TD(X)/RT.1/11

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

UNCTAD X

High-level Round Table on Trade and Development:

Directions for the Twenty-first Century

FINANCING FOR DEVELOPMENT: CURRENT TRENDS AND ISSUES FOR THE FUTURE

Distr.
GENERAL

TD(X)/RT.1/11
25 January 2000

Original: ENGLISH

UNCTAD X

High-level Round Table on Trade and Development: Directions for the Twenty-first Century

Bangkok, 12 February 2000

FINANCING FOR DEVELOPMENT: CURRENT TRENDS AND ISSUES FOR THE FUTURE[*]

Paper prepared by
Kwesi Botchwey
Harvard University, Cambridge, MA

* The views expressed in this paper are those of the author and do not necessarily reflect the views of the UNCTAD secretariat.

GE.00-50278

Executive Summary

In the wake of the recent financial crisis in Asia there has been a renewed interest, and much debate, in academic and policy-making circles alike on the structure and working of the international financial system. While the issues raised in this debate are by no means irrelevant to the low-income countries in sub-Saharan Africa and South Asia, they do not deal with the most critical development problem that these countries face, namely, the increasing scarcity of development finance, especially long-term development finance. The marginalization of these regions in the global debate on the international financial architecture is as much a reflection of their marginalization in the real world of global trade and finance as it is of the complacency to which the seeming triumph of "market forces" has given rise. But although they are largely marginalized in global trade and finance, these countries are not spared the effects of an international financial crisis. They pay for it in reduced growth, in terms of trade losses and in reduced capital flows.

The 1990s have indeed witnessed a phenomenal increase in the amount of private capital flows, especially FDI flows, going to the developing countries. These developments have helped fuel the belief that the market can be trusted to provide the financing that the poorer regions of the world need for their development. However, a closer examination shows that the situation is not quite as sanguine as the general trends might suggest. What is evident is that these large private flows are highly concentrated in a few developing countries. A handful of middle-income countries, mainly in East Asia, account for the bulk of all capital market financing. Even the increase in capital market flows to low-income countries in recent times has been highly concentrated, with the bulk of it going to India alone. The picture is much the same for FDI flows, with close to three quarters of these flows going to about ten middle-income countries in the period 1992–1998, while the oil and mineral exporting countries account largely for the flows going to the low-income countries.

For the vast majority of developing countries and for the low-income countries in particular, official development assistance remains the most significant source of external finance. Yet these official flows have been falling in recent times and all indications are that we are unlikely to see a return to the peak years, although the policy environment in most of these countries is much better than it has been in more than two decades. At the same time, although many low-income countries, including a good number in sub-Saharan Africa, have begun to improve domestic resource mobilization efforts, with impressive results in some cases, domestic resource mobilization cannot realistically be expected to yield anything approaching the level of resources required to sustain, let alone accelerate, the recently improved rates of growth in these countries.

These low-income countries also face well-known and long-standing protectionist barriers in developed country markets in their attempts at export diversification, especially into clothing and textile exports, and are, moreover, burdened by unsustainable levels of external debt and debt servicing ratios that not only dampen the enthusiasm of foreign investors but also preempt vital social and economic investments.

The low-income countries bear much of the responsibility for reversing these trends by pursuing policies that boost growth, enhance competitiveness and help the repatriation of flight capital. Concerted international action is required to improve the effectiveness of aid in these countries but, more importantly, to expand their participation in international trade as well as improve their access to private capital. Debt relief involving a total write-off of outstanding debt for countries undertaking credible efforts at economic reform, along with increased aid flows, would help provide significant fresh resources for domestic investment, especially in the social sectors, and also improve the outlook for foreign investment. In addition, international action would need to focus on creative new mechanisms for mobilizing and channelling long-term capital to the low-income countries. Sub-Saharan Africa must occupy a special place in these efforts by reason of the enormity and complexity of its development challenges.

CONTENTS

Page

FINANCING FOR DEVELOPMENT:
CURRENT TRENDS AND ISSUES FOR THE FUTURE

Kwesi Botchwey

INTRODUCTION

The 1997 Asian financial crisis spawned a vigorous debate about the weaknesses in the international financial system and a frantic search for remedies. The debate was, for the most part, concentrated on problems caused by the volatility of short-term capital flows, and, in particular, on ways, not only of managing crises once they break out, but also of anticipating and preventing them in the future. At a general level, these issues are no doubt important for all countries, including even those in low-income regions of the world that are as yet marginalized from the growing universe of private capital flows. While the recent financial crisis affected the entire world economy, its effects were much more trenchant for the developing countries as a whole than for the developed ones. The GDP growth of the developing countries as a group fell in the immediate wake of the crisis to less than 2 per cent, as they suffered the combined effects of a slowdown in world import demand, a deterioration in the terms of trade and a decline in capital inflows. Net financial flows to developing markets from international markets fell sharply from about $136 billion in 1997 to $72 billion in 1998 (World Bank/IBRD, 1999: 24). Flows to the relatively better performing low-income countries, which in recent years have begun to improve their access to capital financing, also fell from $6 billion in 1997 to $5 billion in 1998. For sub-Saharan Africa (SSA) and South Asia, net equity flows reportedly fell to almost zero from their levels in 1997 (World Bank/IBRD, 1999). Thus, the issues in the debate on crisis prevention and resolution in a new financial architecture are important for all countries, but even more so for the developing countries as a whole. There are lessons to be learned from these recent experiences – especially by the so-called emerging market group of countries in the developing world – notably concerning the dangers of large and rapid accumulation of foreign debt, particularly from short-term loans, and the use of such capital for speculative investment. An equally important lesson that these countries must heed is the crucial importance of overall macroeconomic stability and the proper management of financial sector reforms and capital account liberalization in national development.

