Are Foreign Resources Crucial for Growth?

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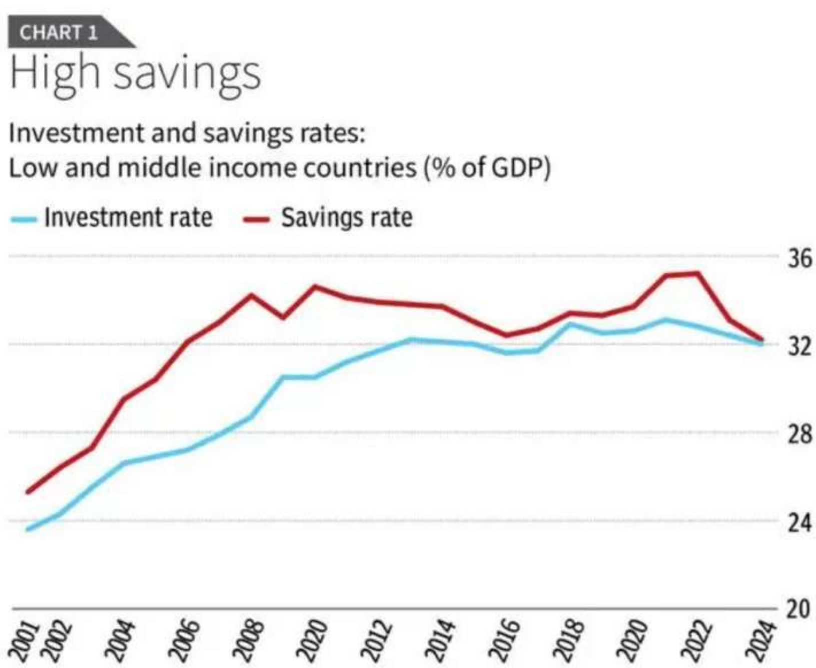
A persistent trope in much of the economic development literature is that significant catch-up by lower income countries necessarily requires additional foreign savings to add to domestic savings, so as enable higher investment rates to generate faster growth. This led to the related argument made especially from the 1990s onwards, that countries should deregulate their financial sectors and particular liberalise cross-border financial flows, to attract more foreign investment, either as equity or loans.

This was so widely accepted by multilateral economic organisations and by policymakers across most developing countries that it became almost axiomatic and resulted in waves of financial liberalisation that swept the Global South over the past few decades. We know now that this has created many problems for developing countries, from greater constraints on domestic economic policy making to extreme volatility in financial flows with associated domestic financial problems, greater vulnerability to crises driven by global shocks and macroeconomic policies in the major advanced economies, to external debt stress in many countries. But did it at least achieve the aim of transferring financial resources from North to South?

Data Points

One way of assessing the macroeconomic outcome is to look not at net financial flows but at the domestic savings and investment rates in developing countries in the period of more open capital accounts. If external capital (of whatever kind) is positively contributing to investment, we expect investment rates to be higher than savings rates. Here we examine data from 2001 onwards, when external financial openness was very widely practised in most developing countries.



As Chart 1 shows, throughout this period, over the past quarter century, aggregate savings rates across all low- and middle-income countries were higher and, in some years, quite significantly higher than domestic investment rates. In effect this amounts to a net transfer of resources abroad, from countries that can ill afford this because they still need to increase investment for their development project and to meet the climate challenge.

China Skew

It could be argued that this aggregate result reflects the disproportionate role of China, which has maintained current account surpluses and high savings rates that have generally been much higher than investment rates throughout this period. Over this entire period, the savings rate in China was 45.4 per cent of GDP, while the investment rate was 40.6 per cent. Given China's large and growing weight in this group of countries, this would certainly have affected the aggregate numbers.

Therefore, it is also worth looking at a sub-group of such countries — the lower middle-income countries that are often also referred to as "emerging markets" while lower income countries are classified as "frontier markets", largely because of the different financial investor perceptions they tend to be associated with.

