

Overview: Building Coalitions for Effective Development Finance

Policy highlights

THE STRING OF FINANCIAL CRISES IN DEVELOPING countries in the second half of the 1990s shook the confidence of many in global financial markets. At the same time, aid, on the decline through much of the decade, was increasingly criticized as ineffective. Together these experiences called into question the long-held view that international resource transfers—both private and official—play a significant and positive role in economic development.

This report concludes that, to the contrary, international financial flows to developing countries are perhaps even more valuable than traditionally thought—and that the prospects for using them effectively continue to improve. These flows work to transfer resources across national borders, from rich countries to poor ones, and to create and realize investment opportunities. But they can have an even greater influence on development by stimulating improvements in developing countries' policies and institutions and keeping them sound. They can thus reinforce those countries' initiatives to step up productivity and efficiency in the economy.

The report also highlights ongoing international initiatives to leverage the far-reaching potential of international financial flows. Among these initiatives are, at the global level, the reform of the international financial architecture and, at the country level, the World Bank's Comprehensive Development Framework, which emphasizes the critical importance of a holistic approach to development. The success of both will depend on effective coordination among various parties, attention to diverse local conditions, and a track record of strong and effective implementation. These, in turn, will require international and national coalitions to inter-

nalize the evolving lessons—and to give them legitimacy. Even then, these and other initiatives will require a period of strong commitment to produce the desired results.

In this context the report attempts to identify the conditions under which international financial transfers support the development process. And it considers what public policy—national and international—can do to foster productive transfers. Among the key findings:

- The cyclical slowdown of the global economy that began toward the end of 2000 has been significant because U.S. equity markets, consumer confidence, and short-term economic prospects have all dropped sharply and in tandem. A rebound in the course of this year seems possible due to the available policy instruments for stabilization.
- After precipitous declines in 1998 and 1999, capital flows to developing countries grew smartly in 2000, but their recovery has still lagged behind growth of output and trade since the late-1990s crises.
- For all countries with strong investment climates, private capital flows reinforce the payoffs to good policies and good institutions through even faster growth. But the volatility of those flows needs to be managed through stronger domestic financial systems and, possibly, larger foreign exchange reserves and sources of contingent credit.
- Aid flows increased in 2000, and the pace of debt relief was stepped up—but it will take vigilance to sustain these gains. The increases in aid effectiveness in the 1990s support the case for greater aid to achieve the Interna-

tional Development Goals set by the international community.

- International resource transfers provide about \$5 billion a year to finance such international public goods as health, a clean environment, knowledge, and peace. To achieve the maximum dividends from these activities, the international financial institutions need to take a flexible and pragmatic approach to coalition building.

Challenges for developing countries during the cyclical slowdown

The cyclical slowdown of the global economy that began in the second half of 2000, brought on by higher interest rates and oil prices, suddenly intensified toward the end of the year. Shifts in market sentiment have become more important in determining short-term output and trade trends.

Chapter 1 of this report argues that a recovery in the course of this year from the current slowdown is more likely than prolonged slow growth, because economic cycles have become shorter and because the scope for policy adjustments (fiscal and monetary stimulus) is greater. However, the possibility of a continued feedback from financial markets to the real economy may delay the recovery. The slowdown is expected to differ in magnitude across developing countries, creating both risks and opportunities. A harder-than-expected landing in the industrial world would have serious consequences in many developing countries but could bring some partially offsetting benefits, such as lower interest rates. Even in the more likely soft-landing scenario, some sectors and countries will be hit hard.

Trends in private capital flows

As chapter 2 documents, resource transfers to developing countries increased in 2000 but remain well below their 1997 levels, before the series of crises. In 2000, private capital flows increased smartly after the precipitous decline in 1998 and 1999, but the recovery of capital flows since the crises has not caught up with postcrisis growth of output and trade. This relative decline reflects some improvement in the “quality” of flows: volatile short-term debt flows have fallen sharply.

