A synthetic view of growth strategies

Private income = appropiability x
productivity x
accumulated factors

$$Y = (1-\tau)\ A\ k^{\alpha}$$

Strategy 1: Accelerate factor accumulation

- Increase domestic savings
  - Public savings
  - Improved financial systems
  - Social security reform
- Facilitate access to foreign savings
  - Official international lending
  - Open capital account
- Promote education
  - Increase allocations and improve effectiveness

Strategy 2. Improve expected appropriability

- Adopt low and predictable taxes
- Reduce the probability of expropriation through macro crises
  - Fiscal sustainability
  - Financial soundness
  - External balance
- Improve contractability
  - Capital, labor, foreign trade and investment
- Improve property rights protection and justice
- Reduce corruption, crime
- Assure political stability and governance

Strategy 3. Increase productivity

- Do's
  - Through education, although watch out for excessive university spending
  - Through openness to foreign trade and investment, although watch out for subsidies, protection
  - Through complementary public investment, although watch out for "picking winners"
  - Through intellectual property rights protection

How to construct an overall strategy?

- The ‘best practice’ checklist approach
  - Go through the list and compare current situation to some benchmark
  - Focus improvements on the most glaring lags
- Problems with the approach
  - No guarantee that identified sectors constitute an important binding constraint
  - No account of the interaction between areas of policy
  - Easy to confuse cause and effect
    - E.g. Lack of growth may complicate fiscal balance or political support for policies

An alternative view

- Factor accumulation is more the consequence than the cause of growth opportunities
  - Growth accelerations preceed savings accelerations
  - Growth generates demands for factors. If they are not adequately supplied, returns go up, encouraging more factor accumulation
  - Increases in factor endowments without increased demand for them lowers their returns
    - In education, 1 more year of education lowers returns by about 1.5 percent
  - Capital - both physical and human - can move to other countries

The self-discovery hypothesis

- Most developing countries do not invent new products
- They find out which of a potentially very large set of products they can profitable make in their countries
- However, finding out can be very costly
  - you have to use a trial and error approach
- However, once shown to be feasible, the idea can be more easily copied
  - E.g. you can profitably grow peaches in Chile, but not apples

The self-discovery hypothesis (cont'd)

- In the non-tradable sector the innovator, by definition, becomes a monopolist
  - Monopoly rents may provide incentives for innovation
- In the tradable sector, the national innovator enters an already competitive market and hence does not expect the monopoly rents that accrue to global innovators or domestic innovators in the non-tradable sector
- This means that there is a systematic innovation bias against tradables (exports).
  - This helps explain the large PPP adjustment between rich and poor countries

The self-discovery hypothesis (cont'd)

- Exports tend to be very highly concentrated in few activities
- Over the long run, growth depends in finding out new sectors
- Once a sector is "discovered", it will have specific technological and human capital requirement as well as specific complementary investments. Costs may decline further over time
- This creates potential increasing returns and scale effects, which create other forms of market failure

The self-discovery hypothesis (cont'd)

- This approach helps explain why the growth impact of reform may have been larger in the short run than in the long run
  - Reforms facilitate the diffusion of existing new ideas, but not the discovery of new ones
- It also helps explain why the Chilean experience has been so hard to copy
  - self-discovery in fruit, wine, fishing, mining and forestry
  - Copying the same macro institutions and policies need not generate similar growth
  - Many of these self-discoveries predate the growth boom
- It helps explain why El Salvador has not fully recovered pre-civil war income levels
  - It lost sugar, cotton and coffee but lacks substitute ideas

Self-discovery: policy implications

- The market outcome is inefficient. There are low private returns to innovation. Governments can improve things
- …but governments do not know where to invest. They can promote self-discovery,
- …but they need to let bad ideas die
- While in principle they can do so across the board, they will inevitably be forced to pick sectors
  - Milton Friedman vs. Isaiah Berlin
  - Complementary investments are sector specific

Self-discovery: policy implications

- There is a trade-off between market failure and government failure
  - Rent-seeking
  - Inefficient subsidies: promote things that would have happened anyway
  - Self-discovery vs. artificial life support
- The challenge is to make this trade-off less binding
  - push the feasible frontier out

What should governments be willing to do?

- Focus on new ideas
  - Innovators, I.e. demonstration projects, not copycats
  - Trade protection and multi-sector loans do not discriminate between them
- Identify ways to be helpful
- …but this involves discresion
  - Limit its consequences through delegation and accountability
- In general, lending in market terms is not enough
  - Potentially more costly activities are required

What should governments be willing to do?

- Subsidize technological adaptation
  - Fundacion Chile and Salmon
  - Competitive grants
- Subsidize on-the-job training by paying for a certain proportion of the first year wage bill
- Participate as share-holder or subordinated lender
- Provide complementary investments and adjust inefficient rules or regulations
  - Constructive role for the trade associations