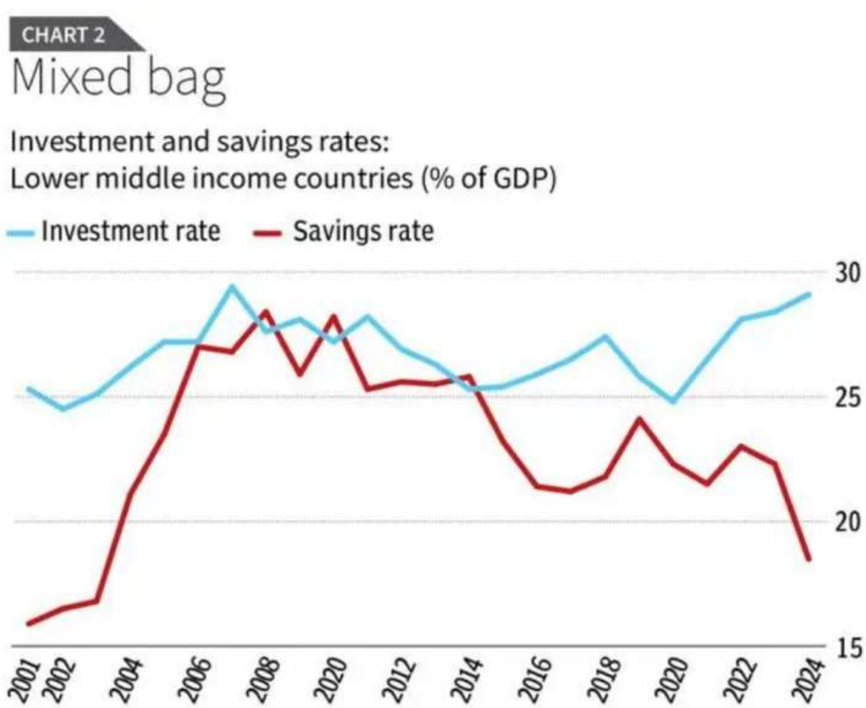
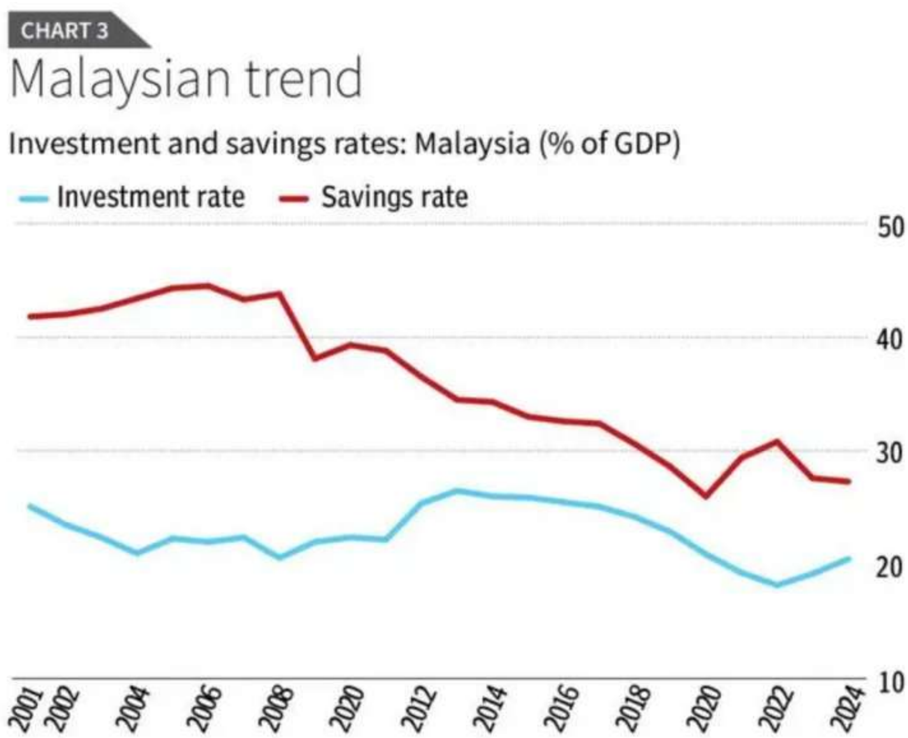


Chart 2 shows the average for the sub-group of lower middle income countries (which includes India) and finds a different time trend. Yet even for these countries, the picture since 2001 has been mixed, with several years of savings rates being close to or slightly higher than investment rates. It is only after 2016 that there seems to be a clear trend of domestic savings rates falling below domestic investment. Also, it is not clear from this whether the countries in this group were able to benefit from foreign savings to actually increase their growth rates more than before.