Trends in capital flows to and from developing countries reflect three forces. The first is the greater, although still imperfect, financial integra-

tion of the global economy. The second is recent technological change, which requires increasingly sophisticated investment environments for efficient business operations. And the third is psychological factors. Some of the chapter’s findings:

- Although the rise in capital inflows to developing countries in the first half of the 1990s received most of the attention, capital outflows also increased. And at least a part of the decade’s increase in capital inflows may reflect transactions tied to capital outflows, perhaps to avoid taxes. Those outflows also reflect greater economic integration with the rest of the world.
- The worldwide boom in cross-border capital flows has been directed to industrial economies, especially the United States, reflecting, in part, optimism about technological trends. Developing-country shares in capital flows have declined sharply since the crises. The greater concentration of capital in a few countries reemphasizes the importance of a hospitable business climate in attracting and sustaining foreign direct investment (FDI) flows, which, although resilient during the crises, appear to have plateaued.
- Capital market flows were bolstered last year by modest improvements in perceived creditworthiness. But a lack of liquidity and indications of investor nervousness suggest that the memory of the crises remains. For countries with marginal access but significant dependence on international capital markets, the risk of being unable to roll over their borrowings could be significant. Despite the strong rise in 2000, international capital flows are likely to account for smaller shares of developing countries’ gross domestic product (GDP) in the next few years.

International capital flows and economic growth

Private capital was implicated in the severe crises of the late 1990s, and some have questioned its efficacy in stimulating long-term growth. Chapter 3 examines how private capital inflows are related to, and perhaps contribute to, domestic investment and productivity, but also to volatility. The chapter concludes that private capital flows bear a significant relationship to long-term growth, although in

general they tend to reinforce an existing positive growth dynamic generated by domestic efforts and initiatives. Among the chapter's findings:

- On average, private capital inflows raise domestic investment almost one for one. But the effect is strongest for those countries least integrated with international financial markets, where FDI augments domestic saving, identifying and financing new investment opportunities. The association between greater foreign inflows and domestic investment is thus strong in Africa. For developing countries in general, however, the relationship has declined since the 1980s, because growing financial integration means that countries' domestic investment decisions depend less on the availability of external financing.
- The potential for productivity growth through private capital flows has probably increased because of the growing importance of knowledge as a production input. But the benefits are available mainly to countries that have a strong capacity to absorb these flows.
- Capital inflows, through their volatility, can also impose significant costs. Although the management of this volatility has improved, prudential safeguards (through greater liquidity and measures to limit domestic financial instability) remain high on the policy agenda.
- There has been no environmental "race to the bottom": FDI to developing countries is not attracted primarily by lower environmental standards. Countries experiencing rapid growth of FDI have also steadily improved their environments, because communities in those countries place a growing value on protecting their environment, and because foreign investors have reputations to maintain.

Making aid and debt relief more effective

The achievement of the International Development Goals will require a significant rise in aid flows—and in their effective use. As chapter 4 reports, aid flows did increase in 2000, and the pace of debt relief was stepped up, but continued commitment is required to ensure that these increases are not temporary.

The effectiveness with which aid was allocated across countries also increased in the 1990s. This happened in part because policies in recipient

countries improved, increasing their capacity to absorb aid, and in part because countries with weak policies got less aid. But there exists significant potential to reduce poverty by directing flows from middle-income to low-income countries and by increasing flows to countries with good performance that thus far have received little or no increase in aid. More resources can also be effectively deployed for international public goods, as discussed in chapter 5.

Recent moves toward donor specialization can also make aid more effective. So can increasing the commitment to provide assistance through predictable and medium-term budgetary support to each country's chosen development programs, based on agreed-on policy frameworks and conditioned on results. The shift to programmatic approaches reflects the importance of country "ownership" of the policy agenda and the long-standing difficulties in coordinating a host of separate projects, each with different donor reporting requirements.

