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FOREIGN ASSISTANCE, AID,
DEBT AND DEVELOPMENT

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Introduction

In an open economy, domestic savings can be supplemented by many kinds of external assistance. This chapter considers the role of foreign borrowing in the development process. The emphasis is on longer term resource flows to developing countries rather than the provision of short-term balance of payments support, which is the traditional function of the International Monetary Fund (IMF), and is considered in Chapter 16.

The chapter starts by showing how the need for foreign resource inflows can be quantified, using the concept of **dual-gap analysis**, and then outlines the conditions under which foreign capital inflows will raise the growth of national income and the growth of national output.

The various magnitudes of resource inflows to developing countries are given, including official bilateral and multilateral aid flows (official development assistance, ODA), foreign direct investment (FDI) and remittances. The various donors and country recipients are identified.

We consider the debate over international assistance to developing countries, the motives for giving aid, the macroeconomic impact of aid on economies, and the critics of aid who say that it can do more harm than good.

The World Bank is a major multilateral donor, and its programmes of **structural adjustment lending** come under scrutiny.

Some resource flows, such as FDI and remittances, do not create debt, but loans from international organizations and the private banking system do, and we look at the debt burden of developing countries and the debt-servicing difficulties they face because debt has to be repaid with interest in foreign exchange, which is scarce and badly needed for imports. We ask the question: Is it possible to define an optimal level of borrowing and sustainable debt?

The 1980s witnessed a severe debt crisis for developing countries, which still lingers today, and we explore the various solutions that have been put forward for relieving the debt burden of poor, developing countries, including the World Bank's **Heavily Indebted Poor Country (HIPC) Initiative**.

The role of foreign borrowing

It is important to understand that lending and borrowing are natural features of capitalist economic activity; without them, capital accumulation would be confined to sectors of economic activity that have a surplus of income over current requirements, which, from a growth point of view, would be inefficient and suboptimal. Very often, the factors that cause the supply of capital to increase create their own demand. The most obvious example of this, at the international level, are increases in the price of oil, which create large surpluses for oil-exporting countries and the need to borrow by oil-importing countries to maintain economic growth without curtailing imports. Going back into history, sovereign lending (and the problems associated with it) has been a feature of international economic life since the Medicis of Florence started to make loans to the English and Spanish monarchs in the fourteenth century. Historically, the international lending and borrowing process has played an integral part in the development of most major industrialized countries, and continues to play a significant role in the economic transformation of today's developing countries.

Traditionally, the role of foreign borrowing has been seen by countries as a supplement to domestic saving to bridge an investment–savings gap and achieve faster growth. The concept of **dual-gap analysis**, however, pioneered by Hollis Chenery and his collaborators (e.g. Chenery and Bruno, 1962), shows that foreign borrowing may also be viewed as a supplement to foreign

exchange if, to achieve a faster rate of growth and development, the gap between foreign exchange earnings from exports and necessary imports is larger than the domestic investment–savings gap, and domestic and foreign resources are not easily substitutable for one another. Foreign borrowing must fill the larger of the two gaps if the target growth rate is to be achieved. The historical sequence of experience originally suggested by Chenery was that countries in the pre-take-off stage of development would have a dominant investment–savings gap, followed by a dominant foreign exchange gap, with the possibility of a skill constraint at any stage. Most of today's developing countries, apart from China and the oil-exporting countries, have a dominant foreign exchange gap, which manifests itself in a chronic balance of payments deficit on the current account, while domestic resources lie idle. These deficits require financing not only in the interests of the countries themselves, but for the sake of the growth momentum of the whole world economy. There is an interdependence in the world economic system because countries are linked through trade. The alternative to the financing of deficits is adjustment by deflation to reduce imports, which means slower growth in the world economy as a whole.

If the historical experience of developed countries is considered, in cases where borrowing took place (mainly from Britain as the major creditor), the borrowing was ultimately converted into an export surplus, which enabled the borrowing country to repay its debt and become a net creditor. The condition for this to happen is that the marginal savings ratio should exceed the average savings ratio in order to eliminate the investment–savings gap, if that is the dominant constraint, or that the marginal propensity to export should exceed the marginal propensity to import if foreign exchange is the dominant constraint. For most developing countries today, there is little evidence that they have either the desire or the option to reduce the level of net resource inflows without a major disruption of their economies. The need for resources is as acute as ever, because of a dominant foreign exchange gap to meet development requirements and to pay interest and amortization on past borrowing. Developing countries find it difficult to convert domestic resources into foreign exchange in adequate quantities, not only cyclically when the world economy is depressed, but also secularly owing to their economic structure; that is, they produce goods whose demand tends to be both price and income inelastic in world trade.

In the first edition of this textbook (Thirlwall, 1972), I predicted that:

unless something is done the debt-servicing problem arising from mounting resource flows may well become unmanageable in the not too distant future. It will certainly be a long time before these countries become net exporters of capital even in the absence of an investment–savings gap.

This has turned out to be true. Developing countries continue to borrow extensively; their debt now stands at over \$5,000 billion, and over \$250 billion flows out of developing countries each year to service the debts.

Dual-gap analysis and foreign borrowing

In national income accounting, an excess of investment over domestic saving is equivalent to a surplus of imports over exports. The national income equation can be written from the expenditure side as:

$$\text{Income} = \text{Consumption} + \text{Investment} + \text{Exports} - \text{Imports}$$

Since saving is equal to income minus consumption, we have:

$$\text{Saving} = \text{Investment} + \text{Exports} - \text{Imports}$$

or:

$$\text{Investment} - \text{Savings} = \text{Imports} - \text{Exports}$$

A surplus of imports over exports financed by foreign borrowing allows a country to spend more than it produces or to invest more than it saves.

