capital inflow. Mexico in 1994, Thailand in 1997 and Argentina in 2001 suffered from the balance of payment as well as from banking crisis due to their over reliance on foreign capital.[35] The balance of payment crisis was also quite critical for Jordan during the period mentioned earlier. The surge of foreign capital in the country led it to import more than the capital inflow and at the same time debt servicing burden reduced the country's export earnings, which created crisis in the Jordanian balance of payment.[36]

FDI, another important component of foreign capital, does not always bring about benefits to the host countries. Although advantages of FDI are recorded in the theories, in practice its impacts on the economies of the target countries are identified as less than encouraging. For example, investment of US companies from 1965 to 1969 did not influence growth of the destination countries positively due to the fact that the repatriated profit to the US was higher than the new investment in the host nations.[37] This phenomenon is consistent with the

[35] Luiz Carlos Bresser-Pereira and Yoshiaki Nakano, *op. cit.*, p. 13.
[36] Riyad Momni, *op. cit.*, p. 77.
[37] Lyroudi Katerina, Papanastasiou John and Vamvakidis Athanasios, "Foreign Direct Investment and Economic Growth in Transition Economies", *South Eastern European Journal of Economics 1*, 2004, p. 99.

early views of a couple of economists from the Dependencia School namely, Hans Singer and Raul Prebisch. They argued that FDI is not growth-enhancing as most of its dividend is transmitted through the multinational companies to the originating countries.[38]

As a matter of fact, the relationship between FDI and growth often demonstrates unclear results. Kabir (2007) identified that FDI did not substantially explain Bangladesh's growth from 1972 to 2005.[39] Kabir further argued that inclusion of some important variables could have resulted in significant impact of FDI on growth. The study, also, performed a Granger Causality Test to report that "FDI does not cause economic growth and vice versa".[40] The growth of relatively weaker economies of the Balkan and the Eastern European countries did not explain by the FDI inflow either.[41] The study employed data on GDP growth rate and FDI of the sample nations for 1995 to 1998 to regress the former variable on the latter one. Similar findings came out from a cross country study conducted by Crakovic and Levine in 2002.[42] They considered the data of 72 developed and developing economies for 1960 to 1995. By using Generalized Method of Moments panel estimator, the authors found that insignificant affect of FDI on growth was true for both economies. FDI has some other adverse impacts on the host economy. For example, technology spillover as a result of FDI can cause unemployment in the recipient country, which in turn slows the long run growth process. FDI also leads to distortion of prices and depletion of natural resources in the less developed economies.

Foreign capital, nonetheless, could be paid dividend under some conditions. For instance, greenfield FDI[43] tends to augment domestic investment in the developing countries "under the condition of free capacities and unemployment".[44] Apart from that if a developing nation employs all her resources then additional import of capital enhances production.[45]

- **Foreign capital spurs domestic consumption by reducing saving**
- **Especially, foreign aid and credit are prone to stimulate government and household consumption**
- **Foreign capital is often used to import consumption goods, thereby creating crisis in balance of payment and external heavy indebtedness (e.g., Jordan and Latin American nations in the 1990s)**
- **Banking crisis could be the result of over reliance on foreign capital**
- **Abrupt reversal of foreign capital leads to macroeconomic imbalances (e. g., 1997 East Asian crisis)**
- **Foreign capital tends to appreciate the exchange rate creating detrimental effect on the export of manufacturing sector**
- **Foreign capital has marginal impact on income (very low**

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38 *Ibid*., p. 98.
39 For details, see, Mahfuz Kabir, "Is Forei
Bangladesh?", *BIISS Journal*, Vol. 28, No. 2
40 Discussed in *Ibid.*, pp. 109-118.
41 For details, see, Lyroudi Katerina, Papanas
*cit.*, 97-110
42 *Ibid*., p. 99.
43 FDI used for building new production p
production unit in the host country is defined
44 Jan Priewe and Hansjorg Herr, *op. cit.*, p. 8
45 *Ibid.*

