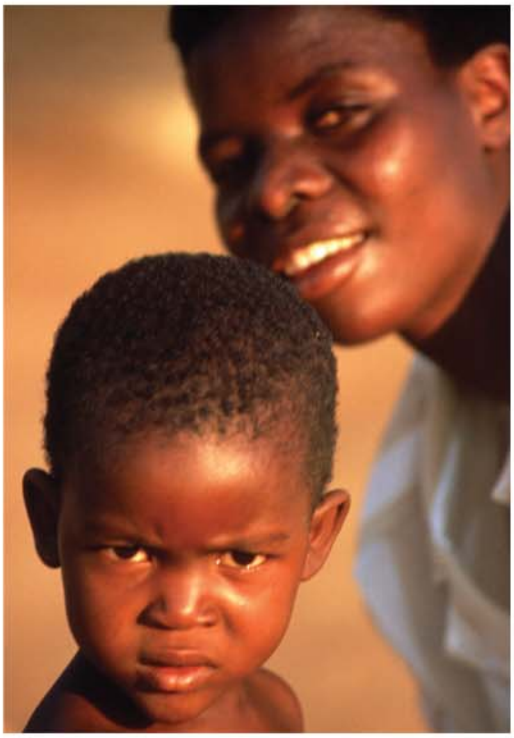
Policy Brief No. 9

Sustainability of External Development Financing to Developing Countries

Matthew Odedokun



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Matthew Odedokun

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EXECUTIVE SUMMARY

External development finance consists of those foreign sources of funds that promote or at least have the potential to promote development in the destination countries if delivered in the appropriate form. This rather broad definition qualifies all forms of external finance, and the quality and quantity of their inflows to developing countries are thus covered in the studies that form the background to this Policy Brief. These include official bilateral and multilateral, private commercial, and private non-commercial flows. A common characteristic is that all these types of flows are inadequate or becoming inadequate on the one hand and that their distribution is lopsided geographically and/or temporally, on the other.

Official financing

The central issue of official financing is the declining volume, particularly of official development aid (ODA), versus the rising need of the recipient countries. To bridge this ever-widening gap, it is not enough for donors merely to increase their aid budget. More than just conventional means are necessary, and one of the more effective means can be explored through the quasi-multilateral, though rather ad hoc, institutional arrangement recently suggested by the British government under the International Finance Facility (IFF).

But even then shortfalls will be inevitable, making it advisable to re-visit the issue of innovative sources of development financing for covering the shortfall. These include international currency transaction tax (so-called Tobin tax); a general tax on the sum of exports and imports; carbon tax; international arms trade tax; international lottery tax; and charges on global commons (geostationary satellites, minerals mined and fishing in international waters; exploitation in Antarctica, etc.). Others could include the Internet or bit tax; international aviation and shipping taxes; pollution charges; and additional issue of Special Drawing Rights (SDRs) and/or the sale of gold stocks by the International Monetary Fund (IMF). Many of these sources can fetch enormous sums of money. With renewed and ever-increasing interests from the international community in (and agitation for) these potential sources of finance, it is hoped that the existing political obstacles can be overcome and some of these sources may be adopted in the near future.

Furthermore, an increasing proportion of the official financing should be delivered multilaterally, instead of the inherently less development-motivated bilateral transfers. Official transfers for financing the delivery of global public goods need to be separated from actual development finance, so as not to crowding-out development finance.

The terms and composition of official financing are also an issue, and pure grants would be preferred in as much as this would not reduce the volume of transfers but the option of grants is unlikely to happen. Finally, it needs to be recognized that the so-called concessional loans create incentives with adverse impacts. These include unproductive loans, reckless borrowing and inefficient utilization of the proceeds by the borrowers. Consequently, there is need for an international official lending architecture to guard against these drawbacks. The architecture we suggest entails separating concessional loans into two constituent parts—pure grants and non-concessional loans—so that the recipient would be given the grant component coupled with a choice to take as much as it wishes from the non-concessional loan component.

Bilateral aspect of official financing and allocation

One area of concern is that bilateral transfers are volatile and rather unpredictable, largely due to factors on the supply side; the fractions of commitments translating to disbursements are unstable.

Probably the greatest concern, however, is that the geographical pattern of allocations is not correlated to the development needs or policy performance of the recipients or any other indicator of altruism. A number of measures reviewed in this Policy Brief should be adopted to rectify this.

Multilateral aspect of official financing

First, there is the need to increase the financing of multilateral development agencies. In addition to increased budgetary allocations for ODA, institutional measures along the lines of the IFF proposed by the UK government should be established. Other issues include the exploration of innovative sources of international development financing, much greater proportions of ODA to be given multilaterally, preferably through a common pool created for the purpose.

Second, there is need for rationalization of the existing duplication of similar multilateral development banks, and the overlap between these and UN agencies. Coordination within the multilaterals as well as between them and the Arab-related multilateral development banks is vital.

Financing for private sector development (PSD)

Private non-commercial external finance should be accorded more attention. The development finance-oriented NGOs need to be adequately funded, but should also be required to work with and, if necessary, through governments in recipient countries. Better institutional arrangements for workers' remittances should be promoted and more humane immigration policies adopted.

With regard to official foreign financing of private sector development (PSD), there is, first, room for better coordination (including information sharing) and division of labour between multilateral and bilateral agencies and within multilateral agencies. Second, more attention should be paid on how to catalyse and avoid crowding-out foreign commercial flows. Third, the geographical allocation of finances needs better targeting in order to rectify, instead of compound, the existing lopsided distribution of private commercial capital flows. Finally, on the issue of support for microfinance institutions, efforts should be made to resolve the inherent conflicts between the targets of financial *sustainability* and the *outreach* of the poor that these institutions are expected to achieve. If financial sustainability is to be an objective, then an adequate timeframe should be allowed for its fulfilment.

A central issue of concern with respect to private commercial capital flows is the geographical distortion, as many low-income countries are virtually overlooked. One major reason for the skewed distribution is the high risk associated with these economies as well as their weak economic and institutional environments. International development policies need to focus on these drawbacks.

Finally, capital flight reversal is potentially an enormous source of PSD. Reversal necessitates stability in the macroeconomic and political environment, enhanced conventional commercial capital flows coupled with more sustainable external debt position, as well as appropriate rate of returns differential.

INTRODUCTION

All types of external finance can promote development, at least, potentially

In this document, a more pragmatic concept of foreign development financing is adopted by considering almost all external sources of finance to be the development type. This is done with good reason. Regardless of evidence that a particular form of foreign finance (say, portfolio capital flows) has not been conducive in the past to the growth and development of the recipient countries, it does not necessarily mean that it should be discouraged. Instead, this should be perceived as an invitation to explore how that particular form of finance could be made pro-development. Almost all forms of external finance are potentially development-friendly if delivered to the recipient economies in the appropriate form. Thus, the objective is not only to sustain or increase the volume of financial flows, but also to enhance the form of the flows.

Accordingly, external development finance encompasses all official bilateral and multilateral flows, including ODA. It also includes all private commercial flows, whether portfolio capital or foreign direct investments (FDI). Lastly, it includes private non-commercial flows, such as unrequited transfers by NGOs and workers' remittances.

Aggregate financial flows have recently manifested a declining trend that still remains intriguing, if not inexplicable

Utilizing this wide concept of external development finance, we start by looking at the totality volumes of net external financial flows from developed to developed countries. By definition, this is the consolidated balance-of-payments surplus of the developed countries (DAC members), and should, in principle, be the same as the saving–investment (S–I) gap in the countries. In Figure 1, although the saving–investment gap differs from the current account balance because of measurement errors, these show very similar patterns: the volume declined after 1998 at the same pace it had risen in the early 1990s and became negative at the start of this century. Not only did the institutionalized financial flows (that is, official transfers and commercial capital flows) decline from 1998, but total flows diminished even faster, implying that non-institutionalized flows declined faster than institutionalized ones.

The declining trend of foreign finance to developing countries is a cause for concern, and is the reason for the recent attention in international development policy circles. But what are the fundamental factors responsible for the pattern witnessed in the early 1990s? In the final analysis, financial flows to developing countries are determined by fundamental domestic and non-domestic elements that drive domestic saving and investment in the developed countries, and this is where the answer lays. One possible factor in the domestic economy is the age structure of the population in developed countries: a rising proportion of non-working aged people is expected to reduce domestic saving and, with it, net foreign financial flows to developing countries. Another factor is the rising per capita income level in the developed countries. However, these demographic and income variables, which change over time, cannot produce the swings in the net financial flows observed in Figure 1. Falling interest rates in developed countries can also affect net financial outflows, as a result of its positive effect on domestic saving and negative effect on domestic investment. But, again, the weighted average annual discount rates in the developed countries was about 6.3 per cent in the early 1990s, indicating that there was an upsurge in the saving-investment gap, compared with 6.8 per cent and 9.2 per cent in the 1970s and 1980s, respectively.

Based on an informal analysis of domestic fundamentals in the developed countries as suggested by orthodox saving and investment macroeconomics, the movements in aggregate net saving or net foreign financial outflow are intriguing. Until more formal statistical analysis can suggest otherwise, it is inferred here that macroeconomic fundamentals external to the developed countries were probably responsible for the observed pattern of financial flows. These factors would include investment opportunities and other events in the developing or finance-importing countries. Future studies are necessary in order to pinpoint the specific factors responsible for the observed movements so that more definitive statements can be made.