Success Stories

Therefore, it is worth looking at the experience of some individual countries. We consider here three of the more well-known "success stories" in developing Asia: Malaysia (which is an upper middle income country now very close to achieving high income status); Indonesia, which is seen as a fast-growing economy; and Vietnam, which has grown rapidly on the basis of a manufacturing export boom largely driven by Chinese investment.

These country cases are instructive. Malaysia had very high rates of both savings and investment in the 1990s, which changed dramatically after the Asian Crisis of 1997-98 after which investment collapsed. Chart 3 shows that it continued to have high savings rates leading up to the Global Financial Crisis, more than double the investment rates, which had fallen and remained low. The savings rate fell thereafter, but remained significantly higher than the investment rate, such that Malaysia has been a capital exporter throughout this period.

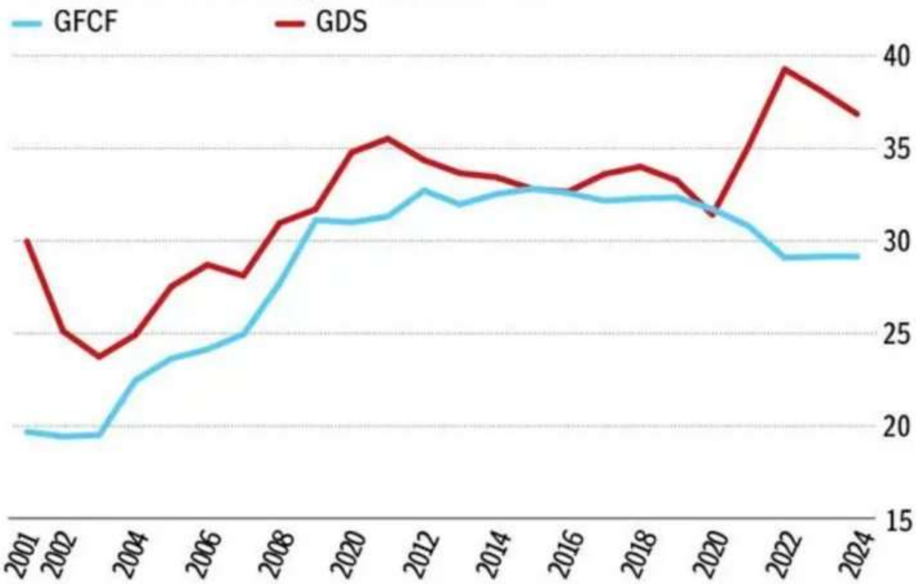


Similarly, Indonesia (Chart 4) also had savings rates higher than investment rates for almost all years over this period, making it a net capital exporter, despite its greater need for investment.