However, there can be no denying that the financial architecture debate has mostly failed to address, or even to recognize, the most pressing problem that the low-income countries face, namely the availability of development finance, especially long-term finance. The insistence that this issue be addressed and concrete mechanisms included in the new financial architecture better

to secure the flow of development finance to the most needy regions of the world is often met with barely disguised bemusement, or polite silence at best, in these debates.[1]

Sub-Saharan Africa's peculiar circumstances serve to put the matter in perspective. For the non-oil producing countries in the region, excluding South Africa, by far the largest proportion of all international flows through the 1990s has come from concessional loans and grants, about three quarters of which have been offset by terms-of-trade losses, thanks to the extreme dependence of these countries on a narrow range of primary commodity exports. To compound matters, they also suffer from a high amount of capital flight and, by 1997, their external debt stock had risen to a level equivalent to over 80 per cent of their combined GDP. Yet, just to achieve the poverty reduction target set by the international community of halving poverty by the year 2015, these countries will have to sustain, for over a generation or more, a rate of real GDP growth of about 8 per cent by some estimates, implying financing needs that obviously go well beyond domestic resource mobilization possibilities. For these countries, and for most of the developing countries, therefore, the issue is clearly not how to deal with the problems of short-term capital volatility, for they attract precious little of it in the first place. About 90 per cent of all private capital flows in the 1990s (loans, bonds, portfolio equity flows and foreign direct investment – FDI) has gone to the middle-income countries. The issue is how to improve their access to more varied and secure sources of development finance, and end their precarious dependence on official development assistance (ODA). Although IDA-12 – the World Bank's soft loans arm – was recently replenished successfully, net concessional assistance to developing countries (mostly in sub-Saharan Africa and South Asia) fell slightly in 1998 compared to 1997, and it pales into insignificance compared to the $190 billion put together in rescue packages for the crisis-stricken countries.[2]

This paper reviews the lessons learned from international experience with development finance from the particular perspective of the low-income, mostly sub-Saharan African countries, whose growth and stability depends most critically on the availability of external, long-term development finance.

Section I looks at the determinants, evolution and concentration of international capital flows. Section II reviews the current trends and issues in the evolution of ODA. Section III argues the case for debt relief as development finance and reviews the Heavily Indebted Poor Countries (HIPC) Initiative of the World Bank and IMF in its post-Cologne form and terms, with particular regard to country eligibility and resource additionality. Section IV draws lessons from the current trends in the evolution of the various constituents of development finance, and recommends actions at the country, regional and international levels to improve the outlook for such finance.

---

[1] In the economics profession itself, the business of estimating financing gaps according to the Harrod-Domar growth model has long gone out of fashion. Only its ghost still lurks. See table 2 for investment rates in Fisher et al. (1998).

[2] Within the space of a few months, August–December 1998, the international community pledged this sum in support of Brazil, Indonesia, the Republic of Korea, the Russian Federation and Thailand. The amount does not include the $30 billion pledged by Japan in support of the East Asian countries (see World Bank/IBRD, 1999: 91–92).

I. THE EVOLUTION AND CONCENTRATION OF INTERNATIONAL CAPITAL FLOWS

A. Private capital flows

The 1990s have witnessed a phenomenal increase in the level of private flows from international capital markets to developing countries and a consequent shift in the composition of capital flows going to these countries. In 1990, of the net long-term resource flows of just over $100 billion, official flows accounted for about 57 per cent. By 1996, before the onset of the Asian crisis, net resource flows had rocketed to $338 billion, of which $299 billion came from private sources. To be sure, these numbers do not capture the whole story of financial transactions between the developing countries and international capital markets. Among other things, they do not take account of capital outflows, which, by some estimates, were quite considerable in the 1990s, especially in the wake of the 1997 Asian crisis. Nevertheless, they mark a distinctive trend in the growth and composition of capital flows to developing countries, underscoring the much-diminished importance of importance of ODA. The most remarkable increase has been in the sub-component of FDI flows to developing countries, which grew from a mere $24.5 billion in 1990 to over $163 billion in 1997, and accounted mainly for the huge increase in average annual flows of global FDI in recent times. The share of global FDI flows going to developing countries rose from 18 per cent in the mid-1980s to an estimated 42 per cent in 1998 (World Bank/IBRD, 1999: 48, fig. 3). A number of factors account for this, among them policy liberalization, regional integration, and technological changes in transport and communications.

The surge in private capital flows to the developing countries helped to fuel the belief that the development financing needs of all developing countries could be met by the normal working of the market. A closer examination of the underlying trends shaping this market, however, suggests that such optimism is misplaced, as these large flows have been concentrated in a handful of countries, namely the so-called emerging market group of countries in East Asia and Latin America, as well as South Africa. The middle-income countries have accounted for over 90 per cent of capital market financing during the 1990s. Moreover, although flows from capital market financing to low-income countries have been rising in recent years, they too are concentrated in a handful of these countries. For instance, of the total private capital flows of about $4.7 billion in 1998, India alone accounted for 70 per cent.

The picture is not much different for FDI, which, on balance, has been far more important for developing countries, especially low-income countries, than capital market flows. Although FDI flows to developing countries have grown the fastest, as we have already noted, and have become more diversified in their country destination, they too have been highly concentrated in a few countries. Ten middle-income countries accounted for about 70 per cent of FDI flows to developing countries in the 1992–1998 period, while middle-income countries as a group accounted for over 90 per cent, compared to 6–7 per cent for the low-income countries. There is a further differentiation in the country destination of FDI flows going to the low-income countries. The vast bulk of these flows have tended to go to the mineral and oil exporters among

them. For the period 1990–1997, FDI accounted for about 68 per cent of total long-term capital flows to low-income mineral producers, compared to under 29 per cent for others (table 1).