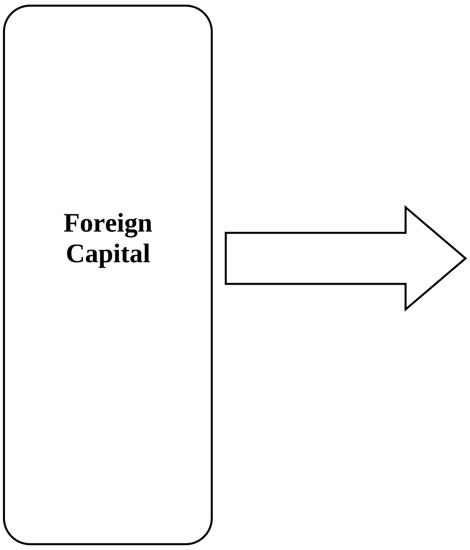


**Figure 2: Arguments against Foreign Capital**

The lack of well functioned and well developed financial market does not help the cause of foreign capital either in the LDCs. Even if a developing country possesses certain profitable investment opportunities and at the same time, has high income, it fails to use foreign capital appropriately due to absence of a developed financial market. With a less developed financial system, inflow of foreign capital is more likely to be invested in non-tradable sectors like real estate, rather than in tradable sector like manufacture.[46] The underdeveloped

[46]Eswar A. Prasad, Raghuram G. Rajan and Arvind Subramanian, "Foreign Capital and Economic Growth", *Project Muse Scholarly Journal Online*, 2007, p. 163.

financial sector according to Prasad *et al* is one of the main hindrances that does not let the capital-starved poor nation to use foreign capital efficiently.[47]

Potentials of foreign capital are also depended on the internal settings of a country. More often bad policies and weak institutions make the environment difficult for foreign capital to work. In addition to that, foreign capital can not play its role in countries characterised by the absence of minimum cultural base and development-oriented social structure.[48] Many countries even with all the necessary institutions fail to accumulate capital from external sources due to bad governance. In fact, well governed countries are better poised to use foreign capital effectively than the countries governed rather poorly.[49]

Another drawback associated with foreign capital is its abrupt withdrawal from a developing or capital-poor country. Economic slowdown, unemployment, bankruptcy, reduction in domestic savings could be the results of such capital reversal. The 1997 Asian crisis is a case in point here. The developing Asian nations from 1988 to 1996 absorbed more and more foreign capital. In 1996, fifty four per cent of global capital inflow was transmitted to the developing economies of Asia.[50] But the 1997 financial crisis hit the Asian countries ultimately led to capital reversal mostly in the form of private capital. The capital outflow from the East Asian nations such as Indonesia, South Korea, Malaysia, Philippines and Thailand in 1997 depressed the domestic saving rate drastically. The sudden saving slash in these nations, which otherwise saved relatively highly, had created an adverse impact on capital accumulation and as a result, rate of growth declined significantly. Especially, Malaysia and Thailand suffered immensely from that downturn. Both of these nations during the pre-crisis period of 1990-96 used about 40 per cent of their saving (from domestic and foreign sources) to accumulate capital. However, the capital reversal repressed the domestic saving, and with the share of foreign capital in the GDP turned negative, the available savings for investment slumped dramatically to a mere 20 per cent in Thailand and around 27 per cent in Malaysia in the post-crisis period. The share of saving plummeted to a meager 10 per cent from around 30 per cent in Indonesia.[51]

Malaysia during the crisis adopted the policy of capital control to restore sanity in its economy. Although international institutes like the International Monetary Fund (IMF) opposed such policy, currently they are in favour of

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[47] *Ibid*., p. 195.
[48] Abdul Waheed, *op. cit*., p. 5.
[49] *Ibid*., p. 11.
[50] Josef T. Yap, *op. cit*., pp. 3-4.
[51] Helmut Reisen and Marcelo Soto, *op. cit*., pp. 72-73.

capital control.[52] The Fund now considers capital control "a legitimate part of the toolkit to manage capital inflows".[53] In fact, Rodrik (1998) identified absence of capital control did not stimulate economic growth of a country.[54] Almost similar findings were reported by Eichengreen and Leblang (2002). The study showed that capital control led to faster growth and ultimately it avoided macroeconomic imbalance despite having microeconomic problems such as resource misallocation.[55]