CHART 4

Indonesian path

Investment and savings rates: Indonesia

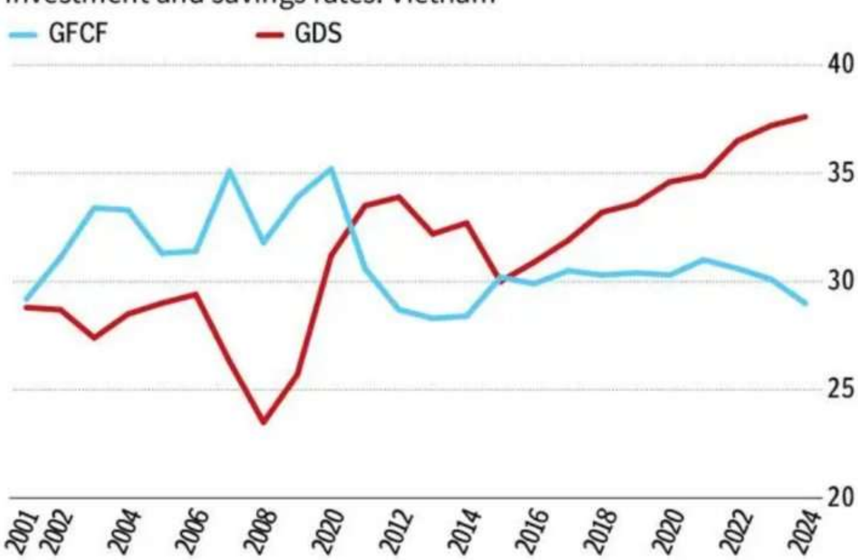


The most striking case may be that of Vietnam as shown in Chart 5. The country became an exporting powerhouse largely based on foreign investment, but even in this relatively short period, switched to becoming a capital exporter after 2011. Since then, the gap between rising domestic savings rates and stagnant or falling investment rates has only widened.

CHART 5

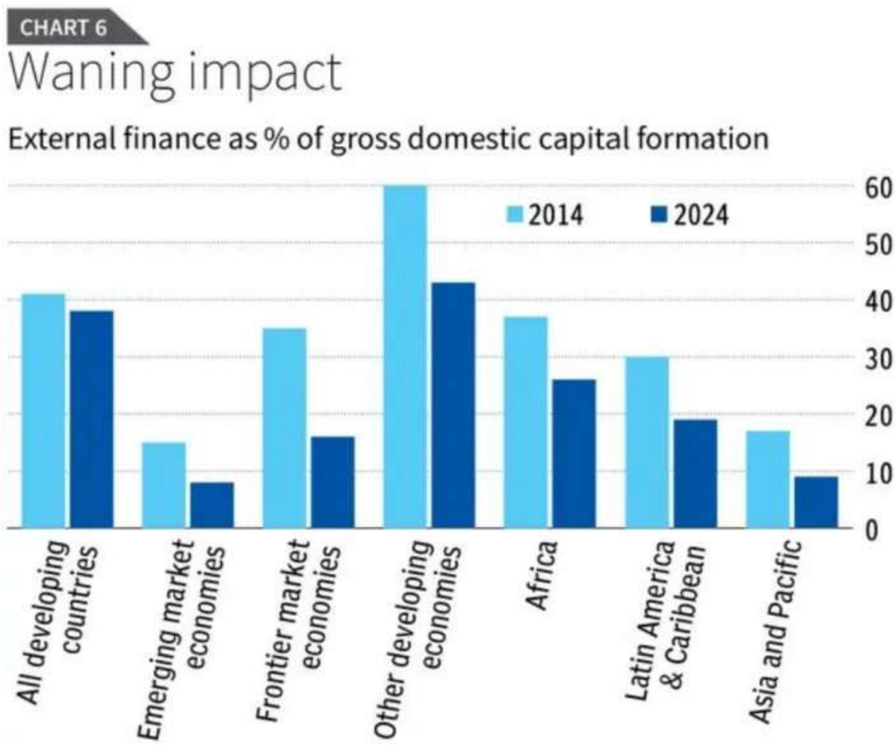
Vietnam's profile

Investment and savings rates: Vietnam



Declining Impact

Chart 6 provides another way of looking at the role of foreign finance, now not in terms of the net macroeconomic effect, but in terms of the share of domestic investment financed by foreign finance in one way or another (through equity or loans). The most striking feature is the rapid decline evident over the past decade, not only for all developing countries, but for all categories as well as for every single developing region. For emerging and frontier markets, where the ratios were already small, they have approximately halved to reach tiny shares of domestic investment.



What all this suggests is the need for foreign finance for economic development has been vastly overstated. Supposedly "successful" countries have become capital exporters well before their development project is anywhere near completion, while over the past decade, lower- and middle-income countries as a whole have had much smaller shares of foreign finance in domestic investment. It is clearly time to move beyond this problematic assumption.

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