Table 1

Share of FDI in long-term private flows to developing countries, 1990–1998

(Per cent)

Country or country group	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998* [a]
Middle-income	59.0	57.0	46.2	39.9	50.3	51.6	44.8	54.2	68.2
Excluding China	63.1	56.8	44.3	29.8	40.8	42.5	36.4	49.1	62.1
Top 10 countries	50.2	54.4	44.8	39.6	58.4	57.9	50.5	59.0	72.8
Excluding China	52.9	53.5	41.5	24.4	45.8	44.5	38.3	52.6	65.2
China	43.0	58.2	52.4	69.5	76.1	82.0	80.2	72.8	89.4
Low-income non-oil exporters									
Mineral producers	78.5	81.6	59.5	69.7	51.3	63.8	66.0	76.6	n.a.
Others	-3.3	32.5	21.3	17.0	19.2	50.5	48.0	46.8	n.a.
Low- and middle-income oil exporters	**	82.6	209.7	67.1	64.2	69.5	74.7	95.4	n.a.

Source: World Bank/IBRD (1999): 52.

a Preliminary.

****** Large negative number (caused by negative total net flows).

Although there is reason to believe that the medium- to long-term prospects for international market flows to the developing countries are good, the prospects for the low-income countries may not be quite as sanguine, as transaction costs (particularly in sub-Saharan Africa) tend to be high and risk perceptions often exaggerated.

The picture that emerges from the above analysis is one of rising flows of capital market financing and FDI to an increasingly diverse, but still concentrated, sub-group of countries in the developing world. It is therefore necessary, in the light of these trends, to classify the developing countries into at least three categories:

- The emerging market countries, mostly the middle-income countries in East Asia, Latin America and South Africa. This group will include: Argentina, Brazil, Chile, China, Malaysia, Mexico, South Africa, Thailand and Venezuela;

- The oil and mineral exporting countries among the low-income countries, mainly in sub-Saharan Africa and South Asia.

- The so-called high performing countries among the low-income countries, mainly in sub-Saharan Africa and South Asia. India would be easily the dominant country in this group.

B. Foreign direct investment

As already discussed, FDI flows – as with capital market flows – which have been the fastest-growing component of long-term flows to developing countries as a whole and which, in the estimation of most analysts, are likely to remain the main source of foreign finance to developing countries over the long term, will, in the final analysis, depend on the growth and stability of the world economy. Moreover, it is important to note that the factors that have been shown in recent studies to be associated with the rapid growth in FDI in the 1990s, including the policy environment, high growth rates, low transaction costs and market size, are not particularly strong in the low-income countries, which have thus far been minor players in the world of FDI flows.

II. EVOLVING TRENDS IN OFFICIAL DEVELOPMENT FINANCE

Official development finance, comprising grants and long-term concessional and non-concessional loans from bilateral and multilateral sources, is the other source of development finance to developing countries. It was indeed a major source of such finance throughout the 1970s and 1980s, when it constituted more than half the total resource flows to developing countries. Even at the start of the 1990s, official flows made up a larger proportion of these resource flows (table 2). However, from a peak in 1991, when they reached about $63 billion, net official long-term flows have declined both in absolute terms and as a percentage of total resource flows to developing countries, falling from about half at the beginning of the 1990s to just over a fifth of total resource flows in 1998. To be sure, some of this decline is attributable to currency values and classification factors (World Bank/IBRD, 1999: 70). But even after correcting for these factors, the decline in net flows of ODA in real terms has been significant, with only four countries – Denmark, the Netherlands, Norway and Sweden – exceeding the UN target for ODA of 0.7 per cent of GNP. The decline has been particularly marked in the G-7 countries.

Apart from the decline in the levels of ODA, there are other important trends that affect its role as a source of development finance. First, the share of ODA directed to emergency and relief work has risen, as has the share going to the administration of aid programmes in the donor countries themselves. Secondly, although the proportion of tied aid in total development assistance has reportedly fallen from a peak of about 50 per cent in 1979 to an estimated 20 per cent in 1996, it is still significant in terms of its impact on cost effectiveness. Some

Table 2

Long-term flows to developing countries, 1990–1998

($ billion)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998* [a]
Net long-term resource flows	100.8	123.1	152.3	220.2	223.6	254.9	308.1	338.1	275.0
Official flows	56.9	62.6	54.0	53.3	45.5	53.4	32.2	39.1	47.9
Private flows	43.9	60.5	98.3	167.0	178.1	201.5	275.9	299.0	227.1
International capital markets [b]	19.4	26.2	52.2	100.0	89.6	96.1	149.5	135.5	72.1
Foreign direct investment	24.5	34.4	46.1	67.0	88.5	105.4	126.4	163.4	155.0

Source: World Bank/IBRD (1999): 14.

***Note*:** Although the Republic of Korea is a newly industrializing country, it is included in the developing country aggregate since it is a borrower from the World Bank.

a Preliminary.

b Bonds, loans, and portfolio equity flows.

estimates suggest that aid tying increases the cost of supplies by between 10 to 30 per cent (World Bank/IBRD, 1999: 73).

Even so, the evidence of recent cross-country economic analysis confirms the rather self-evident view that aid not only promotes growth in countries where the policy environment is good, but also “crowds in” private investment and improves investor perceptions of risk. The World Bank cites the cross-country studies suggesting that an increase in aid of 1 per cent of GDP in the recipient country increases private investment by an additional 1.9 per cent of GDP in countries with good policies (World Bank, 1998). At the same time, the policy environment has improved markedly in the vast majority of countries in South Asia and sub-Saharan Africa. According to the World Bank’s suggested criteria of growth, inflation and trade openness, policy performance in both sub-Saharan Africa and South Asia is better now than at any time in the previous quarter century.