Official flows seem to have moderated volatility in private commercial flows at the aggregate level, but not necessarily at the level of each recipient country

The components of total financial flows also matter, as does the aggregate. Only two very broad components of institutionalized financial flows—official and private—are given here. In Figure 2, the volatile nature of private flows is very clear, contradistinctive to the steadily increasing official flows. Thus, official flows during the 1980s moderated the effect of the greatly reduced private flows. Although this was not the case in the late 1990s when both official and private flows fell in unison, the stabilizing role of official flows was apparent for most of the time. However, what is experienced by the individual recipient economy can be totally different from the aggregate picture in Figure 2—variations and instabilities characterizing individual developing countries would be much greater than the aggregate.

Sectoral distribution of aggregate financial flows: official external financing should be aimed at redressing the imbalance against ‘productive’ sector

The importance of sectoral distribution of foreign financial flows stems from the fact that some sectors need more attention than others. For some categories of foreign financial flows, for example, portfolio non-equity flows, sectoral analysis may be inapplicable. But this is not the case for most official flows and FDI, the sectoral breakdowns of which are shown in Tables 1 and 2.

Table 1 shows that the highest (and increasing) proportion of foreign official assistance has been going to social infrastructure, and recently, to the economic infrastructure and services, whose share is also increasing. Shares to the production sector and commodity *cum* general programme aid declined substantially during the 1990s. Thus, in this regard, a case can be made for the need to further enhance the share of the production sector through direct donor support of PSD activities, including microenterprises. Table 2 shows that the shares of FDI in primary production (agriculture, mining and quarrying) as well as manufacturing activities have been decreasing in favour of various activities under the services sector. Given the positive externalities generally believed to be associated with the 'productive' (that is, primary and especially secondary) activities, the falling shares of FDI in this sector are a cause for concern, and remedial measures are called for. Official foreign financing of PSD should be made to leverage commercial private capital to these 'productive' sectors.

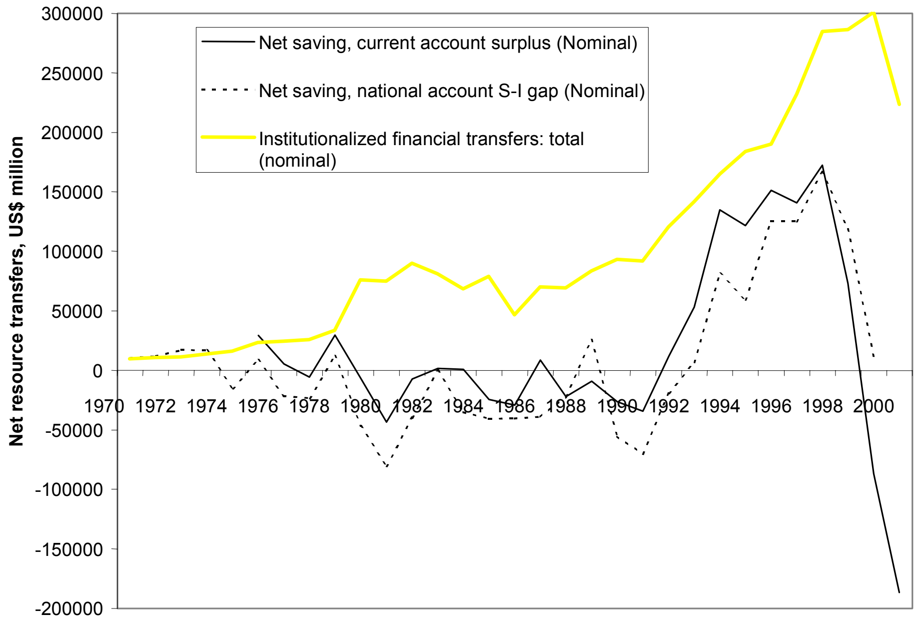
Income level-based and geographical allocation of aggregate foreign finance: official flows are regressive enough, but private flows are even more regressive

There does not seem to be a systematic relationship between the level of economic development (or per capita income) of a recipient country and the amount of per capita official aid received (Table 3). But the same cannot be said of foreign private capital flows, which are very regressive: the lower the level of per capita income, the smaller the share of foreign private capital compared to income. This means that while both are regressive, foreign private capital flows are more regressive than official flows. The regressivity of both (particularly, private flows) needs urgent attention from international development policymakers.

A remarkable feature of the trend is the share of total aid given to the least developed countries, which fell from 29.4 per cent in the 1980s to 23.5 per cent in the 1990s, a level corresponding to the share received in the 1970s. The shares of other income groups remain largely unchanged over the three decades, suggesting that the falling share of the least developed countries must have financed the 10 per cent portion of total aid earmarked to countries in transition (mostly former communist), many of which had never received aid prior to the 1990s. In any event, the reduction in the share of aid given to the least developed countries is a cause for concern, which should be addressed.

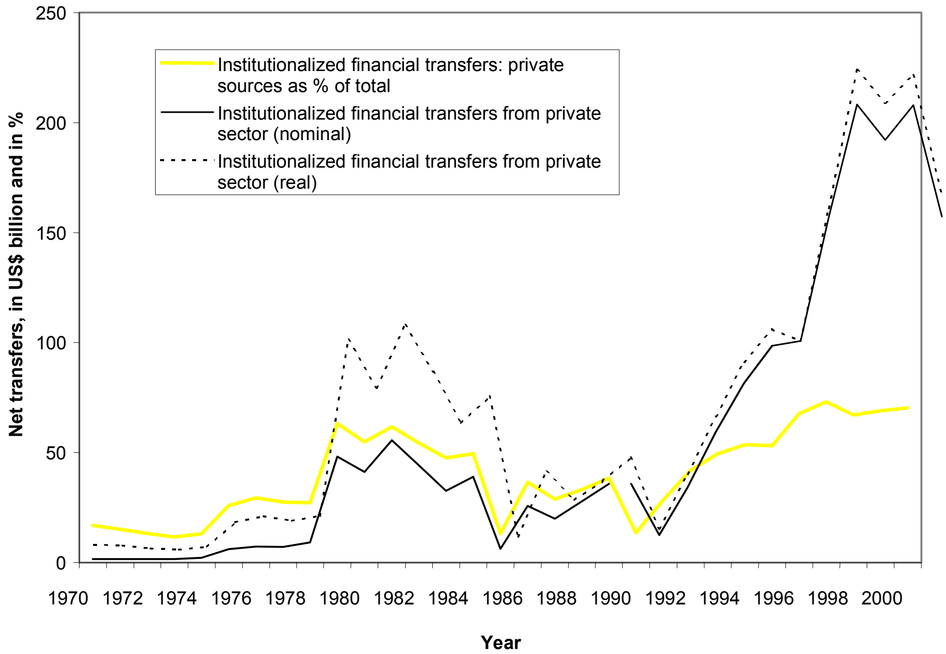
The geographical allocation also needs to be noted: the shares of North Africa, Middle East and South and Central Asian regions in total aid received are steadily falling and the shares of Far East Asia and Europe are correspondingly rising (Table 4). The share of south-of-Saharan Africa rose from 23.4 per cent in the 1970s to 34 per cent in the 1980s, but remained unchanged in the 1990s.

Figure 1
Aggregate net resource flows from developed to developing countries



Source: DAC's International Development Statistics (online, 2003) and World Bank's Development Indicators (online).

Figure 2
Institutionalized private sector-to-private sector net flows to developing countries, 1970-2000



Source: DAC's International Development Statistics (online, 2003).

Table 1
ODA commitments by sector and purpose, DAC donors, 1971-2000

	1971-80	1981-90	1991-2000
Social infrastructure and services	22.6	25.0	27.9
Economic infrastructure and services	12.6	18.7	20.0
Production sectors	19.1	19.7	10.8
Multisector (crosscutting)	1.8	3.0	5.6
Commodity aid and general programme aid	16.5	16.2	9.2
Action related to debt	4.4	4.3	8.8
Emergency assistance	1.1	1.7	6.2
Administrative costs of donors	na	2.6	4.8
Support to NGOs	na	1.5	1.5
Unallocated/unspecified	22.0	7.1	5.3
Total	100.0	100.0	100.0

Source: Howard White (2002) 'Long-run Trends and Recent Developments in Official Assistance from Donor Countries'. WIDER Discussion Paper DP2002/106 (Table 15).

Table 2
FDI inflows to developing countries by industry, 1988 and 1997

	1988		1997	
	Total (US$ billion)	% share	Total (US$ billion)	% share
Primary	1.78	6.7	7.47	4.6
Agriculture	0.57	2.1	1.80	1.1
Mining and quarrying	1.22	4.6	5.67	3.5
Manufacturing	17.80	66.8	81.20	50.1
Chemicals, machinery and electronics	6.46	24.2	24.31	15.0
Others	11.34	42.6	56.89	35.1
Services	6.65	25.0	66.79	41.3
Trade	0.84	3.2	5.56	3.4
Finance	0.86	3.2	7.26	4.5
Real estate	0.68	2.5	7.43	4.6
Communications	0.55	2.1	12.1	7.5
Other	3.72	14.0	34.44	21.3
Unspecified	0.42	1.6	6.45	4.0
All industries	26.67	100.0	161.90	100.0

Source: Oluyele Akinkugbe (2003) 'Flow of Foreign Direct Investment to Hitherto Neglected Developing Countries'. WIDER Discussion Paper No. 2003/02.