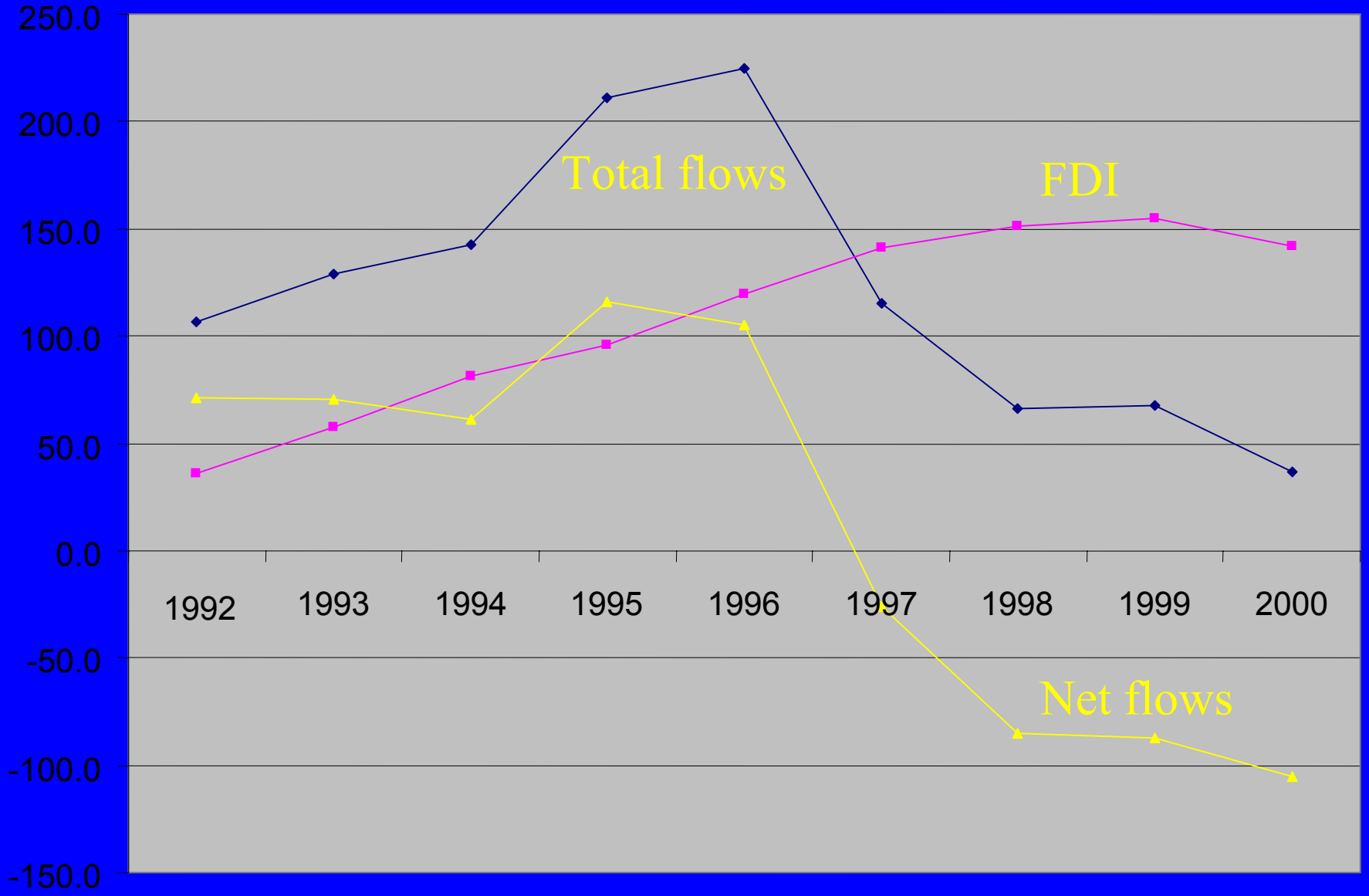
Self-discovery and FDI

- What is special about FDI?
  - Its companies that know how to do something, but do not know if they can do it in your country
  - They face a similar problem
- Same principles apply
  - Demonstration projects, training subsidies, equity, subordinated lending, complementary investments, regulatory adjustments
- Active promotion seems to be required
  - Identify and lobby potential investors