The Heavily Indebted Poor Countries (HIPC) Initiative, which embodies some leading-edge approaches to aid effectiveness, marks an opportunity for a new start. The recent enhancements to the initiative have quickened the pace and increased the resources for debt relief, although the extent to which the initiative will increase total donor assistance is unclear. Since weak policies and institutions are the key constraint on growth in most heavily indebted countries, the tie to policy reform is the key factor for success. At the same time, greater access to industrial-country markets will help these countries integrate with global markets and grow.

Financing international public goods

Chapter 5 attempts a first-ever comprehensive inventory of the use of international resource transfers to fund the creation of international public goods in developing countries. It finds that, for all developing countries worldwide, transfers of about \$5 billion a year go to finance international public goods, and an additional \$11 billion finances the complementary domestic infrastructure that allows the absorption of these goods. These resources mainly support activities in health, environmental protection, knowledge creation and diffusion, and safeguarding peace. With active support from private charitable foundations, donors have been channeling more resources to international public goods, even as aid budgets have de-

clined. Some key global public goods, such as reducing global warming and maintaining financial stability, require more than funding—they also demand greater incentives for collective action. The returns from greater coordination can be extremely high.

The effective provision of international public goods requires a three-pronged approach:

- Integrating global and country-based finance
- Leveraging public resources with additional private money
- Improving frameworks that enhance incentives for responsible action.

The lessons of aid effectiveness also apply to international public goods: good-quality projects in which attention is paid to the details of implementation are required as much as they are for country-based projects.

International financial institutions seeking to support the provision of international public goods will need to adapt to a world of many actors and decision points—sometimes convening the actors, and other times deferring to those with more expertise and legitimacy. In short, they need to take a pragmatic and flexible approach to coalition building.

The overriding message of this report is that the domestic environment of the recipient economy is the key to the effective absorption of international resource flows—whether official or private. To paraphrase Albert Hirschman, resource transfers are “environment takers,” not “environment shapers.” And because many imperfections remain in how official and private flows move across borders, their quality can be enhanced by cooperative action and by coalitions that involve various actors within countries and across national boundaries. The global community is now engaged in exciting experiments to do precisely this.

Numerical highlights

The global economy

- A sharp slowdown in economic activity, primarily in the United States and East Asia, is anticipated to lower world GDP growth from its decade-high advance of 4 percent in 2000 to

2.2 percent in 2001. Industrial country growth should slow from 3.6 percent to 1.6 percent, and growth in the developing and transition economies from 5.4 percent to 4.2 percent.

- The period of slower output growth is expected to be relatively short-lived. Rapid recovery in high-tech sectors (currently hit hard by a downturn in the global semiconductor cycle), lower interest rates, tax reduction, and some softening in the oil price should underpin a rebound in industrial country growth toward 3 percent over 2002–03. Developing and transition countries’ output is anticipated to rise toward 5 percent in these years, supporting world GDP growth at rates around 3.3 percent. However, the risk of a sharper and more prolonged slowdown has increased over the last months.
- World trade growth is likely to be more than halved from its record 13 percent advance in 2000 to 5.5 percent in 2001, and to stabilize thereafter at still-robust rates of more than 7 percent. Diminished demand will require the Organization of Petroleum Exporting Countries to reduce oil production in order to maintain prices within their target range of \$22 to \$28 per barrel. Oil prices are expected to average \$25 per barrel in 2001, easing to \$21 and \$20 per barrel in 2002–03 respectively. Recovery in non-energy commodity prices will be postponed until 2002, with prices falling by 0.3 percent in 2001 before advancing at a 5.5 percent annual rate during the years following.

Trends in external finance

- External resources to developing countries increased from around \$246 billion in 1999 to \$299 billion in 2000.
- Short-term external resources, which had reached a peak of \$43.2 billion in 1996, recorded net outflows in 1998 and 1999, and a small net inflow of about \$3.5 billion in 2000.
- Long-term inflows fell from their peak of \$342 billion in 1997 to \$265 billion in 1999 but rebounded to \$296 billion in 2000.
- Developing countries’ share in global private flows fell from 14.4 percent in 1997 to 7.6 percent in 2000; their share of FDI fell from 36.5 percent to about 16 percent over that period.
- Developing countries’ aggregate current account was in a significant surplus of \$60 bil-

lion, and their international reserves increased by \$53 billion. Hence much of the capital inflow is balanced by capital outflows or inadequately accounted for.

