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Does External Financing drive Growth?

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Evidence for the growth impact of capital inflows remains open to question. Capital inflows can directly support economic growth by relaxing constraints on domestic resources, but can also indirectly weaken growth by hampering competitiveness through a real appreciation of the exchange rate. This policy brief revisits the issue, focusing on a large sample of low- and middle-income countries. Drawing on a recent analytical paper, this brief discusses how the volume, composition, and volatility of capital inflows can have different impacts on real exchange rate and economic growth.

LA FERDI EST UNE FONDATION RECONNUE D'UTILITÉ PUBLIQUE. ELLE MET EN ŒUVRE AVEC L'IDDRI L'INITIATIVE POUR LE DÉVELOPPEMENT ET LA GOUVERNANCE MONDIALE (IDGM). ELLE COORDONNE LE LABEX IDGM+ QUI L'ASSOCIE AU CERDI ET À L'IDDRI. CETTE PUBLICATION A BÉNÉFICIÉ D'UNE AIDE DE L'ÉTAT FRANÇAIS GÉRÉE PAR L'ANR AU TITRE DU PROGRAMME « INVESTISSEMENTS D'AVENIR » PORTANT LA RÉFÉRENCE « ANR-10-LABX-14-01 »

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•••/••• Higher capital inflows tend to support economic growth overall, more than offsetting the concomitant appreciation of the real exchange rate. The real exchange rate appreciation associated with remittances is larger than that due to aid and FDI. While an important issue, volatility of capital inflows does not seem to have had a big influence on growth in low- and middle-income countries, where the most volatile flows such as portfolio investments have been very limited.

Introduction

When analyzing the role of capital inflows in the development process, two different channels have to be considered. On the one hand, there is a potential direct effect on GDP growth in relation to the investment/savings gap, or the benefits resulting from international transfers of know-how. However, an indirect and negative effect through the real exchange rate is also possible. To investigate these econometric relations an econometric analysis was carried out on a sample of 77 low- and middle-income countries, respectively LICs and MICs, for the period 1980-2012. The results clearly show that capital inflows directly and indirectly affect economic growth. Doubling capital inflows per capita would increase the GDP growth by 2 additional percentage points on top of the 3.7% observed across the sample and for the whole period. A 1% increase in total net capital inflows is found to appreciate the real effective exchange rate (REER) by 0.5%; and the real exchange rate appreciation effect of remittances is twice as big as the effect of aid, and ten times bigger than the effect of FDI.

From direct to indirect effects of capital inflows and their components

Remittances, can act as a buffer to smooth consumption for example when the recipient economy is suffering from an economic downturn (Lueth and Ruiz-Arranz, 2007; Chami et al, 2008). In this case, remittances help to maintain stability by compensating for macroeconomic shocks, and present limited risks of a significant real exchange rate appreciation. Conversely, these financial resources may be connected with various kinds of investment projects. The risk of real exchange rate appreciation is then particularly strong if resources are channeled to real estate (construction booms), but probably negligible if they are spent on imported durable goods.

Financial flows related to ODA have been discussed at length in prominent works dealing with the principles that govern aid allocation rules (see Burnside and Dollar, 2000). Empirical effects generally vary depending on the sample, the specification of the econometric model, and the way endogeneity biases are tackled. Aid flows tend to be associated with human capital and infrastructure expenditures. While these expenditures are essential for the development process, their social benefits tend to be only visible in the long run through enhanced productive capacities. The indirect effect of ODA remains itself dependent on how resources are used. When recipient countries suffer from supply side constraints, capital inflows associated with consumption put more pressure on the relative price of domestic goods than those channeled to investments with a significant proportion of imported goods. Foreign aid is expected to appreciate the real exchange rate if it stimulates productivity within the tradable sector, while depreciation is likely to occur if aid is channeled to improve productive capacity in the non-tradable sector.