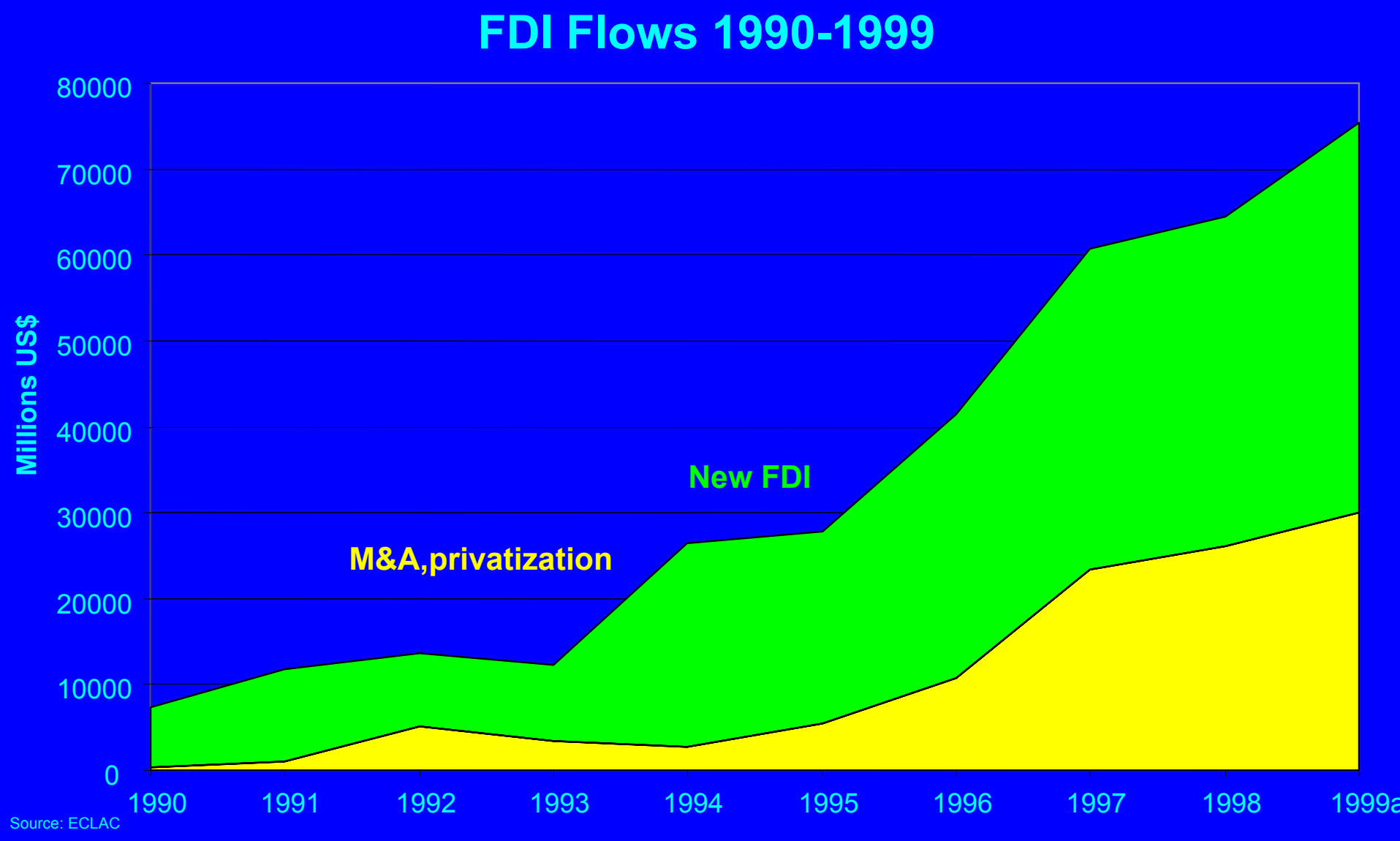
What is FDI

- What we think it is
- What we actually measure
- The difference

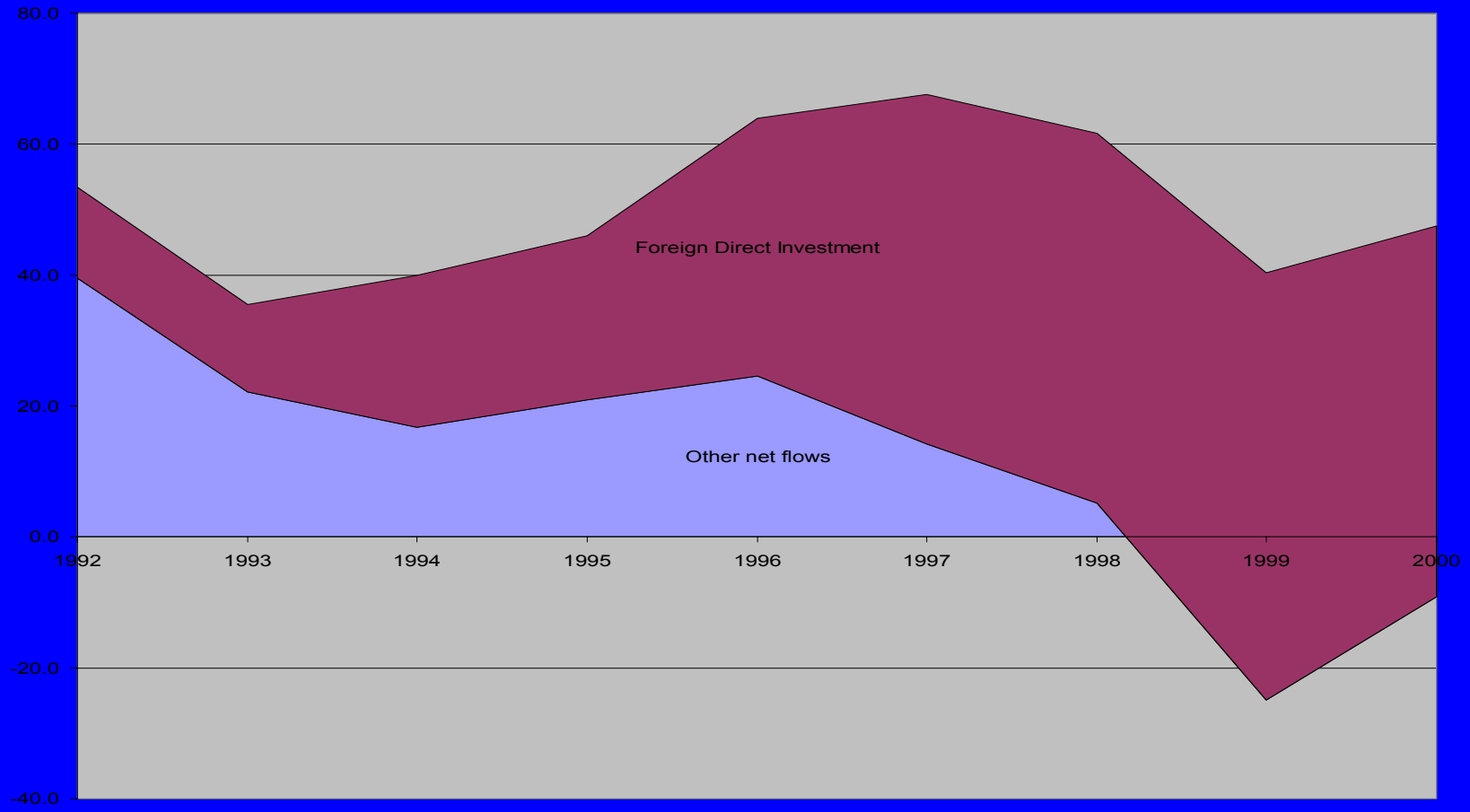
FDI has been booming



FDI has been booming in LA



…as other flows collapsed



…and now represents the only source of net finance

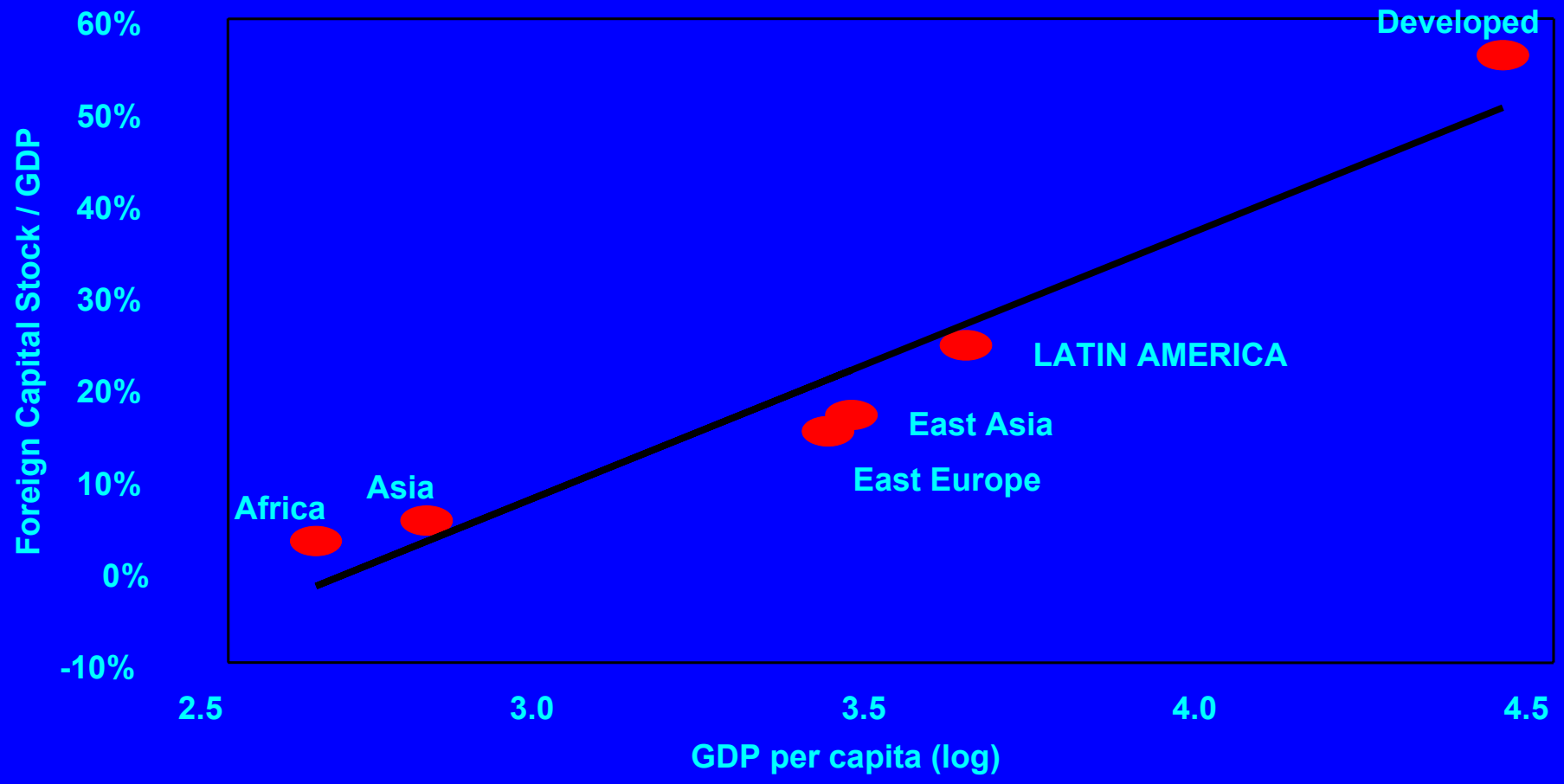
Is FDI like good cholesterol?

A simple decomposition