Table 3
Income level-based allocations of ODA, 1971-2000

	US$ per capita				Percentage shares			
	1971-80	1981-90	1991-2000	1971-2000	1971-80	1981-90	1991-2000	1971-2000
Least developed countries	12.0	24.9	25.0	21.7	23.5	29.4	23.5	25.4
Other low-income countries	1.9	3.2	4.7	3.5	20.6	19.7	21.2	20.6
Lower middle-income countries	14.1	19.2	21.8	19.1	27.4	22.4	21.3	22.6
Upper middle-income countries	3.5	5.4	4.8	4.7	5.8	5.2	3.4	4.4
High income countries	84.0	42.6	31.3	38.8	0.2	0.1	0.1	0.1
Other (unallocated countries)	56.4	111.6	157.9	110.0	22.6	23.2	19.6	21.2
All developing countries	6.0	10.3	12.3	10.0	100.0	100.0	89.1	94.2
Countries in transition	na	na	20.7	20.7	na	na	10.9	5.8
Developing and transition countries	6.0	10.3	12.9	10.3	100.0	100.0	100.0	100.0

Source: DAC's International Development Statistics (online, 2003).

Table 4
Geographical allocation of ODA, 1971-2000

	US$ billion				% of total ODA			
	1971-80	1981-90	1991-2000	1971-2000	1971-80	1981-90	1991-2000	1971-2000
Africa								
North of Sahara	2.1	3.0	3.7	2.9	13.4	9.2	7.8	9.2
South of Sahara	3.6	11.1	16.1	10.3	23.4	34.0	33.9	32.2
North and Central America	0.6	2.1	2.9	1.9	4.0	6.5	6.1	5.9
South America	0.7	1.3	2.4	1.5	4.4	4.1	5.1	4.6
Far East Asia	2.0	4.1	7.8	4.6	12.7	12.6	16.5	14.5
South and Central Asia	3.0	5.4	6.6	5.0	19.6	16.6	13.9	15.7
Europe	0.4	0.7	2.6	1.2	2.7	2.0	5.5	3.9
Mid-East	2.5	3.8	3.8	3.3	16.0	11.5	7.9	10.5
Oceania	0.6	1.2	1.6	1.1	3.9	3.6	3.4	3.5
All regions	15.5	32.6	47.5	31.9	100.0	100.0	100.0	100.0

Source: DAC's International Development Statistics (online, 2003).

OFFICIAL FINANCING—THE DECLINING TRENDS

The volume of ODA recorded a declining trend in the 1990s, but the generosity of most donors has been falling even faster

The bulk of official financing is ODA,[1] and its volume has been in steady decline, especially during the past decade. About 98 per cent of ODA during the 1991-2000 period was provided by the members of the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD). Although DAC membership increased from 17 countries in the 1970s to 22 two decades later, aggregate ODA volume has not kept pace. In the 1970s, nominal ODA volume witnessed a phenomenal increase, rising on average over 14 per cent per annum. This slowed to about 8.4 per cent as the annual average rate of growth in the 1980s and continued contracting during the next decade at an average rate of more than 1 per cent per year. Of 22 DAC donors, nominal ODA from 11 members registered declining trends during the 1990s.

But a clearer picture of the declining trend is portrayed by the aid generosity ratio, defined as the fraction of GDP given as ODA. As shown in Table 5, the aggregate generosity ratio of 0.31 per cent in the 1970s rose marginally to 0.32 per cent in the 1980s, only to fall substantially to 0.28 per cent in the 1990s. The UN-prescribed aid target is 0.7 per cent of GDP, but donors (with the exception of Denmark, Netherlands, Norway and Sweden) have ignored the target. The US, the most parsimonious donor, gave only 0.13 of a cent as aid out of every dollar GDP earned during the 1990s, down from 0.25 of a cent given in the 1970s. In growth terms, the generosity ratio rose in the 1970s on average 0.7 per cent per year but fell on average 0.3 per cent per year in the 1980s and 4.7 per cent per year in the next decade. During the 1990s, all donors (except the five small ones, namely Denmark, Greece, Ireland, Luxembourg and Ireland) recorded declining trends in their generosity propensity; Australia and the US recorded contractions in all three decades.

Possible factors which could have caused the declining trend in aid volume and donor generosity—further studies are needed to pinpoint the actual causes

Notwithstanding some recent attempts to identify the factors responsible for the decline in donor generosity as well as the reasons why some donors are less generous than

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1 According to standard OECD sources of DAC, ODA refers to development-motivated official foreign grant or loans—that are concessional in the sense that the grant element, evaluated on the basis of 10 per cent discount rate, is not less than 25 per cent of the loans' face value. It is loosely and popularly referred to as 'foreign aid' and constitutes the main instrument of official finance from the developed to developing countries.

others at a given point in time, one can only speculate as to the actual causes. In this regard, one likely factor was the end of the cold war in the early 1990s. This may have reduced the foreign aid that had been motivated by international strategies and politics, especially on the part of large donors like the US. Tight budgetary conditions in donor countries and regime changes between right and left wing governments are also possible causes. It is also likely that nations with regimes concerned about their poor domestic population—like the Scandinavian states—would be more generous in giving aid to developing countries. The peer pressure effect may be a factor, whereby aid volume depends on the quantities other donors—particularly the relatively large ones—give, so that a reduction by a large donor like the US might generate a downward 'bandwagon' or spiral effect on total aid volume.

Non-conventional ways of reversing the falling trend in aid volume should be explored

Irrespective of the factors responsible for the downward slope in aid volume and generosity ratio, concerted efforts are needed to reverse the trend. This becomes more imperative in view of the increasing number of poor countries (including the former communist countries since the 1990s) and their increasing population sizes. More important, with the inclusion of environmental issues in the early 1990s and the more recent additional goal of poverty reduction, the scope of activities to be financed by foreign aid has increased.

One way to boost the aid volume and to stem the decline is for donors to consciously raise aid levels through conventional budgetary appropriations. But this is unlikely to achieve much within the near future, and other means should be found. One such means is the quasi-multilateral institutional arrangement recently suggested by the British government, the so-called International Finance Facility (IFF). Under the arrangement, donor governments pledge to contribute a certain sum to IFF. On the strength and credibility of the pledges, IFF would then borrow from the international capital markets for onward transfer, as aid, to countries preferred by the donors. The loans would be repaid when the pledges are redeemed.

In addition to the IFF mechanism, the issue of innovative sources of development financing should be re-visited. Proceeds from these innovative sources should be centrally collected by a multilateral institution for disbursement in accordance with pre-determined allocation formulae. Several innovative sources have been suggested in the literature. These include international currency transaction tax (so-called Tobin tax); a general tax on the sum of exports and imports; carbon tax; international arms trade tax; international lottery tax; and charges on global commons (geostationary satellites, minerals mined and fishing in international waters; exploitation in Antarctica, etc.). Others are the Internet or bit tax; international aviation and shipping taxes; pollution charges; and additional issue of SDRs and sale of gold stock by the IMF. Many of these potential sources can raise considerable sums of money—as with the Tobin tax, which has been conservatively estimated to generate up to US$300 billion per year at a tax rate of 0.2 per cent! However, due to opposition from some developed countries, particularly the USA, these proposals are yet to see the light of day. But with renewed interest from the international community in (and agitation for) these possible sources, there is hope that some will become available in the near future.

Table 5
Trends in ODA, by individual donors, 1970-2000

	ODA/GDP ratio					
	%			Average annual growth rate (%)[a]		
	1971-80	1981-90	1991-2000	1970-80	1980-90	1991-2000
Australia	0.43	0.38	0.29	-1.9	-2.4	-3.2
Austria	0.17	0.26	0.27	13.0	-2.8	-2.6
Belgium	0.53	0.50	0.36	0.5	-2.8	-2.5
Canada	0.45	0.44	0.36	1.2	1.1	-6.0
Denmark	0.54	0.78	0.95	6.6	2.7	1.2
Finland	0.16	0.43	0.41	8.6	11.6	-8.2
France	0.42	0.56	0.51	-2.4	2.3	-6.2
Germany	0.32	0.38	0.32	4.6	-1.4	-4.3
Greece [b]	na	na	0.16	na	na	7.3
Ireland	0.12	0.17	0.20	14.7	-2.0	8.0
Italy	0.11	0.29	0.22	-1.4	10.1	-9.5
Japan	0.23	0.30	0.27	2.1	0.3	-1.6
Luxembourg [b]	0.09	0.18	0.44	na	10.1	10.3
Netherlands	0.69	0.92	0.80	6.0	-0.9	-0.2
New Zealand	0.32	0.25	0.23	5.8	-3.3	0.2
Norway	0.58	0.95	0.90	12.2	2.6	-2.2
Portugal [b]	0.01	0.09	0.25	na	33.4	-0.6
Spain [b]	0.07	0.10	0.23	na	4.3	-0.1
Sweden	0.69	0.83	0.80	9.5	0.8	-2.7
Switzerland	0.18	0.30	0.37	5.6	3.3	-0.2
UK	0.42	0.33	0.29	0.6	-3.3	-0.9
USA	0.25	0.21	0.13	-2.7	3.1	-0.4
Non-DAC [b]	na	na	na	na	na	na
Total	0.31	0.32	0.28	0.7	-0.3	-4.7

Notes: [a] average annual growth rates calculated with the least squares method;
[b] 'na' stands for not applicable, or not available.