It is therefore rather ironical that ODA should be experiencing a steady decline even as conditions are improving for its greater effectiveness. The prospects for a reversal of this trend are at best mixed. While a small number of countries increased their ODA budgets in 1998, it has been significantly reduced in Japan, which has been the largest donor in recent years. Fiscal constraints and the need to reduce deficits (in compliance with criteria set in the Maastricht Treaty for EU member States, for example) have been cited, and will probably continue to exercise a restraining influence on future aid flows, although recent experiences with international resource mobilization suggest that these constraints can be overcome with amazing speed when the stability of the international financial system is threatened! In the light of these experiences, it is probably true to say that the radical shift in strategic interests on the part of the leading industrialized

countries following the end of the cold war is the most credible explanation for the downward trend in ODA, and may very well also determine future trends.

The low-income countries are a particularly capital scarce group among the developing countries. They must import capital from the developed countries (and use it efficiently) even as they improve the environment for domestic resource mobilization through increased savings, which have tended to closely match investment rates.[3] Indeed, their need to reduce reliance on foreign savings is widely recognized. Such an effort is being made in sub-Saharan Africa, for instance, with some impressive results (see table 3). At the same time, it is also recognized that

Table 3

International comparison of savings and investment

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997* [a]	*1990–1994*	*1995–1997*
Investment										
Sub-Saharan Africa	16.2	17.1	16.9	16.4	17.5	18.2	17.7	17.4	16.8	17.8
Western hemisphere	20.2	19.7	20.5	20.3	20.4	20.0	20.4	21.0	20.2	20.5
Asia (excluding Japan)	30.1	30.3	30.8	34.6	34.0	34.6	35.5	34.3	32.0	34.8
Newly industrializing countries of Asia	31.1	32.1	31.7	31.0	32.3	32.3	32.1	31.0	21.0	20.9
Advanced economies	22.1	21.4	20.7	20.1	20.6	20.7	20.8	21.1	21.0	20.9
Private investment										
Sub-Saharan Africa	11.8	12.8	13.1	11.3	12.3	13.2	11.7	11.7	12.3	12.2
Western hemisphere	–	14.3	15.6	15.8	15.4	15.0	15.7	16.2	15.3	15.6
Asia (excluding Japan)	18.2	18.5	18.4	18.4	19.2	20.4	20.9	21.0	18.5	20.8
Newly industrializing countries of Asia	24.1	24.8	24.6	23.8	24.3	25.3	25.1	24.5	24.3	25.0
Advanced economies	18.1	17.4	16.6	15.9	16.6	16.8	16.9	17.2	16.9	17.0
Domestic savings										
Sub-Saharan Africa	18.4	17.6	15.6	15.9	16.6	16.7	17.4	17.0	16.8	17.0
Western hemisphere	20.1	18.5	17.8	16.9	17.5	18.0	18.6	18.0	16.8	17.0
Asia (excluding Japan)	29.2	30.0	30.0	31.9	33.0	33.2	33.9	32.2	33.6	32.6
Newly industrializing countries of Asia	34.4	34.2	33.3	33.3	33.0	33.2	32.4	32.2	33.6	32.6
Advanced economies	21.5	21.2	20.2	19.7	20.2	20.8	21.0	21.2	20.6	21.0

Source: IMF, African Department and World Economic Outlook databases (various years); Fisher et al. (1998).
a Preliminary.

3 For investment rates see Fisher et al. (1998, table 2).

in the near term, these efforts will continue to be constrained by low levels of income. In these countries, therefore, and especially in sub-Saharan Africa, capital scarcity has been filled largely by ODA, the outlook for which is not promising, as discussed in the preceding section. Given the limited prospects for a significant and sustained upturn in the level of ODA flows, the future of the low-income countries depends on their ability to attract larger flows of FDI, the dynamics of which have also been examined above. Increased reliance on FDI will not only enable them to avoid a worsening of their debt burden, it will also, hopefully, improve their access to technology and management expertise. We now turn to the issue of debt relief for the low-income countries, both as a way of improving their ability to attract FDI and also as a way of providing them with additional and predictable financing for development.

III. DEBT RELIEF AS DEVELOPMENT FINANCE

Ever since the HIPC Initiative was launched in 1996, it has become the framework and the operational instrument for negotiations and for the provision of debt relief to debt-burdened developing countries. A reduction in the debt stock through this initiative would promote growth by attracting more investment, especially FDI. At the same time, resources freed through relief from debt servicing would help finance larger investment spending by government, provided the cost of the scheme is not financed by a diversion of current or existing ODA resources.

Under the original HIPC Initiative, eligible countries qualified for debt relief once they went through two stages of three years each. In the first three years, a country seeking relief would establish a track record of good performance in its implementation of a structural adjustment programme prescribed by the Enhanced Structural Adjustment Facility (ESAF) of the International Monetary Fund. In return, its Paris Club creditors would commit themselves to rescheduling debt service payments so as to achieve a roughly 67 per cent reduction in the net present value (NPV) of eligible debt (this essentially meant a Naples-terms rescheduling), while non-Paris Club members would provide comparable relief.

At the end of the first three-year period, the country would reach a “decision point” when it would be decided whether it would be given HIPC debt relief if the Naples-terms reduction it had obtained failed to reduce its debt burden to a sustainable level. The country would then begin a second three-year period, also requiring an ESAF-supported programme, during which time the Paris Club creditors would provide additional debt service relief up to 80 per cent in NPV terms (Lyon terms), with the non-Paris Club members also providing relief. A so-called “completion point” would be reached at the end of the second three-year stage, when the creditors would reduce the country’s debt burden to a sustainable level (a debt-to-exports ratio of 200–250 per cent in NPV terms), implying up to 80 per cent stock relief in NPV terms.