$$\frac{FDI}{GDP} = \frac{FDI}{KF}\frac{KF}{GDP} = share * volume$$

More development, more foreign capital

Foreign Capital Stock and Income

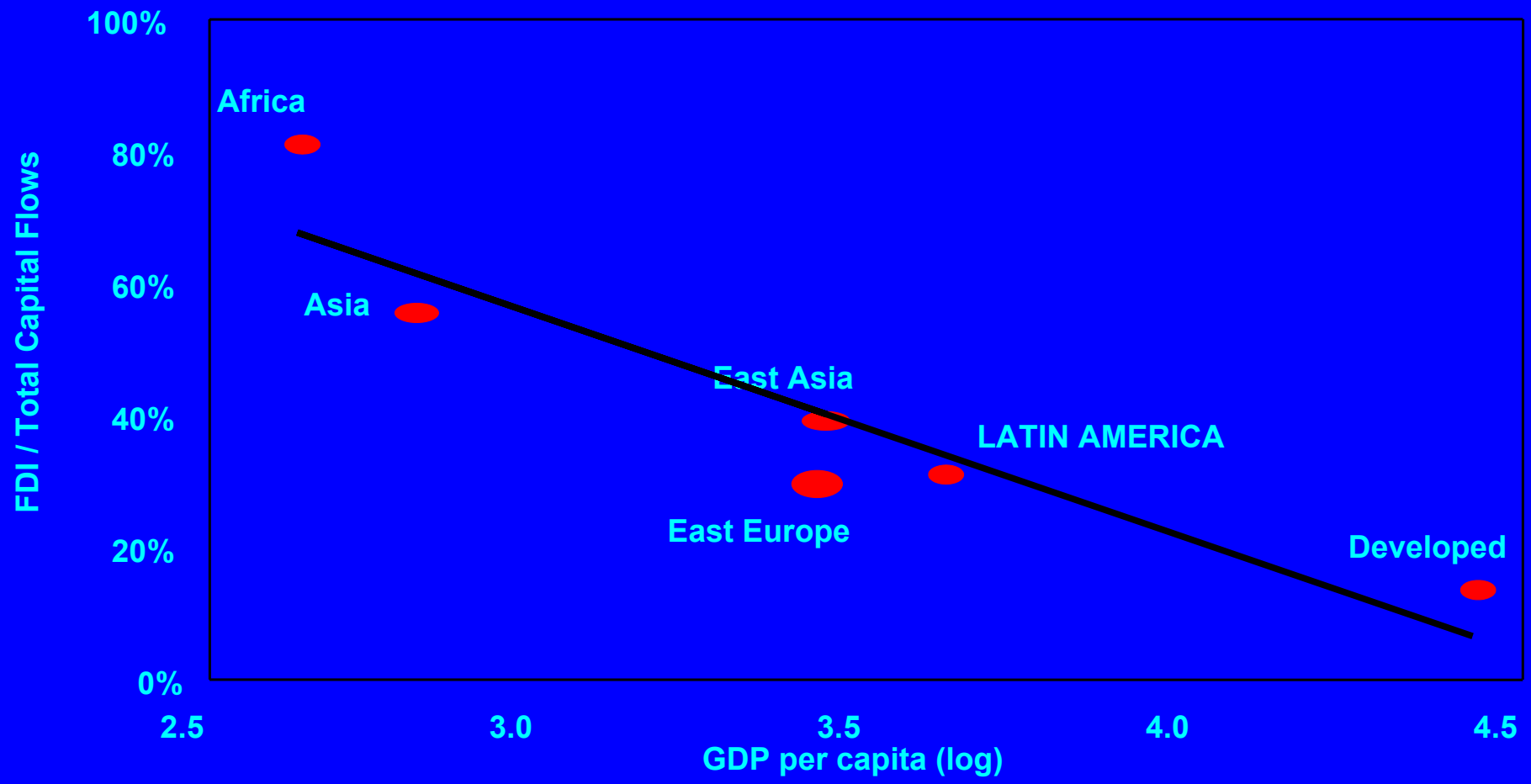


*Data refers to stocks of 1997 in current dollars and GDP in PPP current dollars. The GDP per capita is a weighted average of countries for the same year.

Source: IFS, WB and RES-IDB.