Source: DAC's International Development Statistics (online, 2003).

OFFICIAL FINANCING—LOANS, GRANTS AND CONCESSIONS

Pure grants have advantages over loans but also disadvantages

The debate today is on whether resource transfers by the multilateral development institutions (as well as bilateral aid agencies) should be in the form of grants or loans and, if they are to be loans, the degree of concessionality. The current administration of the United States supports all-grant bilateral aid as well as predominantly grant-based multilateral support through the multilateral development banks under its influence, including the World Bank. Many international development NGOs also support pure grants because, as adduced by protagonists, loans would saddle recipients with the burden of eventual repayment. Furthermore, grants are considered the most appropriate source of financing for most of the pressing problems (for example, health, education and social services) faced by the recipients who, as a pre-qualification, are very poor.

This stand, however, is not favoured by donors on the other side of the Atlantic. Opposition, led at least initially by the UK, has put forward counter-arguments, including the fact that grants would not encourage financial discipline by recipients. Furthermore, in connection with multilateral aid agencies (particularly, the World Bank's International Development Association, IDA), it is claimed that a shift from loans to pure grants would lead to a so-called 'mission creep' and IDA would end up competing, possibly unfairly, with various smaller and inherently pro-grant UN agencies. Some critics also want to see the IDA become financially insulated and independent from donors and their politics, and future reflows to be generated through current lending are seen as a way of achieving this. In addition, a shift from loans to pure grants is believed to reduce the future capacity of the multilateral institutions to make financial transfers because of the cessation of reflows from current transfers. This last argument, however, might not be as tenable as it may appear at first. Given the importance of multilateral institutions to donor countries as instruments of international relations, a period of dwindling resources could only be a temporary or 'disequilibrium' situation. Any pattern of diminishing recycled lending resources would automatically trigger action (manoeuvring, moral suasion, etc.) within the donor community that would eventually, through intra-donor assessment for replenishment contributions, restore the normal situation of expanding scale of operations. The concessional lending windows (or other windows) of these institutions would be affected by a permanent reduction in size only if the original reasons that once prompted their set-up were no longer applicable. For example, poor countries will continue to exist, and it is impossible to contemplate the discontinuation of IDA (or a substantial reduction in their resources).

But the issue of loans versus pure grants transcends the IDA institution. First, IDA is not the only concessional lending window of the multilateral financial institutions—similar soft windows exist with regional development banks—and with the IMF (the fund for Poverty Reduction and Growth Facility, PRGF). Whatever pro- and anti-grant arguments exist for IDA should apply to all regional development banks as well. Second, the regular or relatively non-concessional lending of the multilateral development banks—for example, the World Bank's International Bank for Reconstruction and Development (IBRD)—is concessional to a degree. Third, too often bilateral official assistance (albeit recently decreasing in relative importance) is in the form of soft loans, and the pro- and con-arguments regarding all-grant assistance from multilateral sources should apply here as well. Furthermore, the issue of loans versus pure grants applies to the distinction between soft or concessional loans versus non-concessional loans. A concessional loan (the one currently in vogue) is subsidized credit and includes by definition a grant element. Thus, in comparison to a non-concessional loan, a concessional loan can be conceptualized as a grant. The debate of pure grants versus loans should not be divorced from the related issue of concessional versus non-concessional loans.

Consequently, we propose a new international official lending 'architecture' that largely caters for the disadvantages of loans and grants—irrespective of whether these are made by IDA or not. The proposal offers better and more efficient delivery of concessional loans simply by splitting the loans into two components—pure grants and non-concessional loans, with non-concessional loans being a form of 'standby facility' to be used at the discretion of the recipient.

Concessionality of loans encourages ill-motivated lending, reckless borrowing and unproductive utilization of loans but …

International official loans still constitute an important component of official flows and reforming the terms and mode of delivery can go a long way to enhance the external debt sustainability of the recipient countries. These terms and conditions, including the high loan interests that are being compounded, are the major reason for the debt burden of many developing countries.

But this is not to make a case for the concessional loans which have made it possible for the multilateral (and bilateral) creditors to 'push' loans irrespective of the benefit to the borrowers. Multilateral development banks, to attain some pre-determined targets, are noted for their aggressively persuasive lending, which loan softness facilitates. With pure grants, similar targets for resource transfers would not arise and, in the case of non-concessional loans, would be difficult to implement, as borrowers would need considerable persuasion. In addition, concessionality created the allure to over-borrow, and the softness of the loans encouraged productively less prudent utilization of funds. In addition to low interest rates, the longer grace and/or maturity periods (with, say, a time horizon of less than ten years) tempt governments or finance ministries to borrow more, because repayment in all likelihood will be passed on to the succeeding regime. Also, financial discipline with soft loans would ordinarily be less than with non-concessional loans. Project and programme selections are likely to be less prudent (with those having low combined private and social rates of return included) and their implementation less efficiency-conscious.

Pure grants, however, cannot be singled out as the only means of effecting resource transfers. Shifting from a regime of concessional or non-concessional loans to an all-grant regime would, in reality, entail a reduced volume of financial transfers, so that a country receiving a reduced volume of resource transfers as grants would actually be at a disadvantage compared to a larger volume of official loans.

Table 6
Loan versus grant composition and concessionality of new bilateral financing (%), 1970-2001 [a]

	1970-79	1980-89	1990-99	2000-01
Grants, % of gross ODA	56.2	68.5	73.3	79.8
Grants, % of total gross official flows [a]	37.7	46.0	50.0	62.9
Concessional (ODA) loans, % of total (gross) [b]	47.0	39.2	36.3	42.9

Notes: [a] Total gross official flows are the combination of gross ODA and predominantly non-concessional and debt-creating OOF;
[b] Total loans comprise relatively concessional ODA loans and less concessional OOF loans.

Source: DAC's International Development Statistics (online, 2003).

New international official lending architecture for low-income countries

Concessional loans are, in effect, grants and non-concessional loans bundled together and offered in a 'take it or leave it' manner. The question arises as to whether it is not more efficient and beneficial to unbundle a soft loan into two constituent parts: the recipient is given the grant component and a choice to take (without further questioning or additional conditionality) as much as it wishes from the non-concessional loan component. The non-concessional loan component should, preferably, have a short grace period and/or maturity so as to dissuade finance ministers, intending to pass the repayment burden to the next regime, from over-borrowing.

There is no disadvantage to the donor in granting this option and the recipient is likely to exhibit greater discipline in project/programme selection and implementation in utilizing the loan element. The recipient may refrain on its own volition from drawing the entire amount (or any part of it) if its utilization is not justified by the anticipated combination of private and social benefits (or rate of return). More importantly, this option also minimizes the recipient's future debt burden. For the multilateral development banks (and, to some extent, national aid agencies), the arrangement would also allay their fears that the political will for sustaining or increasing future volumes of resource transfers might not be forthcoming. International official lending practices need to be reformed to minimize the possibility that the future debts of debtor countries become or remain unsustainable. We believe it would be beneficial to explore the separation of future official concessional loans as suggested here. This should affect the World Bank's IDA, concessional lending windows of regional development banks, the IMF's PRGF as well as bilateral concessional lending.

OFFICIAL TRANSFERS FOR FINANCING GLOBAL PUBLIC GOODS DELIVERY SHOULD BE DEALT WITH SEPARATELY AND SHOULD NOT CROWD-OUT DEVELOPMENT ASSISTANCE

Official financing allocated to further global interests—as in the promotion of the delivery of global public goods—should not be considered as ODA. As pointed out earlier, ODA by definition is motivated by the development of the recipient countries. Official transfers for financing the delivery of global public goods (GPG), on the other hand, are for the benefit of the entire global community, and not just for the specific benefit of the recipient country.

Unfortunately under the present system, official transfers for GPG delivery are included in ODA, giving a distorted view of ODA performance by donors and ODA receipts to beneficiaries. While this misconception also applies to bilateral transfers, it is magnified in the case of multilateral transfers. Increasing shares of multilateral ODA—probably at the expense of allocations to multilateral development banks and UN aid agencies—are now allocated to such GPG items as the Global Environmental Facility and Montreal Protocol.

Financing global public goods should not crowd-out development assistance

Financing GPGs should not be allowed to crowd-out development assistance. This can be ensured by explicitly excluding GPG financing from ODA statistics. Even though GPGs by definition should not be a part of ODA, this demarcation is not being followed at present.

Furthermore, allocations for GPG financing at the bilateral level should be dealt with separately and not by the conventional aid agencies. At the multilateral level, separate multilateral agencies should be created to receive and allocate GPG finances.

MULTILATERAL VERSUS BILATERAL OFFICIAL FLOWS—MORE SHOULD BE DIVERTED FROM BILATERAL TO MULTILATERAL ALLOCATIONS

The multilateral framework is generally regarded as a more development-friendly approach to channelling external development funds to developing countries. This is because some economies of scale are likely to exist (perhaps economies of scope as well) when a particular multilateral entity handles the financial ‘intermediation’. Furthermore, self-serving interests of donor countries are less likely to influence decisions regarding the selection of recipient countries and amounts.