Another argument against foreign capital inflow is related to exchange rate. When foreign capital inflow increases in a country, flow of foreign currency rises naturally. It puts upward pressure on the exchange rate of the local currency in terms of the foreign currency. As a result, the local currency appreciates making imports cheaper for the country but export of manufacturing industry becomes less competitive. Less costly imported products mean higher real wage for the workers, which consequently will increase consumption and constrain local savings. Hence, foreign capital can also augment consumption through exchange rate channel. It may be noted here that the above mentioned exchange rate and foreign capital nexus is similar to the so-called Dutch Disease[56], wherein a sudden discovery of natural resources eventually leads to the appreciation of local currency.

A number of economic studies, throwing light on the substitution of foreign saving for domestic saving, observe that if the former increases by one per cent the latter decreases by roughly 0.5 per cent.[57] Consequently, capital accumulation from the domestic sources had been affected negatively. For example, Mexico from 1983-94 experienced an increment of foreign savings by 7.4 percentage points of GDP, but its investment increased only by 4.4 percentage points of its GDP.[58] Again the reason behind such scenario was that a chunk of foreign capital was employed to finance consumption, which strained local savings. At the same time, nations financing development activities from domestic sources achieved much more robust growth in the 1990s than those relied on foreign capital.[59] Most of the Asian nations had high self-financing ratios and quite high growth in

[52] IMF (International Monetary Fund), "Capital Inflows: The Role of Controls", IMF Staff Position Note, February 2010, pp. 1-29.
[53] *Ibid.*, p. 15.
[54] Luiz Carlos Bresser-Pereira and Paulo Gala, *op. cit*., p. 10.
[55] Luiz Carlos Bresser-Pereira and Yoshiaki Nakano, *op. cit.*, p. 13.
[56] This phenomenon originates from the Netherlands, where influx of foreign currency in the 1980s due to oil and gas exports appreciated the real exchange rate of the Dutch currency.
[57] Luiz Carlos Bresser-Pereira and Paulo Gala, *op. cit.*, pp. 14-17.
[58] *Ibid*., pp. 16-17
[59] Joshua Aizenman, Brian Pinto and Artur Radziwill, *op. cit*., p. 4.

the 1990s. But the opposite was evident for the African and the South American economies characterised by low self-financing ratios and low growth rate.[60]

Some famous studies also reveal that despite having higher marginal return, capital flowing into a developing or capital-poor nation is not much and at the same time, foreign capital does not play a significant role in boosting investment. The widely acclaimed "Lucas Paradox" shows that capital just does not always transmit from a rich country with high capital-labour ratio into a poor country which has a low capital-labour ratio. What explains such tendency? Factors like lack of strong institutions and property rights, high cost involved with physical capital, incapacity to repay debt in due time by poor countries' governments might discourage the developed nations to invest their capital in the less developed nations.[61] For example, absence of well defined property rights pulls out foreign capital from industries requiring long-term high investment, instead foreign capital moves towards industries which does not need high level of investment. By contrast, one observes that often current account deficit of developed nations, such as the US, England, Australia and Spain, is financed by capital originating from developing or emerging economies like China and some South American nations, which are surplus in their current accounts.[62]

Another much talked about puzzle, the so-called "Feldstein-Horioka Puzzle" down plays the role of foreign capital, postulating that higher the rate of domestic savings higher the rate of investment.[63] This high correlation between domestic savings and investment rate was tested for 16 Organisation for Economic Cooperation and Development (OECD) nations. This phenomenon has also been found true for the developing economies. Even if foreign capital contributes to growth, it has been found rather meager. Bresser-Pereira and Nakano investigated the linkage between foreign saving and growth for 51 countries over a period of 1979 to 1998. They employed OLS and Feasible General Least Squares techniques to estimate the income elasticity of foreign saving, which was found only 0.005.[64] It implies that with a one per cent rise in foreign capital inflow, income increases by only 0.5 per cent. Conversely, the affect of domestic capital on output growth is found quite robust compared to foreign capital.[65]

Evidences from historical facts further suggest that domestic savings or capital accumulated locally has played a pivotal role in the development of some developing and developed nations. The 2008 growth report of Spence

[60] *Ibid*., p. 10.
[61] Eswar A. Prasad, Raghuram G. Rajan and Arvind Subramanian, *op. cit*., pp. 156-157.
[62] Sebastian Dullien, "Central Banking, Financial Institutions and Credit Creation in Developing Countries", *UNCTAD Background Paper*, 2008, p. 2.
[63] Luiz Carlos Bresser-Pereira and Yoshiaki Nakano, *op. cit.*, p. 10.
[64] *Ibid*., p. 24.
[65] Abdul Waheed, *op. cit*., p. 5.