…but a smaller FDI share

Composition of Foreign Capital Stock and Income



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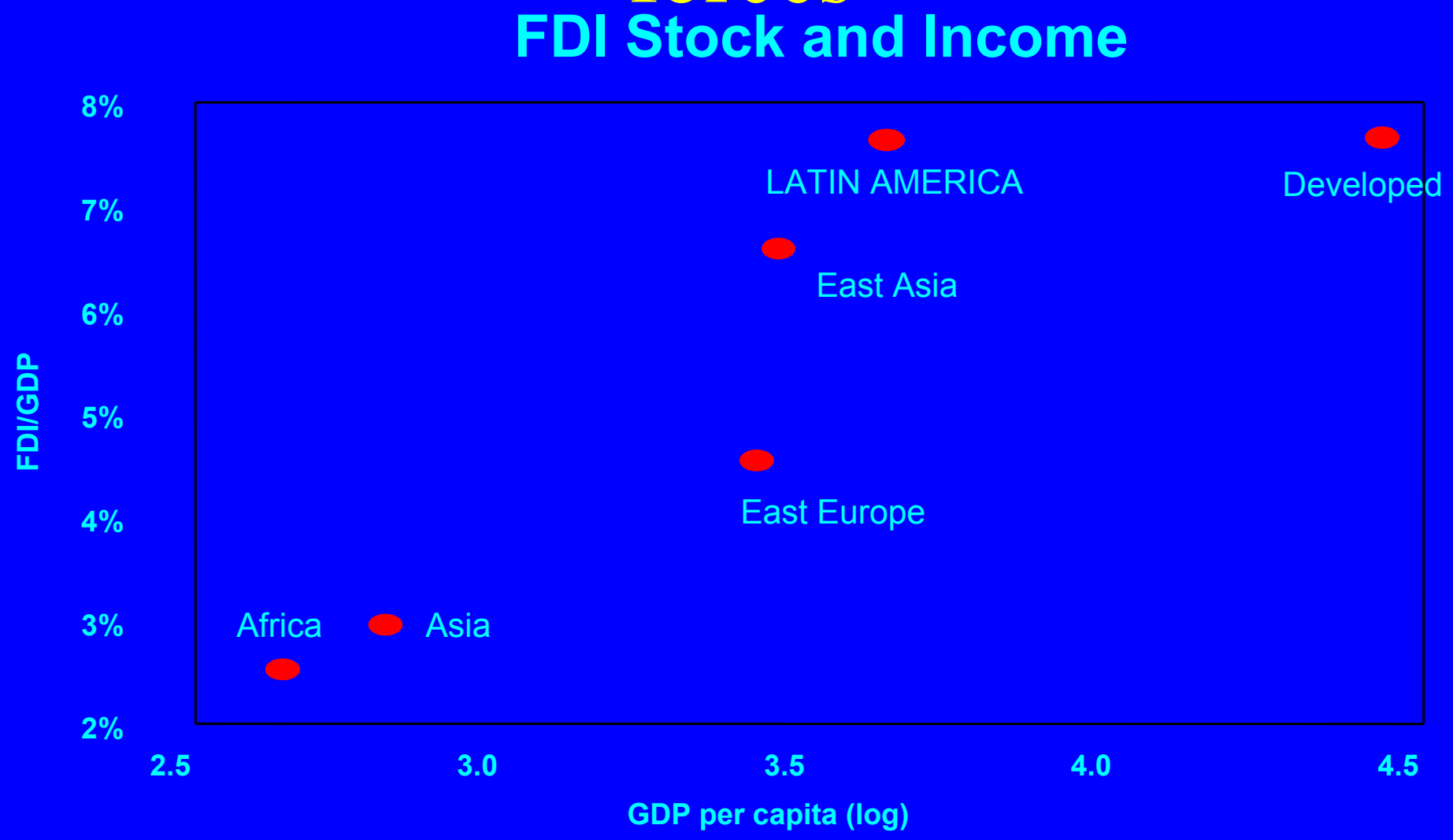
Source: IFS, WB and RES-IDB.