But as is shown in Table 7, the share of official finance from the DAC-member countries has been more or less stable (about 22 per cent of the gross and 26 per cent of the net disbursements) over the last thirty years. An exception is the period 1996-2000 when a minor increase in the share was recorded, reflecting mainly the multilateral financing of the newly created Global Environmental Facility and Montreal Protocol on environmental issues. The need, therefore, exists for increased multilateralism in official financing.

Table 7
Percentage share of multilateral aid in total official flows, 1971-2000 [(a]

	1971-80	1981-90	1991-95	1996-2000
Gross disbursements	21.8	22.2	22.1	22.7
Net disbursements	26.4	26.8	26.9	29.1

Note: [(a] Official flows refer to combined ODA and other official flows (OOF) from DAC-member countries.

Source: DAC's International Development Statistics (online, 2003)

BILATERAL OFFICIAL FINANCING: TERMS, CONDITIONS AND VOLATILITY OF DISBURSEMENT

The volatility and non-predictability of official bilateral disbursements are often caused by donors themselves and this practice should be remedied

The utilization of aid by recipients is often seriously compromised by delays in disbursement and the associated unpredictability of its availability. This compounds the budgeting and macroeconomic capacity of already weak recipient governments. As a result, in case of shortfalls as well as sudden expenditure adjustments, a government, already burdened with a low taxbase and inflexibility to adjust tax rates, has to resort to ad hoc borrowing from the central bank. Ultimately, the outcome is frequent and unpredictable movements in government spending, monetary aggregates, exchange rates, foreign reserves and inflation rates.

While the reasons for delayed, or unpredictable timing of, disbursement of official aid are traceable to some extent to the recipient governments themselves (mainly due to their inability to meet aid conditionalities), donors can also be said to be responsible. Donors may delay disbursements for reasons other than non-fulfilment of conditionality. The reverse also happens: donors turn a blind eye and make disbursements even when conditionalities are not met. Available evidence tends to suggest the lack of transparency in the implementation of disbursement criteria, which are mainly dictated by domestic interplay of political forces among various foreign aid stakeholders in the donor countries.

Therefore, in making disbursements, donors should do their part to ensure greater stability and predictability in bilateral aid flows, including transparent commitment to loan terms. Donors should avoid making disbursements vulnerable to the whims of their domestic political, commercial and other interest groups. In this regard, a third party should be institutionalized to arbitrate the interpretation of clauses relating to the terms and conditions of bilateral aid agreements, as opposed to the current practice of unilateral interpretations by the donors.[2]

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[2] It is noteworthy here that the report submitted in 2000 to the US Congress by its International Financial Institution Advisory Committee (IFIAC), under the chairmanship of Professor Allan Metzler, recommended the use of an independent third party in verifying compliance with their recommended institutional reform loan conditionalities to be granted by multilateral development banks. According to the IFIAC (chapter 3), 'auditors, independent of both the borrowing government and the official lender, would be appointed to review implementation of the reform program annually'.

Official bilateral finance allocation: the pattern is not motivated by, or conducive for, the development of recipient countries

Official bilateral aid allocation is still characterized, if not by actual chaos then, at least by a lack of coordination. Different donors use different criteria, and where a common evaluation guide is used, different weightings are attached.

Donor criteria can broadly be classified as donor self-interest; altruism (in the broad sense) and global interests. Donor self-interest can be strategic, political, commercial or economic, and cultural or linguistic. It can also be geographic, as donors generally give more to recipients sharing the same geographical proximity; it can be historical, with donors favouring certain recipients simply because of past (colonial, for example) ties. Altruism, on the other hand, is aid motivated primarily for the benefit of the recipients; aid for helping recipients solve problems (disaster relief), promoting the development of the beneficiaries, as well as assisting and encouraging them to help themselves to overcome being aid-dependent. Altruism includes aid given for poverty alleviation and for encouraging good policies in recipient countries. Global interests, as an objective of aid allocation include encouraging or 'bribing' recipients to undertake measures that would, according to donor belief, further the interests of the global community. This is exemplified by recent donor interest in enhancing global public goods (including environmental issues), the delivery of which substantially takes place in the developing countries; without such outside inducement, the involvement of these nations would not be enough.

Different donors put different emphases on aid objectives. The end result is that the aid received by beneficiaries is lopsided; many receive much more than their fair share while others receive much less. For example, as shown in Table 8, Nigeria, a low-income country, received aid averaging US$0.6 per capita per annum during 1992-2001. This would not have been the case, had aid allocations been guided by developmental or any other altruistic considerations. Generally, there is a strong bias in favour of small countries (see Table 8). But that is not all. Countries that are former colonies of large donors also have an advantage, as do nations located in the same region as donors.

It can be contended conceptually that most bilateral official transfers are motivated by donor self-interest, and thus should not be classified as aid or ODA which, by definition, should be targeted primarily for promoting development in the receiving countries. But for reason of practical expediency, this definition is not strictly adhered to. Hence, almost all bilateral transfers that are sufficiently concessional are classified as ODA, and the motive often cannot be identified unambiguously.

Table 8
Highest and lowest beneficiaries from bilateral ODA, annual average over 1992-2001

	Highest ODA per population			Lowest ODA per population	
	Per capita bilateral ODA (US$)	Bilateral ODA/GNI, %		Per capita bilateral ODA (US$)	Bilateral ODA/GNI, %
Aruba	182.1	2.08	Brazil	0.8	0.02
Bosnia-Herzegovina	148.7	18.41	China	1.5	0.28
Cape Verde	191.2	17.73	India	1.0	0.28
Cook Islands	346.3	13.53	Malaysia	0.9	0.06
Djibouti	112.7	13.68	Nigeria	0.6	0.24
Dominica	130.4	4.41	Turkey	0.9	0.03
Israel	200.3	1.46			
Kiribati	173.8	19.70			
Micronesia	827.9	37.38			
Samoa	169.7	14.93			
Sao Tome and Principe	202.5	67.56			
Seychelles	116.3	1.75			
Suriname	141.1	12.27			
Tonga	211.3	13.20			
Vanuatu	169.3	14.52			

Source: DAC's International Development Statistics (online, 2003).

The often suggested multilateralism in the form of a 'common pool' would make existing bilateral transfers more development-motivated

Bilateral transfers could be made specifically more development-motivated and development-friendly with an injection of multilateralism. As suggested in the literature, this could be done through the establishment of a 'common pool' as mechanism for aid delivery. This would safeguard aid allocations from the narrow self-serving interests of the donor and ensure that developmental needs and other altruistic considerations govern aid allocation.

A second-best option would be for DAC to attach lower weightings to (or to the lopsided) portions of bilateral transfers in assessing donors' performance

But if a common pool approach is not politically feasible, a second-best method could be for the DAC to attach different weightings in its routine assessments of members' aid performance: lower weighting for bilateral ODA and full weighting for multilateral

ODA (discussed further under multilateral financing). This would motivate higher proportions of ODA budgets to be given multilaterally.

Similarly, in routine performance assessment of members' aid efforts, DAC could exclude, from the ODA definition, allocations to recipients that are in excess of, say, 5 per cent of a donor's bilateral aid budget or allocations that accrue to the recipients in excess of, say, US$10 per capita. Donor self-interests are often pursued by concentrating aid intensively to those few countries which best serve the donor. Thus, excluding the geographical over-concentration of aid from the definition of ODA would limit the extent of self-interest motivation and correspondingly encourage altruism in aid allocation. Unlike the second-best weighting measure, this method may not necessarily increase multilateralism, but could make bilateral aid more development-motivated.

MULTILATERAL OFFICIAL FINANCING: SCOPE AND NATURE OF MULTILATERAL DEVELOPMENT AGENCIES

There are many multilateral organizations, making it difficult and impractical to classify them on the basis of what they stand for. Nevertheless, at the risk of some inaccuracy, these can be classified roughly into six groups: predominantly military type (for example, North Atlantic Treaty Organization); largely political type (core organs of the UN, for example, and regional equivalents like the African Union, Organization of American States, League of Arab States, etc.); and the primarily financial in nature, as in the case of the IMF, the Bank for International Settlements, and so on. Some stand for promotion and sustenance of common historical *cum* linguistic ties, as in the case of the Commonwealth and other commonwealths (Commonwealth of Independent States, for example). Also, some organizations are predominantly for the promotion of trade, as in the case of World Trade Organization and several regional trade blocs. Some of these have evolved to higher degrees of politico-economic integration (for example, the European Union). Finally, others are motivated essentially for the development of either member states (the UN developmental aid agencies, the World Bank Group and regional development banks)—or other states that are not necessarily members (European Commission and some regional development banks like the Nordic Development Fund). It is this final group we intend to focus on, but some aspects of our review are also applicable to other multilateral organizations since all strive in their own way to promote development. For example, the IMF has recently veered into development financing through its Poverty Reduction and Growth Facility.