Commission provides a glaring example in this regard. The report focuses on the success stories of 13 nations,[66] which have been maintained an annual GDP growth rate of seven per cent in the last 50 years and it further underlines the fact that the contribution of domestic saving among other factors was immense towards their development.[67] Countries like Malaysia, Japan, South Korea and Thailand had adopted mandatory savings policy to stimulate savings rate.

Another point of view is that foreign capital may not be needed at all for the developing nations; rather credit from domestic financial system could be used to accumulate capital. Keynes has contested for lesser role of foreign finance as he told that capital generated from domestic sources could increase local investment. By using the Keynesian-Schumpeterian view, Dullien (2008)[68]argued that given some preconditions,[69] financial system and central bank of the developing nations can pump credit into the system for investment, which would eventually result in creation of saving.[70]

## 4. Concluding Remarks

The article has tried to find out whether inflow of foreign capital has influenced development of the poor or developing countries. Despite all the advantages of foreign capital rooted in the neo-classical theories and growth models, the evidences suggest otherwise. This article reveals that foreign capital has its adverse affects on the growth of developing nations as it often fails to bring about the expected outcomes. Foreign capital is more likely to crowd out domestic investment and convert into consumption, for both households and government. Although the short-term growth is boosted by such increment in consumption, long-term growth can be damaged. Inflow of foreign capital may also overvalue the local currency, thereby creating a detrimental effect on the export sector. The absorption capacity of foreign capital by the developing nations is also poor due to lack of good governance and developed financial market. Hence, expected benefits of foreign capital tend to be very low in these economies. Additionally, there are other factors that do not help the capital to flow from rich countries to poor countries. Instead, one observes the other way

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[66] These 13 countries are Botswana, Brazil, China, Hong Kong, Indonesia, Japan, the Republic of Korea, Malaysia, Malta, Oman, Singapore, Taiwan and Thailand. India and Vietnam are not far from joining this group.

[67]"The Growth Report 2008: Strategies for Sustained Growth and Inclusive development", available at: http://cgd.s3.amazonaws.com/GrowthReportComplete.pdf accesses on 24 February 2010.

[68] Hansjorg Herr and Jan Priewe, *op. cit.*, p. 80.

[69] The conditions are: i) the financial system needs to be sound and ii) the financial institutions should have the desire to lend out to the business plant or unit which is production or investment oriented. (See, Sebastian Dullien, *op. cit.*, p. 9)

[70] For details, see, Sebastian Dullien, *op. cit.*, pp. 1-53.

around. Conversely, the evidences further demonstrate that domestic capital has been playing a significant role in the development of the less developed and developing economies. Countries that financed their development from domestic sources grew rapidly vis-à-vis the nations depended on foreign capital. Keeping all these in mind, one may argue that foreign capital is not quite a feasible option for development in developing nations.

However, one can observe that the models employed to identify the effectiveness of foreign capital inflow suffer from limitations. For example, the time period under consideration is often very short. Models are also sometimes miss-specified as they left out important variables, putting the affect of the missing variables in the error term. To measure the impact of foreign capital on growth, generally, the models include saving rate, investment, real exchange rate, current account balance, rate of inflation along with capital inflow as explanatory variables, ignoring qualitative variables like governance and stability of financial sector. These variables are responsible for explaining the foreign capital-development links as mentioned earlier. Estimation of econometric models is another problem as studies often follow methods such as OLS and 2SLS while dealing with time series and cross-sectional data, which do not generate good results. In the light of all these, studies in the coming days might adopt panel data econometric models to find a more reliable result. Future researches, at the same time, could develop or take into account variables which capture the governance and financial stability factors.