The changes in the HIPC arrangements agreed at the recent meeting of the G-7 in Cologne (hereafter referred to as the Cologne Initiative) made important modifications to the original proposals, which would improve them in at least four ways: first, by accelerating the pace of debt relief through the provision of interim relief before the “completion point”; secondly, by allowing

countries to advance the “completion point” by accelerating the pace of policy reforms; thirdly, by broadening country eligibility through changes in the sustainability thresholds. Finally, the Cologne Initiative also sought to link debt relief to poverty alleviation.

However, even with these improvements, the Cologne Initiative still suffers from three major pitfalls that erode the potential of the HIPC Initiative to become an important stimulus for development finance: (i) it applies an inappropriate criterion for determining the ability of the HIPCs to pay their debts; (ii) it misses the fact that these countries need large transfers from the rest of the world and that, for the most part, they pay their debts at the cost of investments in physical infrastructure and human capital; and (iii) the current mechanisms for easing the debt burdens of these countries leave them with marginally positive net resource flows that are grossly inadequate to meet urgent social expenditures; moreover, they are unstable and unpredictable, making long-term strategic planning impossible.[4]

A. The capacity to service debt

The original HIPC Initiative determined a country’s ability to pay based on its ratio of debt to exports, when in fact its capacity to service debt depends more on its fiscal position. Although “fiscal sustainability” is by no means a trouble-free concept,[5] it nevertheless provides a better measure of debt-servicing capacity, since not all export receipts accrue to the country’s budget from which debt service payments must be made.

Indeed, it would seem that the world already recognizes that these countries simply cannot service their debts. Under current arrangements, a proportion of debt service due is rescheduled either formally through negotiation, or informally through a build-up in arrears. The substantial portion that is paid is, in fact, financed from new loans and grants from bilateral sources. In general, the HIPCs receive net resource transfers that are just marginally positive. In 1997, these net resource transfers amounted to less than $10 per head in the HIPCs. As figure 1 shows, for the years 1996 and 1997, net resource transfers were negative for all loans for the HIPCs as a group; that is, they paid more in interest and amortization than they received in new loans. New grants, however, exceeded the negative net transfers from loans, thereby making the overall net resource transfer positive; in effect, grants and loans together exceeded interest plus amortization. Net resource transfers from the rest of the world to the HIPCs – that is grants plus new loans minus debt servicing – have been positive throughout the 1990s. But, as figure 1 shows, they have been on the decline as new loans have declined in relation to debt servicing, while grants have remained more or less unchanged in nominal terms. Net transfers have fallen from a peak of about $10 billion in the mid-1990s to about $6 billion in 1998.

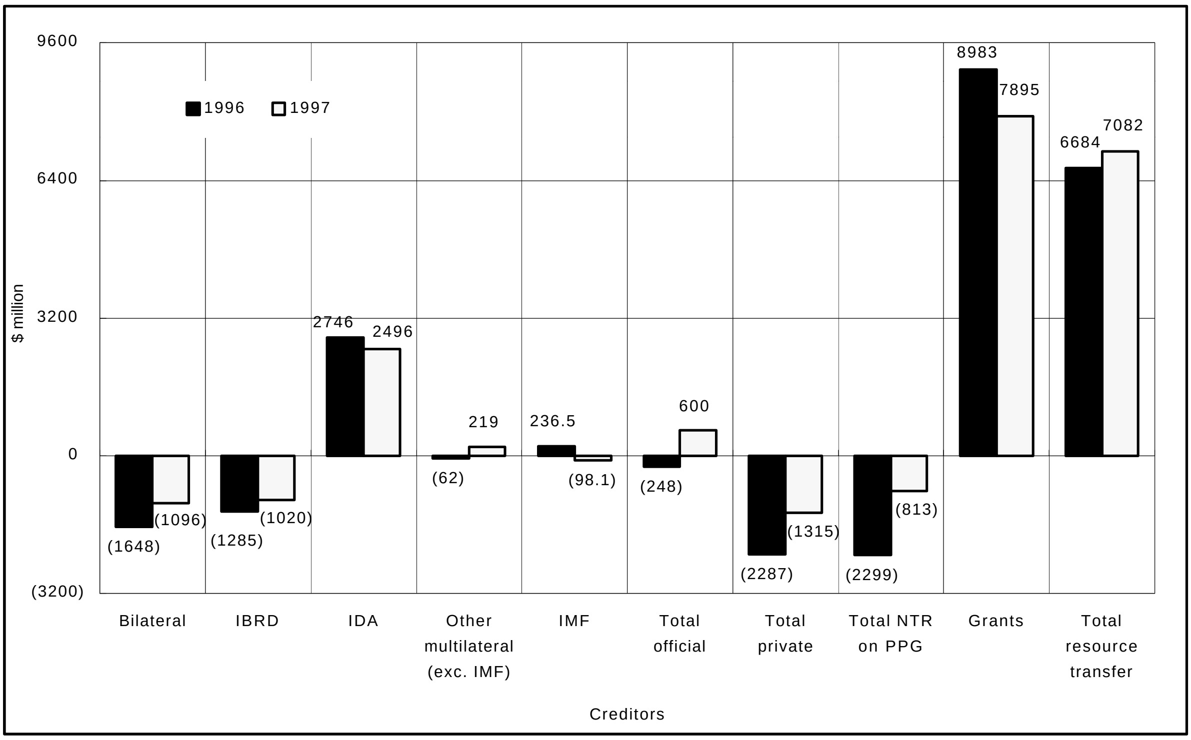
---

4 This critique is based on a study by Sachs et al. (1999).

5 It is difficult to apply where, for instance, a country’s fiscal position depends, to a significant extent, on foreign grants.

Figure 1

Net debt transfers to HIPCs, 1996–1997, by category of creditor



Source: Sachs et al. (1999).