Multilateral organizations can raise funds through a number of channels and instruments. The World Bank and regional development banks, because of their high credit rating (derived mainly from the callable capital of the most reputable members, mostly developed countries), can borrow from the international capital markets at fair interest rates. They can also generate and accumulate surpluses, mainly from the spread between borrowing and lending rates. Some UN agencies (UNICEF) can also raise funds through donations from non-governmental concerns. But in general most of the funding for multilateral organizations comes from member countries and in particular from the very few affluent ones, reflecting the ability-to-pay principle of financial burden sharing.

For multilateral organizations with global membership (like the UN and its agencies, including the IMF and the World Bank) and regional development banks (with non-regional members), this has meant that the developed countries are the main providers of funds, most of which are in the form of ODA.

Two major issues on multilateral financing centre on the funding of multilateral institutions and reform of the institutions themselves.

FUNDING OF MULTILATERAL DEVELOPMENT INSTITUTIONS

Monetary volume of multilateral ODA effectively recorded a downward trend in the 1990s

Almost all ODA is provided by members (commonly known as the developed countries) of OECD's Development Assistance Committee (DAC). But even though DAC membership since the 1970s has increased from 17 countries to 22, the aggregate volume of multilateral ODA has not kept up, especially in real terms.

In the 1970s, multilateral nominal ODA witnessed a phenomenal volume increase, on average over 22 per cent per annum. This slowed to just over 6 per cent in the 1980s, and was on average only 0.8 per cent in the 1990s. The three types of multilateral agencies recording increases in their ODA receipts during the 1990s are ones with unique circumstances.[3] Without the impact of these special circumstances, the aggregate and multilateral recipients of all ODA categories would have experienced annual declines.

But the degree of generosity of multilateral ODA donors recorded an even faster declining trend

A clearer picture of the declining trend is evident when multilateral aid volume is considered in real terms or, as shown in Table 9, according to the multilateral aid generosity ratio, that is, the fraction of GDP given as ODA. The aid generosity ratio also implicitly indicates the degree of a donor's disproportionate burden in relation to its capacity (measured by its size of GDP). This can be inferred by comparing its multilateral aid generosity ratio with the average ratio for all donors. Donors with above-average ratios carry disproportionate capacity-adjusted burdens while those with a below-average are free riders. In the literature, services provided by these multilateral institutions are likened to global public goods or club goods so that their financing, similar to financing the provision of any other public goods, can give rise to the free rider problem. The aggregate generosity ratio of 0.09 per cent in the 1970s rose marginally to 0.10 per cent over the next decade, only to fall substantially to 0.08 per cent in the 1990s. Relatively parsimonious countries, i.e., free riders or, rather, 'cheap riders', include Japan, New Zealand, Portugal and the US while the main relatively

[3] European Commission's receipts rose 3.2 per cent per annum because of enlarged European Union membership; regional development banks' receipts rose 4 per cent per annum because of inclusion of the European Bank for Reconstruction and Development (EBRD) established in 1991 for the former communist countries; and receipts by other multilateral institutions grew 8.7 per cent yearly because of inclusion of the 1994-established Global Environmental Facility and Montreal Protocol.

generous nations included Belgium, Canada, Germany, the Netherlands, Norway, Sweden and the UK.

There is need for increased financing of multilateral agencies

There has been a declining trend in the generosity tendency of major financiers of multilateral developmental agencies. Concerted efforts are needed to reverse the trend. This becomes more imperative in view of the expanding number of recipient agencies and the increasing population size of each ultimate recipient country that these multilateral agencies serve. More important, the scope of activities financed by the multilateral agencies has grown with the inclusion of environmental issues and especially the more recent poverty reduction goal. There has also been discussion that the concessional lending window of the World Bank (namely, the IDA) and the equivalent for regional development banks should not only be converted to a grant-giving window but that they should also write-off their outstanding debts to the poor debtor countries. This, due to the cessation of re-flows from their resource transfers to poor countries, would result in diminished resources, necessitating additional replenishment from bilateral donors.

As discussed earlier, increases in total official financing can be brought about through increased budgetary allocations for ODA, institutional measures along the lines of the IFF proposed by the UK government, and the exploration of innovative sources for international development financing. We do not plan to repeat these proposal here, but would emphasize instead the necessity of increasing the multilateral share of donor budgets for ODA. We already endorsed the proposed ‘common pool’, for the collection of donor ODA. The proposal here is essentially another way of introducing the same issue, because the common pool is multilateral. To encourage multilateralism in ODA, the DAC—in assessing performance by members—should attach higher weighting to multilateral than bilateral ODA for determining the total ODA of each donor. For instance, in computing ODA contributions, every US$1 given to multilateral institutions would attract full weight while it would attract only 50 per cent weighting (i.e., treated as only US$0.50) if made bilaterally.

Table 9
Trends in multilateral ODA/GDP ratios, analysed by donor countries, 1970-2000

	%			Average annual growth rate,[a] %		
	1971-80	1981-90	1991-2000	1970-80	1980-90	1990-2000
Analysed by donor countries						
Australia	0.08	0.11	0.07	9.3	-1.4	-4.1
Austria	0.07	0.07	0.08	0.6	1.0	3.9
Belgium	0.16	0.19	0.15	2.9	-0.4	-1.8
Canada	0.16	0.16	0.11	8.6	-0.6	-6.2
Denmark	0.25	0.36	0.40	6.4	2.1	0.1
Finland	0.08	0.17	0.15	3.1	11.0	-5.7
France	0.09	0.13	0.12	2.0	2.0	-3.4
Germany	0.10	0.12	0.12	9.3	-1.4	-0.9
Greece [b]	na	na	0.11	na	na	-4.0
Ireland	0.09	0.10	0.09	9.9	-3.5	1.5
Italy	0.08	0.12	0.10	8.4	-0.1	-0.9
Japan	0.06	0.09	0.07	10.0	-2.2	0.2
Luxembourg [b]	na	0.12	0.14	na	-0.6	3.8
Netherlands	0.21	0.27	0.24	5.8	0.5	-0.4
New Zealand	0.07	0.05	0.05	5.9	-10.5	3.4
Norway	0.27	0.39	0.27	8.5	1.6	-5.9
Portugal [b]	na	0.03	0.07	na	22.7	2.6
Spain [b]	na	0.04	0.08	na	16.8	1.8
Sweden	0.26	0.27	0.23	3.7	0.7	-1.8
Switzerland	0.07	0.08	0.11	5.0	1.6	2.5
United Kingdom	0.15	0.15	0.13	7.0	-1.1	-2.5
United States	0.07	0.05	0.03	6.6	-8.9	-6.8
Non-DAC [b]	na	na	na	na	na	na
TOTAL	0.09	0.10	0.08	7.4	-2.0	-2.6

Notes: [a] Average annual growth rates were calculated by the Least Squares method.
[b] 'na' stands for 'not applicable' or 'not available', as applicable.

Source: DAC's International Development Statistics (online, 2003).

REFORM OF MULTILATERAL DEVELOPMENT INSTITUTIONS

Presently, there are many regional and sub-regional development banks that duplicate the World Bank Group within their own limited geographical domains. They are funded by almost the same group of DAC member countries, whose reputation-backed callable capital provides the institutions with high credit ratings in the international capital markets. The policy question needing to be answered here is whether economies of scale exist in multilateral development banking. Based on casual empiricism, a situation where two or more multilateral development banks (the World Bank, one or more regional banks and one or more sub-regional banks) are lending to a particular country is wasteful and suggests the existence of economies of scale. If the economies of scale exist, a case can be made for mergers, or at least for an institutionalized arrangement for coordination among the multilateral banks to avoid duplication.

Related to the above is the parallel existence of Arab-related multilateral development banks (Islamic Development Bank, Arab Fund for Economic and Social Development, and Arab Bank for Economic Development in Africa) with limited interaction with DAC-related or Western-type institutes. Since both types are working toward the same goals—the development of their common recipient countries—they ought to explore avenues of mutual coordination and shared experiences.

Finally, there is the existence of Western-type multilateral development banks and UN aid agencies. Unlike the UN aid agencies, the former borrow from international capital markets and provide development finance mainly in the form of loans. But this distinction is very thin, as they pursue the same broad goal of development financing. Therefore it is a question of the need to rationalize these agencies, all of which derive basic funding from the same source: the DAC member countries. Given the recent demands of the US and international NGOs that the soft lending windows of the multilateral banks be converted to grant-giving institutions, the distinction between such windows and UN aid agencies would be reduced further. This, again, strengthens the case for the rationalization of the two types of development financing institutions.

FINANCING FOR PSD: NATURE AND SCOPE OF FOREIGN FINANCING

The implicit rationale for foreign official assistance to be targeted to private sector development (PSD) is based on capital/foreign exchange obstacles and particularly entrepreneurial barriers to development. Related to this is the development philosophy of the 1980s, which perceives the private sector to be the engine of growth.

Evidence has sometimes been adduced in the literature to support the view that foreign assistance destined to the official sector of recipient countries is like channelling resources to a ‘bottomless pit’, with practically little or nothing to show for it. One reason often given for this state of affairs is the ensuing dependency syndrome, which merely supplies beneficiary countries with fish to eat, instead of teaching them how to catch fish on their own. Foreign assistance aimed at recipient-country PSD is generally regarded as being less prone to this dependency syndrome. Given these premises, it follows that the government sector should no longer be the almost-exclusive beneficiary of foreign official assistance. Also, the practice arising from the current development philosophy of eliminating poverty and reducing the gender gap through assistance to the public sector has often been ineffective in achieving empowerment. Empowerment is generally better accomplished through a focus on the development of small-scale and microenterprises as well as microfinance institutions in recipient countries. Both bilateral and multilateral donors are now earmarking increasing (albeit still insufficient) portions of foreign transfers to this end.