FDI/GDP: Outcome of opposite forces



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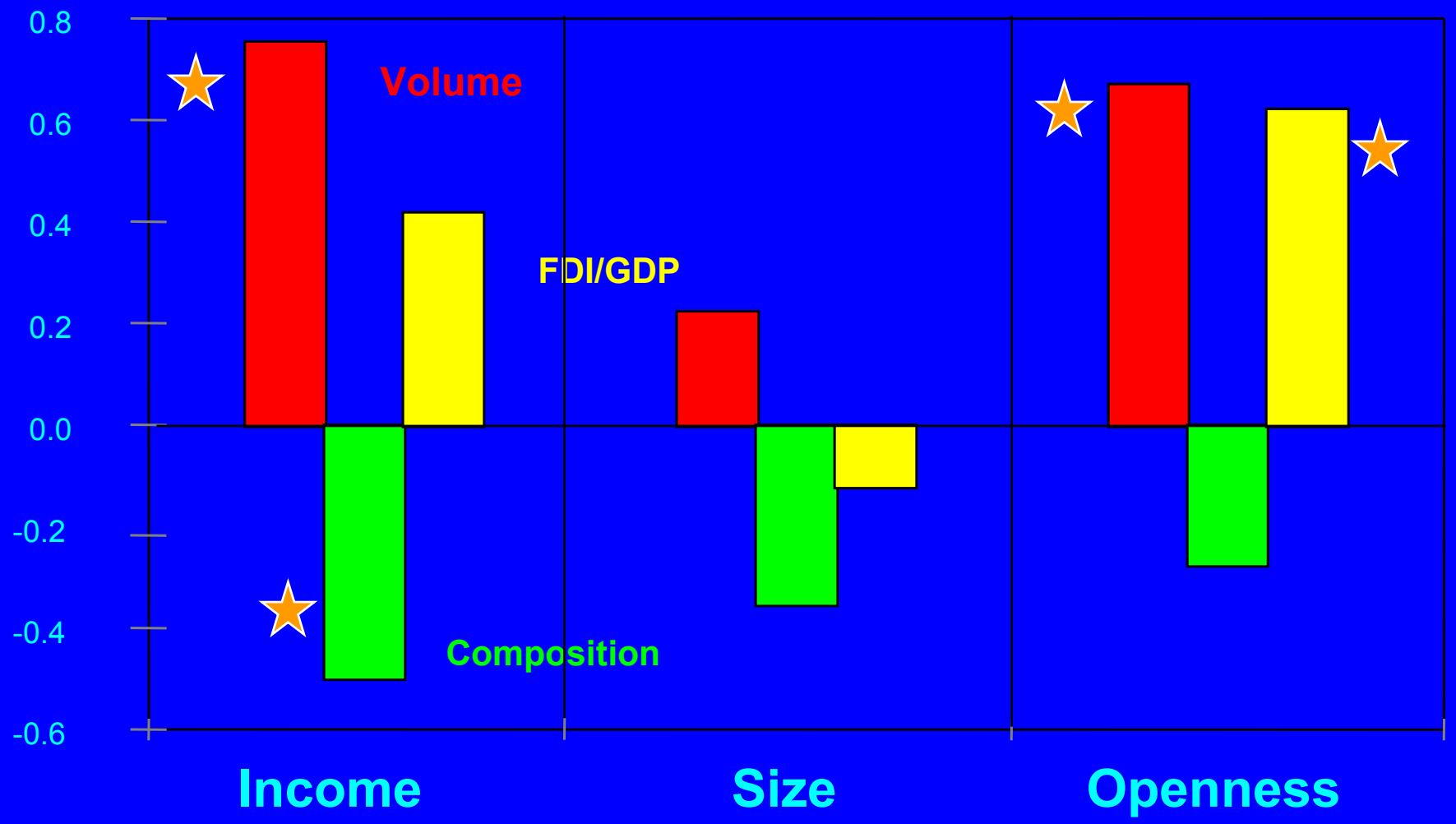
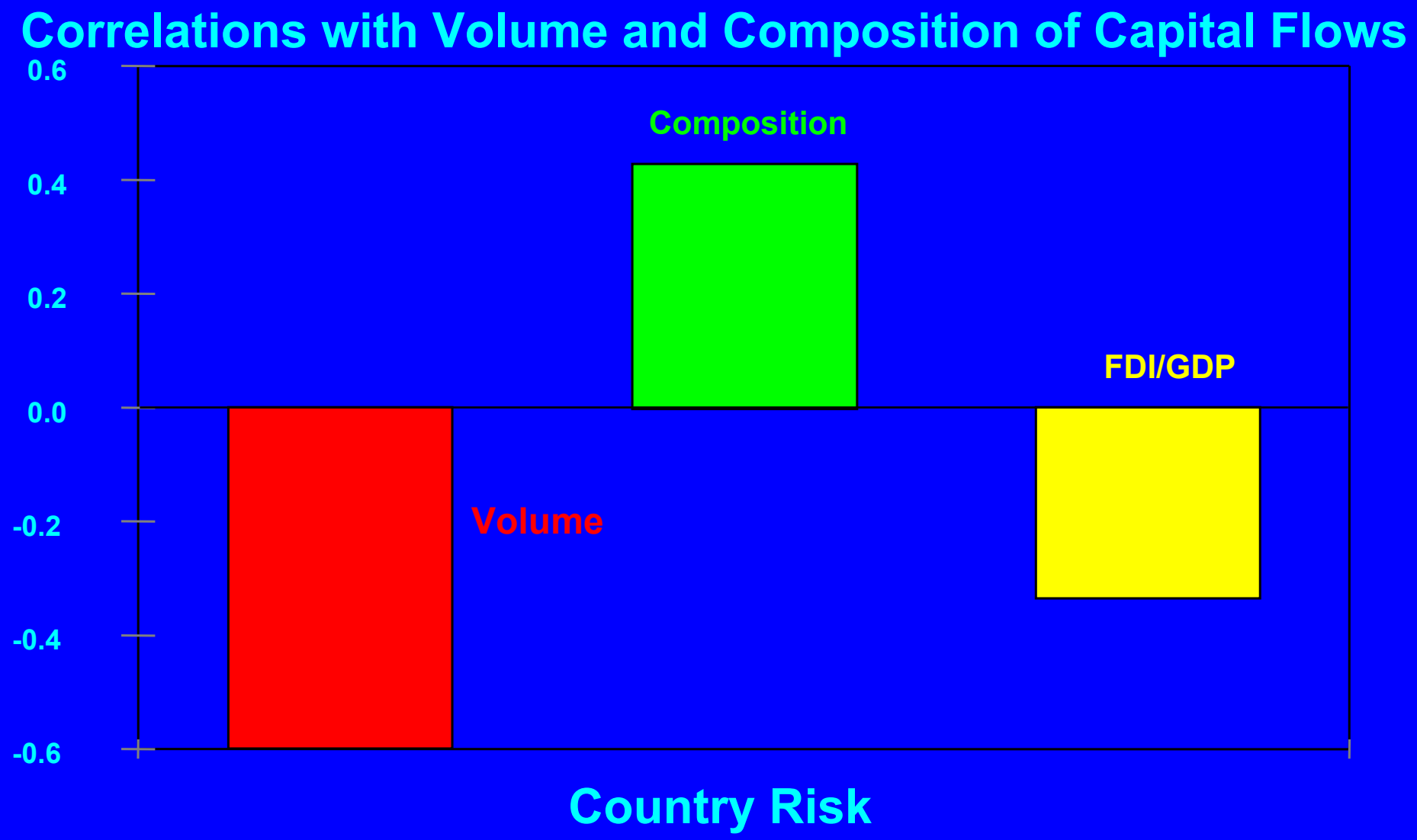
Source: IFS, WB and RES-IDB.