Moreover, the process by which these burdensome debt service payments are financed through new loans and grants is rather unstable, and the net resource transfers are highly volatile and unpredictable (annex tables1, 2 and 3). Malawi, for instance, saw its net resource transfers fall dramatically in a two-year period, from 129 per cent of revenues in 1995 to 48 per cent of revenues in 1997. In contrast, a write-off of debt servicing on public and publicly guaranteed debt, with bilateral loans and grants remaining unchanged at current levels, would result in positive net resource flows of some $5 billion a year to the HIPCs,[6] compared to net flows of long-term debt of $4.8 billion and net FDI of $4.0 billion to these countries in 1998. Thus, the case that is being made by some academics and NGOs, notably Jubilee 2000, for more generous relief than is envisaged under the Cologne Initiative is particularly strong.

However, in a development that is very much a sign of the times, it is worth noting that even the original HIPC Initiative was never fully financed, and it is therefore reasonable to expect that there would be difficulties with financing the Cologne Initiative, let alone proposals for a complete write-off of outstanding debt for all or the poorest of the HIPCs.

---

[6] This would be half the gross bilateral ODA disbursements to sub-Saharan Africa in 1996, for instance.

Total costs of the original HIPC Initiative were estimated at $12.5 billion in 1998 NPV terms,[7] and of the Cologne Initiative at about $27.4 billion.[8] Costs are based on a proportional basis, or burden-sharing principle. Under the Cologne Initiative, the costs for bilateral and multilateral creditors are estimated to be about equal, with multilateral costs being roughly doubled. Estimated costs by creditor group are broken down in table 4.

Table 4

Costs of HIPC Initiative by creditor group

(Including retroactive assistance, $ billion)

Creditor group	*Original HIPC*	*Cologne*
Bilateral and commercial creditors	6.3	14.2
Paris Club	5.2	11.5
Other government bilateral	1.0	1.7
Commercial	0.1	0.9
Multilateral creditors	6.2	13.3
World Bank	2.4	5.1
IMF	1.2	2.3
African Development Bank & Fund	1.0	2.0
Inter-American Development Bank	0.5	1.0
Other	1.3	2.9
Total	**12.5**	**27.4**
Memorandum:		
Total cost for all 41 countries (including Liberia, Somalia and Sudan)	19.0	36.1

Source: HIPC documents (IDA/SecM99-187/2, 12 May 1999 and EBS/99/52, 12 May 1999) and IMF staff estimates.

[7] Excluding Liberia, Somalia and Sudan. With these countries included, total costs were estimated at about $19 billion.

[8] Without Liberia, Somalia and Sudan. With these countries included, the costs would increase to $36 billion.

Judging from these orders of magnitude, and also from the recent record of international resource mobilization for bail-out operations and for humanitarian relief in the wake of the Kosovo crisis, it is clear that the question of HIPC financing is largely a matter of political will. The total cost of some $40 billion is, after all, about a fifth of the resources that were mobilized in the space of a few months for bail-out operations for a handful of countries as a result of the Asian crisis. Indeed, the speed with which the G-7 has mobilized a consensus to revise the terms of the original HIPC Initiative proves the point. However, for the Initiative to be truly effective in providing HIPCs with fresh budgetary resources – estimated by the IMF to be about 2 per cent of GDP – the financing will have to come from genuinely additional sources, along with a commitment by the bilateral donors to continue to provide ODA. But funding difficulties still remain, among them the unevenness of creditor country exposure, with a disproportionate burden falling on Japan and France. It is also worth noting that Japan's decision to make countries, notably Ghana, choose between HIPC relief and continued Japanese concessional assistance is a most unfortunate development.[9]

B. Africa's special circumstances

Of all the regions of the world, sub-Saharan Africa faces the most daunting development challenge in the new millennium. According to the World Bank's latest estimates, output per head – without South Africa, which accounts for about 40 per cent of the region's output – was lower than South Asia's. Sub-Saharan Africa also has the largest "poverty gap" and, arguably, the highest levels of income inequality. Although Africa shares these grim indicators with South Asia, there is a growing belief that development prospects for South Asia are more hopeful than for sub-Saharan Africa (see, for instance, Qureshi, 1997).

Understandably, therefore, much attention has been focused on the region's development prospects in recent discussions on development cooperation, and also in academic literature. Attempts have been made over the years to estimate the development finance needs of the region, some of them under the auspices of the United Nations,[10] and others by international financial institutions (ECA, 1993; ADB, 1995). Most recently, fresh attempts have been made to estimate the level of development financing that would be required to achieve the development targets set by the international community, including that of reducing poverty by half by the year 2015. However, none of these exercises is free from methodological and other technical problems. One recent critique has focused, for instance, on the use of the incremental capital output ratio (ICOR) for these estimates (Easterly, 1997). Nevertheless, these calculations offer broad indications of Africa's resource needs, and, provided their limitations are understood, they can be useful points of departure in measuring the depth of the crisis in development finance.

---

[9] Ghana has in fact opted out of the HIPC Initiative for this reason, although it is by no means clear that this is in its best long-term interest.

[10] For example, the United Nations Programme of Action for African Economic Recovery and Development (UNPAAERD) in 1986 and the United Nations New Agenda for the Development of Africa in the 1990s (UN-NADAF).

One such recent study by Amoako and Ali (1998), based on ICORs and domestic savings and investment rates that the authors consider reasonable, estimates external financing requirements that far exceed what would be considered within the realm of possibility, given current trends. For 1998, for instance, they estimate development financing requirements for sub-Saharan Africa alone of $82.4 billion.[11]

IV. LESSONS AND A MINIMUM AGENDA FOR ACTION

While in recent years international capital markets have surged and become by far the most significant source of development finance to developing countries, even in the wake of the Asian crisis, market access has been highly concentrated in a narrow group of middle-income countries. Flows to low-income countries have been rising in recent years, but these too are concentrated in a narrow range of countries, with India alone accounting for the bulk of these flows. Overall, capital market financing has been less important than FDI, but it too has been characterized by a high degree of concentration among oil and mineral exporting low-income countries.