External sources of finance to developing countries’ private sector come from either the public or private sectors of the developed countries, as well as from NGOs and individuals based in these countries. Official foreign sources can be grants or loans, either concessional or non-concessional. Non-official types of sources can be non-commercial (mainly, private remittances and NGO sources) or purely commercial (mainly in the form of FDI and portfolio capital flows, broadly defined).

NON-COMMERCIAL BUT STILL NON-OFFICIAL SOURCES ARE IMPORTANT AND DESERVE ATTENTION

The NGO channel is relatively insignificant at present and needs to be encouraged

Compared to other financial and economic activities, the amounts being channelled through foreign NGOs are not only insignificant, but also seem to be maintaining a general downward trend. This suggests the need for further efforts to promote the role and activities of these PSD development agents so as to keep pace with other economic and financial factors.

However, bearing in mind that foreign NGOs do not have democratic mandates, the channels through which they reach ultimate beneficiary enterprises should be harmonized with the overall development objectives and strategies of the recipient-country governments. The NGOs should be required to work with and, if necessary, through the latter.

Workers' remittances also need to be facilitated

For many developing countries, receipts from worker remittances are used for financing PSD, and the amounts surpass proceeds from all other foreign sources—official, commercial and otherwise combined. The international market for remittances is segmented and costly, as money transmitter operators charge high fees and use overvalued exchange rates. Commercial banks in both source and recipient countries account for only a small share of the global remittances market. The mode of making remittances should be more organized.

More important, more attention needs to be focused on immigration issues in various international development policy arenas. If host countries have more humane policies towards immigrants from the developing world, this could generate much more external development finance than conventional official sources.

OFFICIAL FINANCING FOR PSD

There are narrow and wider concepts of PSD but the present interest is mainly on the former

In a sense, official financing of PSD, whether channelled directly to business enterprises or indirectly through recipient governments, refers to all forms of foreign official bilateral and multilateral financial support that is intended to benefit the business sector of the recipient country. But a narrow and more focussed concept (adopted here) refers only to the type of support that is directly channelled to—and also directly benefits—the business enterprises, without government guarantee.

Support for PSD has become the 'toast' of official bilateral and multilateral financiers, with many instruments and many channels of interventions

Within the context of this narrow concept, it is not just the volume of official financial flow that matters. First, of central importance are the type and extent of entrepreneurial assistance packaged with it. In the context of multilateral sources, such entrepreneurial support (including the provision of a 'template' for private investors to replicate and the undertaking of pioneering experimental projects) is actually a part of the role of a development bank. Second, the investment-banking role (co-financing, loan syndication, risk and credit guarantees, etc.) is also important because of the catalytic effect it might have. It is expected that such a catalytic effect (foreign source or cross-border) will be high in sectors and/or countries which attract the interests of foreign private investors (including foreign banks) or where they can be relatively easily 'cajoled' into committing funds.

Bilateral donors have various instruments for supporting PSD in developing countries, and most donor aid agencies now have specialized units for PSD-related assistance. On the multilateral front, many multilateral development banks and non-bank institutions provide PSD assistance in one form or the other. Many UN agencies (UNIDO, IFIAD, UNDP, UNESCO, etc.) offer technical support and grants, particularly for small-scale business and microenterprise development. Also, many multilateral development banks, particularly the World Bank Group, provide indirect support through their adjustment lending with the aim of improving the business environment in developing countries. More important, they provide direct financial and non-financial forms of support. Some are established exclusively to provide financial support for PSD, while others whose original mandate was to provide direct support to the public sector, have since diversified into establishing more or less autonomous affiliates charged with the provision of direct support for PSD. Other multilateral development banks, albeit without similar autonomous affiliates in their organizational structures, are providing direct financial and non-financial assistance to enterprises in the countries of their domain, generally through non-autonomous organizational units or departments. They also have specialized units for microfinance and microenterprises.

But there is the need for coordination in many areas

At present, with respect to PSD, there is little coordination between multilateral agencies, bilateral donors, or even amongst different divisions or windows of the same multilateral agency and there is little evidence of any clear division of labour. There is scant evidence of information-sharing or even of knowledge of each other's portfolios. Although this lack of coordination (and the fact that donors tend to formulate similar programmes) can be considered an advantage because it provides developing countries with a large reservoir of funding, it also militates against their ability to choose between programmes on a strategic basis and generates incoherence. This, in turn, makes the ownership of PSD by developing countries more difficult. Furthermore, there is overlap in terms of destination by sector and country.

Also, attention should be paid on how to catalyse and avoid crowding-out foreign commercial flows

The investment bank-like activities associated with foreign financing of PSD (for example, through co-financing, loan syndication, risk and credit guarantees, etc.) are expected to have a catalytic effect by leveraging foreign commercial capital. Official financing, by carefully selecting destination sectors and countries, is expected to avoid displacing or crowding-out existing foreign finance so as to maximize its overall catalytic effect.

However, available empirical evidence suggests that official financing has not achieved many catalytic nor cross-border effects. Therefore, achieving significant catalytic effects remains a challenge faced by the national and multilateral aid agencies.

In addition, the geographical allocation of finances needs improvement through additional allocations to low-income countries

Commercial capital flows are lopsided in favour of the high- and middle-income developing countries, with virtually nothing going to low-income countries—except those to the latter's mining enclaves. This imbalance is supposed to be at least partly rectified by official PSD financing. However, the bulk of official bilateral and especially multilateral financing for PSD goes to the high- and middle-income developing countries, reinforcing the existing imbalance. It is therefore being suggested here that more allocations be made to low-income countries.

Finally, microfinancing objectives and strategies should be streamlined, and inconsistencies eliminated

There is an inherent tension between profitability (to ensure continuity and growth in the scale of operations) and the social or developmental roles of the aid agencies, particularly the multilateral ones like the IFC. However, this tension seems more magnified when it comes to the financing of microfinance institutions (MFI) for on-lending to microenterprises.

An interesting recent development is the attention now being focussed by donors on microfinance and microenterprises, as donors currently see this channel as a way of accomplishing the goal of poverty reduction in developing countries. Also, donors' involvement in the microfinance movement over the past decade or so is explained mostly by their desire, through financial and technical support, to create and sustain MFIs as social enterprises. These MFIs are supposed to have 'a double bottom line' with both financial/institutional and social objectives. Therefore inherent conflicts exist between the target of financial *sustainability* and the *outreach* of the poor that donors supporting developing-country microfinance institutions often expect of these institutes.

It is being suggested here, however, that donors should be more aware of the tradeoff between the two goals in their microcredit campaigns when microfinance mechanisms are instituted in different local conditions. The tension between the two objectives at the conceptual level is in fact directly translated into incredible pressures on both the microfinance institutions and their clients in the field in many parts of the world. Donors should not try to preach for a standardized across-the-board attainment of full financial sustainability for all microcredit programmes in an unrealistically short period. Instead, they should, in the light of local conditions, pay more attention to projecting a realistic timeframe for attaining different categories of financial sustainability for each of their sponsored MFIs, and for helping to draw up a strategic plan of measures and policies to achieve intermediate targets in sequence. Also, the challenge that economists and the donor community should acknowledge is the need to design a microfinance programme so that the subsidy element would not be used as a mere justification for permanent inefficiency so as to perpetuate aid dependency culture, as is sadly observed in many other official aid programmes.

COMMERCIAL CAPITAL FLOWS ARE NOT ONLY VOLATILE, BUT ARE UNACCEPTABLY GEOGRAPHICALLY LOPSIDED

Two major issues are pertinent to commercial capital flows to the developing countries. First, the flows (especially the portfolio type) are highly volatile or temporally unbalanced in the sense that a period of very high net inflows is often accompanied by a period of excessively low volume of net inflows, if not outflows. Second, and more important, the flows—whether FDI or portfolio—are geographical unbalanced so that the low-income developing countries receive virtually nothing except the little FDI that trickles to their mineral enclaves.

The first issue here is more systemic than developmental and calls for international financial architecture. The second issue, on the other hand, poses a serious developmental challenge which has to be addressed through international concerted efforts. Otherwise, low-income developing countries will continue to be marginalized far into the distant future in terms of the inflow of commercial capital, including FDI. This is because these countries are still characterized by low levels of per capita income, fragmented and underdeveloped financial systems, low levels of integration into the international trading and financial systems, poor infrastructural bases, and a slow pace of response of economic fundamentals to reforms that could appreciably raise the level of investor confidence. Efforts of the international development partners should be geared towards the amelioration of these obstacles and reduction of the investment risks associated with low-income countries. In addition, as pointed out earlier, re-direction of official bilateral and multilateral financing for PSD in favour of low-income countries can rectify this imbalance.