Private finance

- FDI to developing countries declined modestly (by 4 percent) for the first time in a decade, reflecting a slowing of merger and acquisition activity and the completion of some large-scale privatization projects.
- World FDI flows continued to grow rapidly and even accelerated somewhat in the second half of the 1990s. Mergers and acquisitions grew particularly rapidly, reaching \$720 billion in 1999. Industrial countries accounted for much of this upsurge, with their share in world FDI flows rising from a low of 65 percent in 1994 to an estimated 84 percent in 2000.
- Capital market flows to developing countries, after falling in 1998 and 1999, rose in 2000 but remained at about three-fourths of their 1997 level. Developing countries' share of worldwide capital market flows has also fallen.
- Flows to three middle-income countries (Brazil, China, and Turkey) increased by \$43 billion in 2000, or just \$7 billion less than the total rise in capital market flows to developing countries as a group. The Republic of Korea and South Africa together received an additional \$11 billion. Capital market flows to the rest of the developing world fell by \$4 billion.

Official finance

- Official development finance—concessional and nonconcessional—to developing countries fell to \$38.6 billion in 2000, from \$45.3 billion in 1999.
- Nonconcessional flows from official sources fell from their peak of \$16.2 billion in 1998 to \$5 billion in 1999 and were -\$3.0 billion in 2000 as new lending fell and some countries prepaid funds received to contain financial crises.
- Concessional official flows rose slightly, continuing the trend that started in 1998 after the sustained fall from 1992 to 1997. Concessional aid flows—official development assistance, consisting of grants and loans with a grant component of at least 25 percent—increased to

\$41.6 billion, although even after the rise, aid levels were lower than in the early 1990s.

International private capital and growth

- Just as in the last major episode of large international capital flows a century ago, capital flows in recent decades have for the most part been reactive rather than proactive—in where they go and the impact they have.
- Bank lending and FDI are strongly related to increases in domestic investment: a dollar of such flows is associated with an increase in domestic investment of about a dollar.
- Cross-country growth regressions suggest that private capital flows are associated with faster productivity growth: an increase in capital inflows equal to 1 percent of GDP is associated with an increase of about 0.25 percent in GDP growth. This influence may have become more pronounced over time. Case studies show that the assimilation of productivity benefits requires a strong investment climate.
- The regressions also reveal a negative relationship between capital flow volatility and growth rates—more volatility means slower growth.
- Despite the high visibility of recent crises, the volatility of capital flows does not appear to have increased substantially for developing countries as a group. Countries are also, in general, managing volatility better.
- Although exposing domestic financial markets to foreign capital tends to increase instability in the first year, in the medium term (starting from about the third year) foreign inflows are associated with greater stability, not less. Larger international capital market flows are, on average, associated with greater development of the financial sector.
- There is no sign of a race to the bottom in pollution levels in the urban centers of Brazil, China, and Mexico during the past two decades: particulate pollution is down in all three countries, even though foreign investment is up.

Trends in official flows

- Official development assistance, measured from the donor side (and including technical cooperation grants), rose 5 percent in 1999, to \$56 billion.

- This represents 0.24 percent of the combined gross national product of the principal donors: the 22 members of the Development Assistance Committee of the Organisation for Economic Co-operation and Development.
- This increase continues the upward trend that began in 1998, when aid flows rose \$3.2 billion, and suggests an end to the decline in aid from 1992 to 1997.
- Japan registered the most significant increase in aid among major donors, thanks to its special assistance program for countries affected by the East Asian financial crisis. At \$15.3 billion in 1999, Japanese aid was \$4.6 billion higher than in 1998.
- The other major factor influencing the 1999 rise in aid flows, particularly those from the United States, was the international effort to assist refugees from Kosovo.
- Among developing regions, East Asia and Pacific, and Eastern Europe and Central Asia, saw a marked increase in aid in 1999–2000, accounting for nearly 45 percent of total flows.
- But their larger shares meant smaller shares for Sub-Saharan Africa and, to a lesser extent, South Asia.
- East Asia's increase was driven by the surge in aid from Japan. The main beneficiary was Indonesia, where the net inflow of aid doubled between 1997 and 1998 and doubled again in 1999–2000, to an annual average of \$1.9 billion.