The impact of foreign direct investments (FDIs) on GDP growth is limited when it consists only of "pure" transfers of assets from the public sector to international private companies. Broadly speaking, different forms of FDIs or in different national contexts are likely to affect economic

growth in different ways. At first glance, one cannot exclude unfavorable outcomes in low-income African economies or natural resource rich-countries where resource endowments may hamper the emergence and the diversification of a large manufacturing sector. On the contrary, FDI concentrated in manufacturing activities, as is generally the case in most Asian economies, can further enhance growth. The failure to distinguish between different categories of FDIs has been interpreted by Stiglitz (2008) as a potential explanation of the difficulty to identify the effect of these resources on GDP growth in the long term.

The impact of FDI on non-tradable prices varies greatly according to the specific type of operation. When FDI capital inflow is related to imported machinery and equipment, beyond a potential transitory effect, there is little risk of sustained appreciation leading to exchange rate disequilibrium. A positive effect of FDIs on the use of productive resources can be expected through transfers of technology, managerial know-how, and other intangible assets (Agénor, 1998; Javorcik, 2004; Kinda, 2010). However, when FDIs are "pure" transfers of domestic assets between residents and non-residents, bonanzas resulting from public enterprise selling may be channeled to permanent current expenditures, increasing the price of non-tradables.

The openness of the capital account to short-term flows has undoubtedly been one of the most controversial issues in recent decades. In the historical context of the late 1990s, the liberalization of capital transactions has sometimes been perceived as an extension of the free trade of goods. An open capital account offers an incentive to improve market discipline, with promising expectations in terms of macroeconomic stability and additional financial resources. Stiglitz (2008) countered this argument with the idea that liberalization of short term capital stimulates economic fluctuations when they do not cause them. Short-term resources are unlikely to be channeled to investments and can jeopardize the realization of social well-being objectives. In middle-income countries, which have liberalized their capital account, these inflows have sometimes been the cause of exchange rate movements. In a recent paper dealing with transition in Central and Eastern Europe economies, Boero, Marvomatis and Taylor (2015) provide evidence that these economies have known two sources of long run appreciation of their currencies. The first one comes from the Balassa-Samuelson effect. It closely relates to the relative importance of FDIs, which positively affect both the internal productivity level, and the convergence of living standards. The second effect relates to the other components of the capital account. They do not necessarily affect the productivity level and can be a driving force for a prolonged real appreciation.

Main results of the empirical analysis

The effect of net capital inflows on both the real effective exchange rate and the GDP economic growth rate can be analyzed by using Blundell and Bond's 1998 system-GMM estimator for dynamic panel. The aggregated net total of external financing and 5 broad components are considered: private unilateral transfers or remittances; official development assistance (ODA); foreign direct investments (FDIs); portfolio investments, including corporate bonds and other private debt securities; and other inflows including liabilities to foreign banks.

Net capital inflows per capita have substantially increased over the last 30 years. For MICs, it has more than tripled, increasing from 74 U.S. dollars in the 1980s to 223 U.S. dollars for the period 2000-2012. This long-term evolution illustrates the financial integration of developing economies into the globalization process. Although the dynamic of net inflows is much less pronounced for LICs, it

does nevertheless exist. For LICs over the same periods, total net inflows have almost doubled, from 50 to 95 U.S. dollars per capita per annum. Similarly, the structural composition of external financing has greatly changed. At the beginning of the 1980s, regardless of the level of development, official aid constituted the bulk of the inflows. It accounted for about 40% of total financing for the MICs and 80% for the LICs, more than remittances, the second largest category.

In relation to the decreasing role of aid, the composition of ODA has also changed dramatically with a tendency to substitute grants for loans. ODA flows are now focused primarily on LICs and on extending human capabilities rather than directly supporting productive investments or hard infrastructure as in the 1980s. In the 2000s, FDIs represented the largest component of total external inflows for MICs, more than 50%, against 17% for LICs. For MICs, FDI inflows have been much more dominated by the purchase or creation of manufacturing firms with potential positive upstream and downstream effects on economic growth. Accordingly, one can logically expect that the size as well as the composition of financial inflows matter. Different kinds of external resources are likely to induce different impacts depending on the per capita income level.