REDUCTION OF FLIGHT CAPITAL AND ITS REVERSAL HAVE ENORMOUS POTENTIAL TO BOOST FINANCING FOR PSD

Existing stock of flight capital is enormous

Capital flight is still a serious issue. Many developing countries have suffered from considerable capital flight over the last few decades. The potential for capital reversal is quite substantial. In 1998, stocks of capital flight held abroad amounted on average to over 40 per cent of GDP for the Sub-Saharan African countries; for the East Asian countries these stocks were 60 per cent of GDP. Thus there may be potentially large resources available for development financing if countries are able to introduce policies to promote the reversal of capital flight. A review of the theoretical and empirical literature on the determinants of capital flight provides insights into the factors that may possibly contribute to this reversal.

Macroeconomic stability is necessary for reversal of flight capital

Policymakers have to recognize the need for macroeconomic stability in order to stem continued capital flight and induce capital flight reversal. Macroeconomic instability may appear in a number of ways: budget deficits rise, current account deficits increase, exchange rates are overvalued, and inflation grows. In all these cases, macroeconomic instability leads (indirectly) to increased taxes and tax-like distortions. This lowers returns, increases risk and uncertainty of domestically-held wealth and compounds the incentives for capital flight. In this context, it is necessary to adopt appropriate exchange rates and positive real interest rates, as well as pay attention to budget deficits in order to increase the prospects for the reversal of capital flight.

But, so is political stability

Policymakers also need to look at the institutional context in which good macroeconomic policies have been carried out. The institutional context itself may give rise to capital flight. Public sector behaviour may have an impact on the risks and uncertainty regarding the policy environment and its outcomes. More specifically, residents—due to a lack of confidence in the domestic political situation and its consequences for the future value of their assets—may decide to hold their assets abroad. Hence, political stability is important in order to stem continued capital flight and induce capital flight reversal.

As also are enhanced private capital flows and more sustainable external debt position

Capital flows may be an important determinant of capital flight, mainly because high inflows could signal future payment problems for the government. If residents perceive that the costs of these repayments are passed on to them by the government, for example through an inflation tax, they may choose to convert their domestic assets into foreign assets. Moreover, the occurrence of capital flight itself stimulates agents to hold money abroad, since the future cost of debt repayment by the government has to be shared by a decreasing number of wealth holders. In this context, policymakers need to pay attention to external debt management. Building up large stocks of external debt may actually reduce resources available for macroeconomic policy when this leads to large capital flight by residents. The empirical evidence is clear on the importance of adverse incentives of large external debts on investment decisions by domestic wealth holders. Knowing this, the international financial community may be advised to consider providing debt relief in a number of individual country cases.

And an appropriate rate of return differentials, too —although this may be a less important factor

Consistent with economic theory and empirical studies, capital flight may occur simply because the returns on assets are higher abroad compared with assets held domestically. In order to deter continuing capital flight and promote capital flight reversal, policymakers should not only maintain positive real interest rates but also ensure a competitive interest rate and capture the covered and uncovered parity conditions. Yet, a review of the empirical evidence would also show that interest rate differentials in general have been a less important determinant of capital flight. Therefore, maintaining a positive interest rate differential may be a necessary but not sufficient condition to secure capital reversals.

CONCLUSION

The destination countries can do much to promote financial flows, but the source countries can do even more

There are many types and sources of external development financing, each with its own unique characteristics. Developing countries need them all as sources of external development finance. Consequently, inflows from all sources, albeit in the right mix, should be encouraged.

Some of the policies for enhancing inflows are at the instance of the developing or recipient countries themselves. These include the promotion of appropriate and enabling macroeconomic, technological, institutional and political environments, and the recipient countries need to make improvements along these lines.

However, much of the increase in inflows can be brought about only through the actions and interventions of the developed or source countries. First, they can use official transfers to leverage improvements in the enabling economic, technological, institutional and political environments of the destination countries. Indirect official transfers via multilateral institutions should have a comparative advantage in accomplishing this. Second, they can use the same official transfers to leverage and 'crowd-in' commercial flows to the same destination countries. Third, by increasing the volume of official transfers, they would increase the totality of flows directly.

More questions have been raised than answers provided

What is discussed in this Policy Brief is addressed to researchers, academics, scholars, policymakers, and to the staffs of bilateral and multilateral aid agencies and NGOs, etc. However, it has to be noted that the sustainability of external development financing covers a very wide area. While the scope is briefly covered here, many of the areas are yet to be thoroughly examined by researchers. This is particularly the case with the official financing aspect: for example, researchers have hardly analysed the fact of why some donors are parsimonious while others are generous, or why some are more inclined to tie their bilateral aid than others.

Efforts have been made to address a number of these issues, from examining the basics in some of the background studies to this overview Policy Brief, but the findings are still too tentative and exploratory for any definite policy conclusions to be made. As a result, in a number of cases we refrain from making definite statements. Instead, we have tried to identify the issues needing further investigation and study. However, this is not to say that the Policy Brief is completely void of policy recommendations and conclusions—and some of these may appear provocative, if not radical.

PUBLICATIONS

The UNU-WIDER project on the 'Sustainability of External Development Finance' has resulted in several publications, including WIDER Discussion Papers, an edited manuscript and special issues of three academic journals.

External Finance for Private Sector Development: Appraisals and Issues

edited by Matthew Odedokun, published by Palgrave Macmillan (isbn 1-4039-2091-5)

Chapter 1 Foreign Financing of Developing Countries' Private Sectors: Analysis and Description of Structure and Trends
Matthew Odedokun

Chapter 2 Comparative Appraisal of Multilateral and Bilateral Approaches to Financing Private Sector Development
Peter Gibbon and *Lau Schulpen*

Chapter 3 Bilateral Official and Non-governmental Organizations' Support for Private Sector Development
Ayodele Jimoh

Chapter 4 Multilateral Development Banks and Private Sector Financing: The Case of IFC
George Mavrotas

Chapter 5 Donors' Support for Microcredti as Social Enterprise: A Critical Reappraisal
Machiko Nissanke

Chapter 6 Flow of Foreign Direct Investment in Developing Countries: A Two-Part Econometric Modelling Approach
Oluyele Akinkugbe

Chapter 7 Flight Capital and its Reversal for Development Financing
Niels Hermes, Robert Lensink, and *Victor Murinde*

Chapter 8 The 'Pull' and 'Push' Factors in North-South Private Capital Flows: Conceptual Issues and Empirical Estimates
Matthew Odedokun

Journal of Economic Development, volume 28, number 1, June 2003

Four Selected Articles from the UNU/WIDER Research Project on "Sustainability of External Development Finance". Guest Editor: Matthew Odedokun (issn 0254-8372)

An Examination of the Long-run Trends and Recent Developments in Foreign Aid
Howard White and Simon Feeny

Analysis of Deviations and Delays in Aid Disbursements
Matthew Odedokun

Modelling Aid Allocation: Issues, Approaches and Results
Mark McGillivray

Strategic Interaction, Aid Effectiveness
and the Formation of Aid Policies in Donor Nations
S. Mansoob Murshed

The World Economy, volume 27, number 2, February 2004

UNU/WIDER Special Issue on Development Financing, edited by Matthew Odedokun (issn 0378-5920)

Introduction – Sustainability of Development Financing:
Multilateral Issues and Perspectives
Matthew Odedokun

Reforming the International Financial System for Effective Aid Delivery
Sylvanus I. Ikhide

Conditionality and Aid Effectiveness Re-evaluated
Oliver Morrissey

Donor Funding of Multilateral Aid Agencies:
Determining Factors and Revealed Burden Sharing
Tony Addison, Mark McGillivray and Matthew Odedokun

Innovative Sources of Development Finance:
Global Cooperation in the Twenty-first Century
Raghbendra Jha

Financing the Provision of Global Public Goods
P. B. Anand

Multilateral and Bilateral Loans versus Grants: Issues and Evidence
Matthew Odedokun

Bankruptcy Proceedings for Sovereign State Insolvency
Jonathan P. Thomas

Arab-related Bilateral and Multilateral Sources of Development Finance:
Issues, Trends and the Way Forward
Eric Neumayer

International Review of Economics and Finance, volume 13, forthcoming 2004
(issn 1059-0560)

Trends in the Volume and Allocation of Official Flows from Donor Countries
Howard White

Bilateral Donors' Aid Allocation Decisions. A Three-dimensional Panel Analysis
Jean-Claude Berthélemy and Ariane Tichit

Descriptive and Prescriptive Analyses of Aid Allocation:
Approaches, Issues and Consequences
Mark McGillivray

Aid Effort and its Determinants
Jeffery I. Round and Matthew Odedokun

Strategic Interaction and Donor Policy Determination
S. Mansoob Murshed

Additionality of Debt Relief and Debt Forgiveness,
and Implications for Future Volumes of Official Assistance
Léonce Ndikumana

Bankruptcy Proceedings for Sovereign State Insolvency
and their Effect on Capital Flows
Jonathan P. Thomas

POLICY BRIEFS

PB1 Forests in Global Warning, by Patrick Humphreys and Matti Palo, January 1998 (available only in PDF from www.wider.unu.edu)

PB2 Social and Economic Policies to Prevent Complex Humanitarian Emergencies: Lessons from Experience, by Jeni Klugman, March 1999

PB3 Access to Land and Land Policy Reforms, by Alain de Janvry and Elisabeth Sadoulet, April 2001

PB4 Inequality, Growth and Poverty in the Era of Liberalization and Globalization, by Giovanni Andrea Cornia and Julius Court, November 2001

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