The Heavily Indebted Poor Countries Initiative

- In the three years from September 1996 to September 1999, seven countries were approved under the original HIPC Initiative: Bolivia, Burkina Faso, Côte d'Ivoire, Guyana, Mali, Mozambique, and Uganda. From September 1999, when the enhanced HIPC Initiative was endorsed, to the end of 2000, debt relief was granted to 15 more countries: Benin, Cameroon, The Gambia, Guinea, Guinea-Bissau, Honduras, Madagascar, Malawi, Nicaragua, Niger, Rwanda, São Tomé and Príncipe, Senegal, Tanzania, and Zambia.
- By the end of 2000, total committed debt relief stood at \$20.3 billion in net present value (NPV) terms, and \$33.6 billion in nominal

terms. The eventual cost of the HIPC Initiative in NPV terms is estimated at \$28.6 billion.

- With debt relief, debt service due for the 22 countries that had reached decision points by the end of December 2000 will decline to \$2.1 billion a year (in current dollars) in 2000–05, or 25 percent less than the average in 1998–99. Debt service as a share of fiscal revenue is projected to decline by about 10 percent in 2001–05 (by an average of 14 percentage points from 1998). Debt service as a share of exports is expected to decline over the same period, from about 17 percent to about 8 percent.

Financing international public goods

- About \$5 billion in international resource transfers (about 10 percent of official development assistance) is spent each year on the production of international public goods.
- This expenditure, referred to as core spending on international public goods, is supplied by private foundations (\$1 billion), official trust funds (\$2 billion), and official development assistance (\$2 billion), to provide different public goods with varying reach.
- In addition, an estimated \$11 billion of official development finance is devoted each year to complementary spending on international public goods: country measures and infrastructure for the effective absorption of these goods.
- Annual foundation spending for international programs is now about \$1 billion, having grown at roughly 8 percent a year in the 1990s.
- A decade ago, international grants of private foundations, at about \$400 million, were less than 1 percent of official development assistance. Today they are about 2 percent of official development assistance (which has been declining) and about 20 percent of resource transfers for international public goods.
- Official trust funds contribute about \$2 billion a year to regional and global activities, or about 4 percent of official development assistance, up from modest amounts in the early 1990s.
- Official donors contribute to many trust funds administered by various agencies. The World Bank has the largest portfolio of these trust funds, with \$1.3 billion in cash contributions

in 2000, about \$700 million of which is targeted to regional and global programs. Other international organizations manage another \$200 million. An important resource and catalyst for funding directed to regional and global programs is the World Bank's Development Grant Facility, which mobilizes about \$1.1 billion a year for international public goods. An additional \$900 million from multi-partner trust funds brings the total channeled through official trust funds each year to about \$2 billion.

- A significant part of development assistance—estimated at about \$8 billion a year in the late 1990s, or about 15 percent of the total—is channeled to complementary expenditure for international public goods. Such expenditure
- rose from about 7 percent of all official development assistance in the 1970s to more than 15 percent in the late 1990s.
- Core and complementary aid allocated to health has grown the fastest, boosting overall expenditure on international public goods.
- Nonconcessional lending from the multilateral lending organizations has largely been for complementary activities. At about \$3 billion a year in recent years, such financing constitutes about 8 percent of lending by such organizations.
- The official financial community has pledged more than \$280 billion in rescue packages to prevent financial distress in crisis countries, thus contributing to the international public good of global financial stability.