Many low-income countries in both South Asia and sub-Saharan Africa have undertaken important policy reforms and have begun to achieve high levels of growth, in some cases backed by a rising share of investment in total output. But even for these fast growing countries with a good policy environment, the recent levels of growth are unlikely to be sustained without significant flows of external finance, especially private finance.

The mobilization of additional resources to help sustain high levels of growth where they have already been attained, and to accelerate growth in other cases, will require action both in the domestic policy arena and at the international level. Important domestic policy issues include export expansion, diversification and competitiveness. Much has been written about the need for further policy reform to improve the macroeconomic and governance environment. This is important not only for attracting foreign investment but also for reducing the extent of capital flight, which, by all indications, is higher than in other regions of the world (see table 5). In addition, a lot can be done at the regional level to bolster the macroeconomic environment and improve investor perceptions of risk. Promoting the image of the sub-Saharan region as an emerging market, for instance, would be a good way of improving prospects for attracting investments in equity portfolios. There are over 13 functioning stock markets in the SSA region, with a total capitalization of over $309 billion and a turnover of $21 billion as at end-December 1995. The markets have great potential but are fragmented, and have, on average, low levels of capitalization. The World Bank estimates that between 1970 and 1993 Africa's loss of market share in current prices amounted to an annual loss of some $68 billion (equivalent to 21 per cent of GDP). For non-oil producing African countries (excluding South Africa), for instance, the

[11] This compares to net official development finance of about $48 billion for that year to all developing countries.

Table 5

Estimates of capital outflows

Source	*Region/country*	*Data covered*	*Amount*
Chang et al., 1997	Sub-Saharan Africa	Cumulative 1971–1990	80 per cent of 1990 GDP
	Middle East and North Africa	Cumulative 1971–1990	90 per cent of 1990 GDP
Schineller, 1997	Latin America	Average 1978–1993	1.4 per cent of GNP per year
	Asia	Average 1978–1993	0.8 per cent of GNP per year
Claessens, 1997	All developing countries	Average 1971–1992	$20 billion per year
Collier et al., 1998	East Asia	Flow in 1997	$80 billion
	Sub-Saharan Africa	Cumulative to 1990	39 per cent of private wealth
Institute of International Finance, 1998	All emerging markets	Flow in 1997	$161 billion
World Bank, 1993	All developing countries	Cumulative to 1991	30 per cent of GDP
	East Asia	Cumulative to 1991	20 per cent of GDP
	Sub-Saharan Africa	Cumulative to 1991	90 per cent of GDP
Lopez, 1998	Mexico	Cumulative 1973–1991	$27 billion
Pinheiro, 1998	Brazil	Cumulative 1986–1994	$25 billion
Tikhomirov, 1997	Russian Federation	Cumulative 1991–1995	$60 billion
Loukine, 1998	Russian Federation	1991–1995	$125 billion

Source: World Bank/IBRD (1999): 25.

World Bank estimates that the cumulative terms-of-trade losses since the early 1970s represent about 120 per cent of GDP.

In the domain of international action, the crucial issue of debt relief (which we have discussed in the preceding sections) and the important issue of trade access, especially for textiles and clothing, need to be addressed. The successful resolution of developing country trade issues within the framework of the WTO is, like debt relief, an important aspect of the development finance debate.

V. CONCLUSION

There has been phenomenal growth in prosperity since the end of the Second World War. A number of developing countries, mainly in Asia, have made unprecedented strides in eradicating poverty. Some of these gains have suffered significant erosion in the wake of the recent crisis, and even with the faster than anticipated recovery that is taking place in the crisis-hit countries, a return to pre-crisis peaks of growth will take time. At the same time, the recent improvements in the policy environment in many low-income countries, and their efforts at achieving faster growth through integration in the world economy, are in danger of being throttled by the limited availability and undue concentration of development finance. The low-income countries themselves have the primary responsibility for pursuing domestic policies aimed at boosting domestic competitiveness. These include policies in the areas of exchange rate management, trade and technology. But conscious efforts are required at the international level, not just to boost the outlook for and effectiveness of aid, but also to create new instruments for the mobilization and channelling of long-term development finance to the low-income countries. It is important that these efforts also include action to improve developing country access to the markets of the developed countries, and to their products of science and technology. Above all, the reform of the international financial architecture should include contingency financing arrangements for compensating the low-income countries with limited access to capital market financing for income losses arising from the global effects of international crises. They have a decidedly better claim to compensation than the large international banks and hedge funds that benefit from bail-out operations. There should be a special focus on sub-Saharan Africa in future discussions on development finance for reasons of its exceptional capital scarcity and relatively weak prospects for rapid integration in the growing world of foreign private capital flows.

Annex table 1

Debt servicing actually paid as percentage of total government revenue

	1992	*1993*	*1994*	*1995*	*1996*	*1997*	***Standard deviation***
Angola	-5	-2	-5	-27	-27	-29	**13**
Guinea	-21	-22	-27	-43	-28	-35	**8**
Guinea-Bissau	-26	-14	-24	-46	-32	-22	**11**
Guyana	-73	-53	-56	-52	-42	–	**11**
Honduras	-57	-55	-71	-69	-75	-50	**10**
Madagascar	-34	-26	-26	-21	-23	-62	**15**
Malawi	-27	-20	-30	-39	-21	-19	**8**
Mali	-15	-21	-35	-24	-27	-19	**7**
Mauritania	-34	-54	-43	-44	-35	-36	**8**
Mozambique	-28	-41	-47	-58	-44	-24	**13**
Nicaragua	-16	-24	-41	-53	-38	-49	**14**
Niger	-11	-35	-36	-19	-18	–	**11**
Sao Tome and Principe	-24	-21	-37	-24	-48	-86	**25**
Senegal	-16	-11	-39	-36	-36	-30	**11**
Uganda	-66	-65	-40	-25	-24	-28	**20**
United Republic of Tanzania	-42	-35	-27	-28	-27	-15	**9**
Zambia	-58	-69	-55	-379	-36	-33	**135**
Average	**-33**	**-33**	**-38**	**-58**	**-34**	**-36**	

Source: Sachs et al. (1999).

