UNITED ARAB REPUBLIC

التخطيط القومي

THE INSTITUTE OF
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Memo. No.1156

THE ROLE OF FOREIGN CAPITAL IN LONG-TERM DEVELOPMENT

BY

M. M. EL-IMAM, Ph. D.

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Foreword

This study was prepared in response to an invitation to the first Conference of Egyptian Economists which took place on March 25 th 1976. My choice of the subject was decided by two main considerations. The first was my previous research in long term development and the contribution of foreign resources, especially foreign loans to the process of growth. The second was my feeling that the role of foreign capital seemed to be **exaggerated** to the extent that it may lead to relaxation of other conditions of growth, normally given more weight when foreign resources do not seem forthcoming in sizable amounts.

When I undertook the study I did have some expectations that the outcome would not be quite rosey. However, I did not expect it, either, to be that gloomy. The results were presented to the conference in time in summary form. Owing to the nature of the study, I have prefered to give full details of the models used and the numerical calculations for further reference. The summary in Arabic is attached to this Memo.

At the time this was prepared, I was in the service of the United Nations as a Team Leader of a Project assisting the Council of Arab Economic Unity. Needless to say that the opinions expressed here are strictly my own, and do not necessarily reflect the views of either organization. Further they need not represent the views of the Egyptian Government, **whom** I came to serve at the time the conferance was held. This scientific study is meant as a contribution dealing with one important aspect of foreign capital; and does not claim to give a comprehensive account. It is hoped that it will help in initiating further investigation of the subject.

M.M. El-Imam, Ph.D.

March 1976

I. THE PROBLEM:

In a previous series of Memos.[(x)] I had indicated that foreign loans need not be considered as a purely positive element in fulfilling hopes usually attached to them as a stimulant to long-term development. In fact it was proved that according to conditions familiar to developing countries and normally prevailing in world capital markets (which even became worse since then), the marginal short-term benefits of foreign loans, may turn into absolute losses over the longer run.

There had been a lot of discussion lately as regards the role of foreign capital in supplementing domestic resources for financing substantial developmental efforts. It seems that a number of issues are being confused together. The scarcity of domestic savings and of foreign exchange is one known argument. Another is the so-called transfer of technology, which is considered to be facilitated if technology-bearing capital is imported. Together with the production technology there is also improvement of management and productivity. Still a third argument is that of market extension. It rests on the

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(x) M.M. El-Imam: Foreign Loans and Economic Development; Memo. 779 (4 Parts): I.N.P., 1967. See also M.M. El-Imam Contribution of Foreign Loans to the Process of Long - Term Development The Vienna Institute of Development, 1968: Confrontation; The First Development Decade, a Preview; The Second Development Decade, a Preview.

assumption that greater chances of invading new foreign markets may be secured through foreign partners whose exporting machinery and world reputation are already established. If there is clear need to diversify markets and to enter new exporting fields, this factor should receive some attention.

If the limited burden of debts (confined to interest charges) were that unfavourable, we are justified in questianing the impact of foreign capital which expects profits over and above interest yields. On the other hand, if we follow the I.B.R. D. approach, we may consider a cycle similar to the debt cycle, and investigate under which conditions it may be expected to explode. In other words, what are the boundaries of reliance on foreign capital.

Brezil is often quoted as an example of a country which has given foreign capital all temptations to assist in its development. It has the advantage of being a large country with abundant natural resources. It has turned out that the flow of capital is under one billion dollars per annum . Moreover, about half that amount is merely ploughing back of profits generated within the country. This draws our attention to the effects of income accruing to foreign capital on domestic income distribution and on the command on exportable surpluses.

II. THE APPROACH:

A full treatment of the role of foreign capital in economic development deserves a more exhaustive study than what we claim to present here. Our approach is to develop a series of models which simulate movements over time under alternative patterns of capital inflow.

The first model starts by giving the economic accounts of a country at a base year. It is assumed that those accounts reflect as much as possible present structure of Egypt with one major difference. This is the assumption that government consumption is equal to government current income less investment of the public administration sector. On the other hand total investment is put equal to savings so that imports could be put equal to exports. This involved a contraction of all macro variables to ensure this hypothetical equilibrium.

In a second round of the base year, allowance was made to additional economic activity to bring about a desirable increase in the rate of investment. This helps to estimate the initial investment multipliers, and the corresponding foreign trade gap, which may be taken as an initial inflow of foreign capital.

With the help of a 9-sectors input-output table and sectoral growth rates, investment needs and derived incomes and demand, the movement ever time is estimated. So long as there is a foreign deficit, it is added to previous capital flow. Surpluses are assumed to represent an antflow which pays out income due to foreigners and later an as repayment of outstanding capital. The year 25 was then used to estimate the parameters of a macro model which represents average changes ever time as calculated above.

This model was then used in a limited number of simulations to indicate the outcome under certain alternative assumptions. Another model was estimated under the assumption of a zero foreign trade gap sterting from the low base - year equilibrated values. Comparison of results helps to throw same light on some aspects of the problem stanted above.

III. TOTAL EFFECTS OF INVESTMENT:

1. Initial Interflow:

Let us assume an economy planned to be in a state of balance at a low rate of investment. Table (1) represents the interflow table of the economy in the base year, with value added in the business sector = £ 1000 millions (at factor cost). Nine production sectors are distinguished:

Sector 1: Agriculture

Sector 2: Extractive industries (including crude oil).

Sector 3: Agricultural industries; i.e., manufacturing industries relying mainly on agricultural materials; including food, drinks, tobacco, spining & weaing, clothes, footwear, wood, paper and products.

Sector 4: Non-Agricultural industries; including other manufacturing industries; chemical, mineral, metallic and engineering.

Sector 5: Energy, including petroleum industries and electricity.

Sector 6: Construction.

Sector 7: Transportation, communications and storage.

Sector 8: Trade and Finance.

Sector 9: Services, including housing and other services of the private sector.

Imports by origin and destination are indicated. Incomes are distributed among wage incomes, private non-wage and public non-wage. Indirect taxes on production are indicated, leading to sectoral value added and production at market price. Final demand is broken down by type of demand and structure from domestic and foreign sources. Import duties are given separately, to arrive at values c.i.f., after allowing for trade margins. This helps to give the initial base year macro - variables.

2. <u>Adjusted Investment:</u>

The initial situation leaves some unutilized capacities in the domestic economy. It is assumed that exports only have reached their full capacity utilization. Further investment and the related final demand (through multiplier effects) would lead to the expansion of domestic production, as well as imports. Three adjustments are required at this stage. The first is to adjust the investment column itself. At a low investment rate and under limitations on importation, the structure of investments differs from that related to a higher rate with a different sectoral structure. To adjust for this element the following steps were taken:

1- The technical matrix was calculated from table (1), and the inverse obtained.

2- Direct and inirect effects of initial investment could thus be estimated, and deducted from the initial interflow.

3- Sectoral capital/output ratios were obtained through analysis of recent data and current plan estimates. These were found to be

Agriculture	3.3	Transportation	7.1
Extractive	3.6	Trade	0.4
Agro Industry	4.2	Housing	16.8
Other Industry	4.6	Private Services	0.6
Energy	5.2	Public Administration	0.7
Censtruction	0.7	Public Services	6.5