A 1% increase in capital inflows appreciates the REER by roughly 0.5%. This empirical result is after taking into account the introduction of various variables including government consumption, but also the instability of net total capital inflows, which was not found to be significant for the explanation of both the GDP growth and the REER. In addition, FDI and Aid only appreciate moderately the real exchange rate, while Portfolio investments have a strong impact. The effect of Remittances is only significant when we control for government consumption. The positive effect of this variable is approximately twice as big as the effect of Aid and ten times bigger than the impact of FDI. The influence of total inflows on the real effective exchange rate proves to be higher in low-income countries (LICs) where the demand side outperforms the supply response, generating a real appreciation. The elasticity of the real effective exchange rate is about 1% for LICs but less than 0.4% for MICs. When the different categories of capital inflows are considered, the appreciation effect of remittances proves greater for LICs. The adoption of a peg regime for the exchange rate seems to efficiently mitigate the appreciation effect stemming from capital inflows. One possible explanation of this result is that a peg regime means more efficient efforts by monetary authorities to regulate domestic credit, and prevent inflation pressures which are a source of economic uncertainty. A good example of this effect can be found in the Franc Zone where the fixed parity of the CFA franc vis-à-vis the Euro goes hand-in-hand with efficient regulatory controls of the money supply.

Not only do total capital inflows positively affect growth, but also their instability does not hamper it. By doubling per capita total capital inflows, the average annual growth rate would increase by about 50%. The transmission channel can be more deeply explored by controlling for the real exchange rate impact, then distinguishing between positive and negative effects of capital inflows. The results confirm our initial expectation: a 100% appreciation of the REER is associated with a 25% reduction in annual GDP growth, a loss of about one percentage point.

Policy lessons

After a sharp decline during the 1980s, net capital inflows to developing countries have significantly increased in the 2000s. This dynamic has been in line with the acceleration of globalization via the traditional channel of international trade, but also through increasing financial openness in developing economies. Global-

ization has also been accompanied by a pronounced change in the composition of capital inflows. While foreign aid was initially the prevailing financial source, and remains so for low-income countries, the role of ODA is now much smaller for middle-income economies, which now rely mainly on FDIs and to a lesser extent on remittances. Net capital inflows significantly influence the real effective exchange rate dynamics with a more pronounced effect for LICs.

Total capital inflows have a strong positive impact on GDP growth, in line with the expected contribution of these external resources to fill the saving/investment gap. On average, doubling net capital inflows would have resulted in a net increase of average growth of about 2% over the whole sample and period (1980-2012). Excluding the negative impact caused by real exchange rate appreciation would imply an even larger impact of about 3.7%. While the direct impact on growth does not differ across income levels, the indirect impact is significantly higher for LICs. The elasticity of the real exchange rate to total capital inflows is about 1 for LICs but less than 0.4 for MICs. Within the sample, the instability of the total net capital inflows and their components does not affect in a statistically significant manner the REER or the GDP growth rate.

Although the influence of ODA does not seem to explain GDP growth, including in LICs, it is likely to affect the long-term well-being of populations through different indirect channels. The impact of FDIs on growth is much more direct, stronger in LICs than in MICs, most likely reflecting higher returns in these economies. This conflicts to some extent with some views that the attractiveness of a country is conditional on the quality of its institutions, the availability of a high level of human capital or the quality of the financial market. This finding might need to be further investigated because LICs generally benefit from FDI oriented to the exploitation of natural resources with few backward and forward spillovers effects. FDIs in MICs are likely to have stronger horizontal and vertical influences within the domestic economy. Therefore, the challenge for LICs is to use FDIs as a lever to promote both raw material processing and a larger participation in global value chains. The role of Portfolio investments has been quite limited in LICs. If the regression coefficients show significant impacts on GDP growth, some risks of currency overvaluation are also shown. The same problem arises with remittances, which support domestic consumption and housing investments in a context where the relative price of non-tradable goods goes up. Developing countries should fully take into account the fact that capital inflows while critical to finance development needs and spur economic growth, can hamper competitiveness. Together, the complex nature of interrelations between variables calls for an active role for the State in maintaining an efficient balance between excessive regulation and unbridled liberalization of capital inflows.

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