Annex table 2

Net transfers on debt actually paid as percentage of total government revenue

	1992	*1993*	*1994*	*1995*	*1996*	*1997*	***Standard deviation***
Benin	21	26	47	22	25	2	**14**
Burkina Faso	32	33	44	34	21	13	**11**
Burundi	48	25	7	4	3	-8	**20**
Central African Republic	25	43	60	18	23	-8	**23**
Chad	117	48	127	68	91	57	**32**
Equatorial Guinea	34	37	23	1	-5	–	**19**
Ethiopia	21	40	14	7	-2	–	**16**
Guinea	32	56	25	7	8	27	**18**
Guinea-Bissau	143	80	73	27	61	66	**38**
Guyana	-13	-6	-29	-24	2	–	**13**
Honduras	17	38	-14	-24	-27	19	**27**
Kenya	-3	-6	-20	-1	-9	–	**8**
Lao People's Democratic Republic	34	31	21	32	68	40	**16**
Madagascar	9	16	8	13	22	36	**11**
Mali	32	6	31	43	17	18	**13**
Mauritania	26	24	26	9	19	-0.1	**11**
Mozambique	71	26	52	28	54	50	**17**
Nicaragua	42	-4	35	-0.5	4	-21	**24**
Niger	30	27	58	2	18	–	**20**
Sao Tome and Principe	248	156	195	169	141	-15	**88**
Togo	8	-4	30	17	19	–	**13**
Uganda	123	108	47	28	24	23	**45**
United Republic of Tanzania	45	7	13	5	-2	18	**16**
Average	**50**	**35**	**38**	**21**	**25**	**19**	

Source: Sachs et al. (1999).

Annex table 3

Net resource transfers as percentage of total government revenue

	1992	*1993*	*1994*	*1995*	*1996*	*1997*	***Standard deviation***
Angola	17	19	12	31	-13	-15	**19**
Benin	84	74	103	72	62	42	**21**
Burkina Faso	91	97	148	121	97	79	**25**
Burundi	130	93	153	133	121	69	**30**
Central African Republic	98	133	213	121	205	85	**54**
Chad	211	151	326	203	204	143	**66**
Côte d'Ivoire	7	11	66	20	9	-15	**27**
Equatorial Guinea	103	82	74	57	35	–	**26**
Ethiopia	99	112	74	50	31	–	**34**
Ghana	53	50	34	34	23	20	**14**
Guinea	87	101	71	65	46	55	**20**
Guinea-Bissau	254	208	242	186	223	189	**28**
Lao People’s Democratic Republic	73	69	64	81	125	88	**22**
Madagascar	84	84	77	75	81	200	**49**
Malawi	106	87	118	129	78	48	**29**
Mali	85	53	119	102	68	73	**24**
Mauritania	70	99	80	62	74	53	**16**
Mozambique	348	252	304	316	205	178	**67**
Nicaragua	118	38	72	78	119	13	**42**
Niger	133	149	326	127	121	–	**87**
Sao Tome and Principe	498	386	540	494	435	214	**118**
Senegal	42	39	86	48	36	35	**19**
Togo	47	37	92	80	53	–	**23**
Uganda	328	218	133	102	80	74	**99**
United Republic of Tanzania	171	139	100	63	43	61	**50**
Zambia	95	78	35	48	37	36	**25**
Average	**132**	**110**	**141**	**111**	**100**	**78**	

Source: Sachs et al. (1999).

REFERENCES

ADB (1995). *African Development Report*. Abidjan, African Development Bank.

Amoako KY and Ali AAG (1998). Financing development in Africa: Some exploratory results. African Economic Research Consortium (AERC), Collaborative Research Project on the Transition from Aid Dependency (mimeo).

Collier P and Gunning W (1997). Explaining economic performance. Oxford, University of Oxford, Centre for the Study of African Economies.

Easterly W (1997). The ghost of financing gap: How the Harrod-Domar growth model still haunts development economists. Policy research paper No 1807, Washington DC, World Bank.

ECA (1993). *Strategies for Financial Resource Mobilization for Africa's Development in the 1990s*, E/ECA/CM.19/5. Addis Ababa, Economic Commission for Africa.

Elbadawi I, Ndulu B and Ndungu N (1996). Debt overhang and economic growth in sub-Saharan Africa. In: Igbal Z and Kanbur R, eds. *External Finance for Low Income Countries*. Washington DC, IMF.

Fisher S et al. (1998). Africa: Is this the turning point? *IMF Paper on Policy Analysis and Assessment*. Washington DC, International Monetary Fund.

Qureshi M (1997). Persistent poverty in developing countries. Opening address at the Conference on International Peace and Security, The Aspen Institute, Broadway, United Kingdom, 2 December.

Sachs J et al. (1999). Implementing debt relief for the HIPCs. Policy paper 2 (mimeo). Cambridge MA, Center for International Development, Harvard University, August.

World Bank (1998). *Bank Policy Research Report, Assessing Aid: What Works and What Doesn't, and Why*. New York, Oxford University Press.

World Bank/IBRD (1999). *Global Development Finance: Analysis and Summary Tables*. Washington DC, World Bank/International Bank for Reconstruction and Development.

World Bank et al. (forthcoming, 2000). *Can Africa Claim the 21st Century?* Washington DC.