Richer, larger, more open economies don't have higher FDI-shares

Correlations with Volume and Composition of Capital Flows

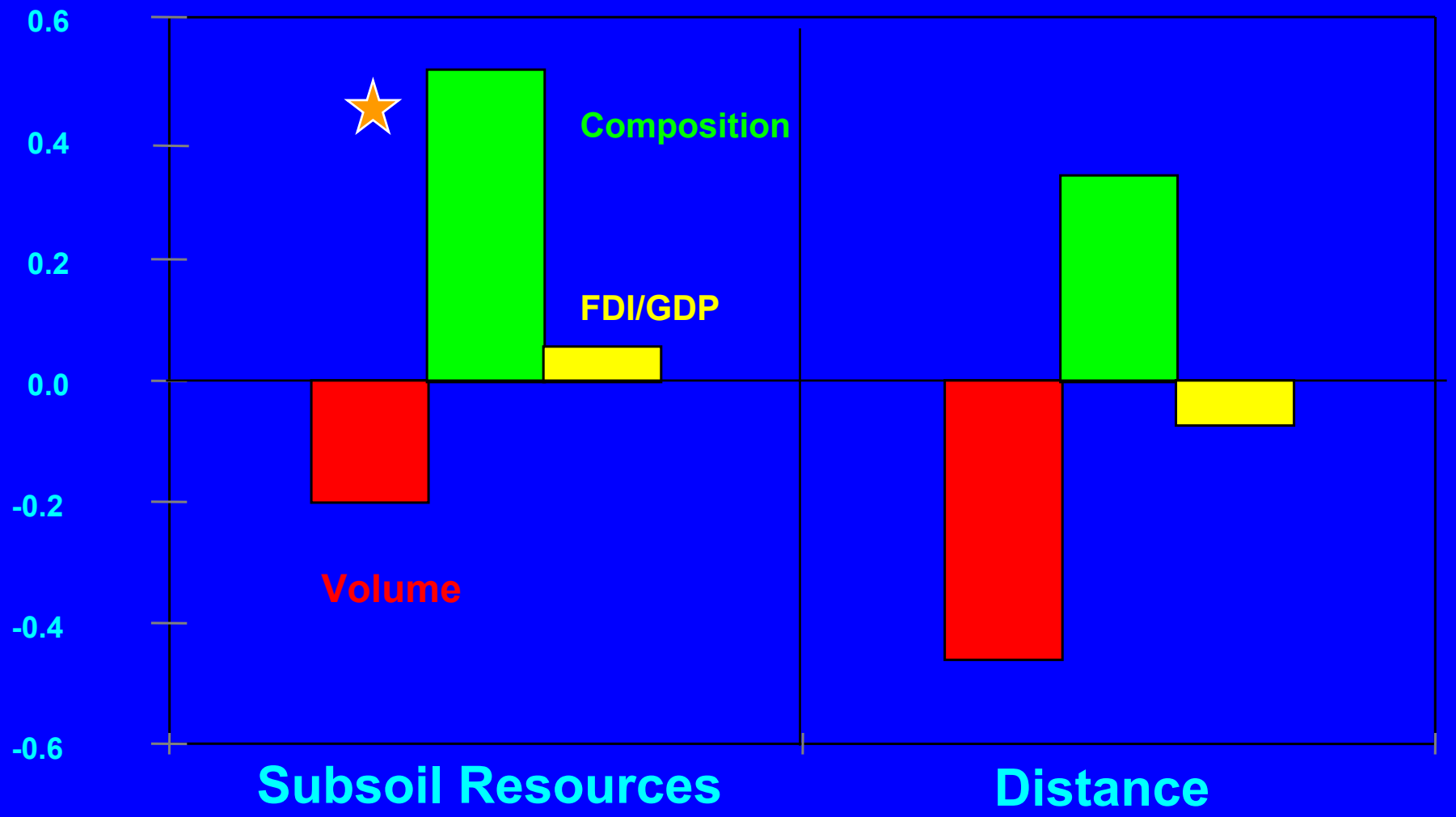


Riskier countries get less capital, but a larger share of FDI



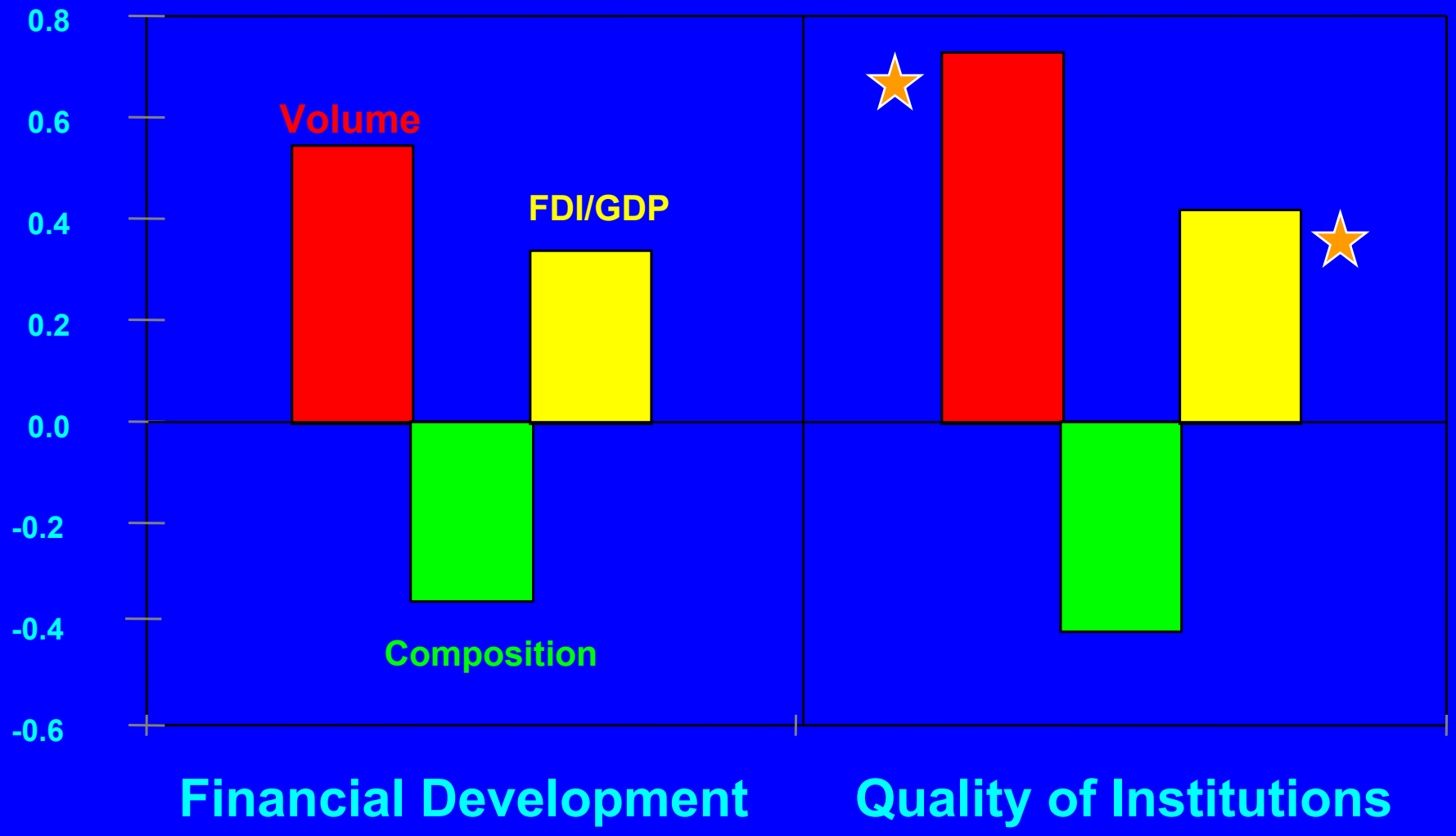
Resource rich, distant countries don't get more capital, but higher FDI-share

Correlations with Volume and Composition of Capital Flows

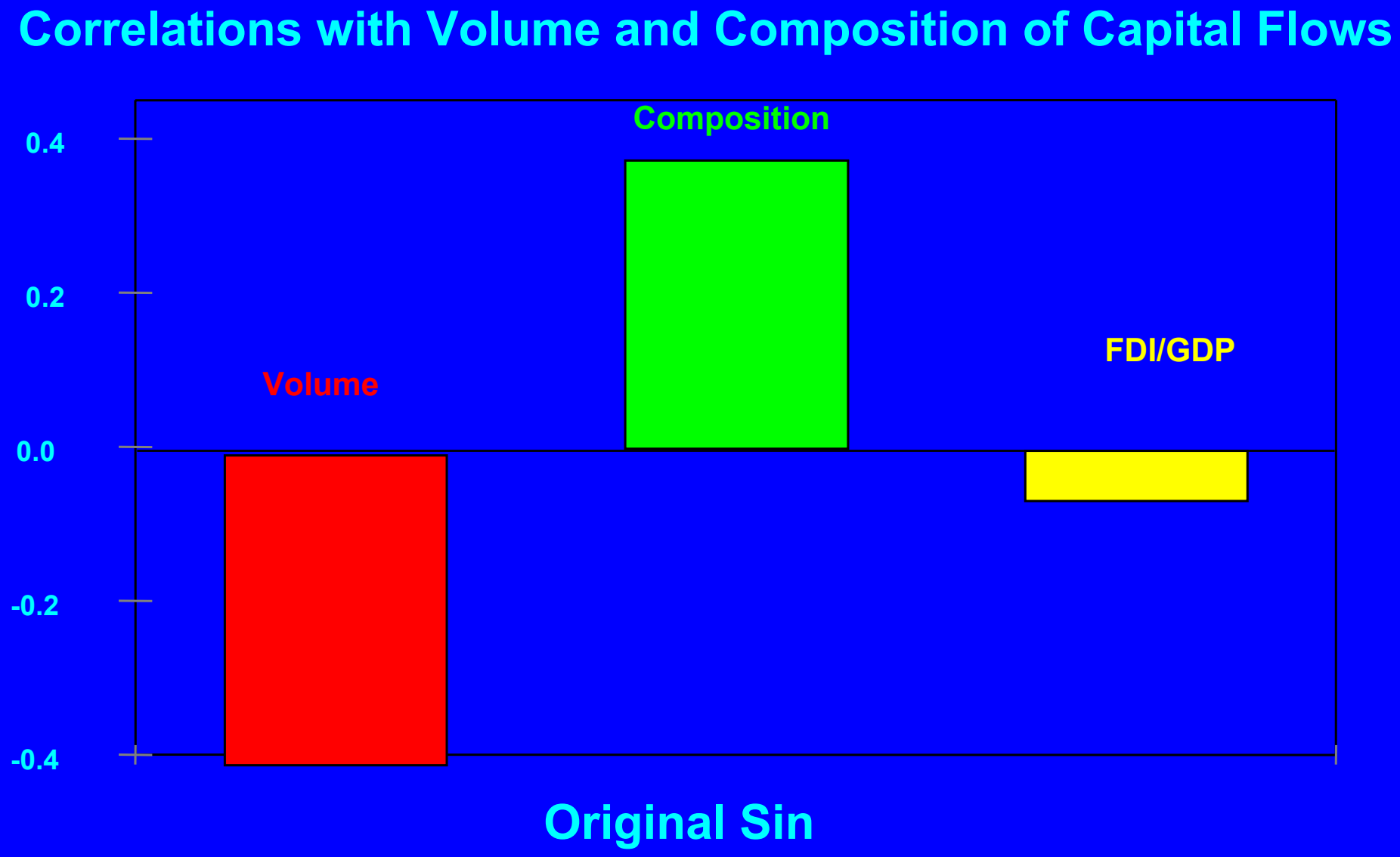


Better finance, better institutions don't beget more FDI-share

Correlations with Volume and Composition of Capital Flows



Original sin increases FDI-share



“Good things” are associated with more foreign capital inflows but a lower share of FDI

Controlling for income, size and openness, lower risk and better institutions do not increase the share of FDI

Can we make sense of this?

- Accounting
- Theories of the firm
- Corporate finance

Accounting

- Technology, management are assets
- FDI is just one liability
- If a foreign firm can borrow domestically or internationally to buy assets it is good,
- …but it is not FDI
- FDI is not a proxi for total asset accumulation, as its share changes
- …rising under bad conditions

Theories of the firm

- Make or buy? Transaction costs
- Firms are substitutes for poorly functioning markets/institutions (Coase, Williamson)
  - intellectual property
  - debt and equity markets
- Poor functioning debt markets make M&A profitable

Corporate finance

- Is the structure of finance relevant? (M&M)
- Taxes may make debt preferable
- Costly bankruptcy gives a reason to have equity
- Share of equity rises when
- …growth prospects are lower
- …risks are higher
- ...bankruptcy procedures are more inefficient
- Is a rising FDI share a reflection of greater risks?

Conclusions

- Measured FDI is more a financing decision than an investment decision
- The share of FDI in total flows is not an indicator of a good macro/institutional environment or improving risk perceptions
  - e.g. share of FDI in CAD
- The increase in the share of FDI may be optimal, given the circumstances
- It reflects the markets attempt to compensate for bad or deteriorating conditions