Note that, in accounting terms, the amount of foreign borrowing required to supplement domestic savings is the same whether the need is just for more resources for capital formation or for imports as well. The identity between the two gaps, the investment–savings ($I - S$) gap and the import–export ($M - X$) gap, follows from the nature of the accounting procedures. It is a matter of arithmetic that if a country invests more than it saves, this will show up in the national accounts as a balance of payments deficit. Or, to put it another way, an excess of imports over exports necessarily implies an excess of the resources used by an economy over the resources supplied by it, or an excess of investment over saving. There is no reason in principle, however, why the two gaps should be equal *ex ante* (in a planned sense); that is, that *plans* to invest in excess of *planned* saving should exactly equal *plans* to import in excess of *plans* to export. This is the starting point of dual-gap analysis.

Before going into dual-gap analysis in more detail, a reminder of elementary growth theory is in order. Growth requires investment goods, which may be provided domestically or purchased from abroad. The domestic provision requires saving; the foreign provision requires foreign exchange. If it is assumed that some investment goods for growth can be provided only from abroad, a minimum amount of foreign exchange is always required to sustain the growth process. In the Harrod model of growth (see Chapter 4), the relation between growth and saving is given by the incremental capital–output ratio (c), which is the reciprocal of the productivity of capital (p), that is, $g = s/c$ or $g = sp$, where g is the growth rate and s is the saving ratio. Likewise, the growth rate can be expressed as the product of the incremental output–import ratio ($\Delta Y/M = m'$) and the ratio of investment-good imports to income ($[M/Y] = i$), that is, $g = im'$.

If there is a lack of substitutability between domestic and foreign resources, growth will be constrained by whatever factor is the most limiting – domestic saving or foreign exchange. Suppose, for example, that the growth rate permitted by domestic saving is less than the growth rate permitted by the availability of foreign exchange. In this case, **growth will be savings-limited** and if the constraint is not lifted, a proportion of foreign exchange will go unused. For example, suppose that the product of the savings ratio (s) and the productivity of capital (p) gives a permissible growth rate of 5%, and the product of the import ratio (i) and the productivity of imports (m') gives a permissible growth rate of 6%. Growth is constrained to 5%, and for a given m' , a proportion of the foreign exchange available cannot be absorbed (at least for the purposes of growth). Some oil-exporting countries fall into this category; they cannot use all their foreign exchange. Conversely, suppose that the growth rate permitted by domestic savings is higher than that permitted by the availability of foreign exchange. In this case, the country will be **foreign exchange-constrained** and a proportion of domestic saving will go unused. Most developing countries fall into this category. The policy implications are clear: there will be *resource waste* as long as one resource constraint is dominant. If foreign exchange is the dominant constraint, ways must be found of using unused domestic resources to earn more foreign exchange and/or raise the productivity of imports. If domestic saving is the dominant constraint, ways must be found

of using foreign exchange to augment domestic saving and/or raise the productivity of domestic resources (by relaxing a skill constraint, for example). (If there were complete substitutability between imports and domestic resources, any surplus of domestic resources could be immediately converted into foreign exchange, and any surplus of foreign exchange could be immediately converted into domestic resources, and there could only be one gap, *ex ante*, as well as *ex post*.)

Suppose now a country sets a target rate of growth, r . From our simple growth equations (identities), the required savings ratio (s^*) to achieve the target is $s^* = rc$, and the required import ratio (i^*) is $i^* = r/m'$. If domestic saving is calculated to be less than the level required to achieve the target rate of growth, an investment–savings gap is said to exist equal at time t to:

$$I_t - S_t = s^*Y_t - sY_t = (rc)Y_t - sY_t \quad (14.1)$$

Similarly, if minimum import requirements to achieve the growth target are calculated to be greater than the maximum level of export earnings available for investment purposes, there is said to exist an import–export gap, or foreign exchange gap, equal at time t to:

$$M_t - X_t = i^*Y_t - iY_t = (r/m')Y_t - iY_t, \quad (14.2)$$

where i is the ratio of imports to output that is permitted by export earnings. If the target growth rate is to be achieved, foreign capital flows must fill the larger of the two gaps. The two gaps are not additive. If the import–export gap is the larger, then foreign borrowing to fill it will also fill the investment–savings gap. If the investment–savings gap is the larger, foreign borrowing to fill it will obviously cover the smaller foreign exchange gap.

The distinctive contribution of dual-gap analysis to development theory is that if foreign exchange is the dominant constraint, it points to the dual role of foreign borrowing in supplementing not only deficient domestic saving but also foreign exchange. Dual-gap theory thus performs the valuable service of emphasizing the role of imports and foreign exchange in the development process. It synthesizes traditional and more modern views concerning aid, trade and development. On the one hand, it embraces the traditional view of foreign assistance as merely a boost to domestic saving; on the other hand, it takes the more modern view that many of the goods necessary for development cannot be produced by the developing countries themselves and must therefore be imported with the aid of foreign assistance. Indeed, if foreign exchange is truly the dominant constraint, it can be argued that dual-gap analysis also presents a more relevant theory of trade for developing countries that justifies selective protection and import substitution. If growth is constrained by a lack of foreign exchange, free trade cannot guarantee simultaneous internal and external equilibrium, and the efficiency gains from trade may be offset by the underutilization of domestic resources. We shall take up this matter in Chapter 15.

A practical example of dual-gap analysis

Now let us give a practical example of how dual-gap analysis may be applied to a country. We shall be applying equation (14.1) to estimate the investment–savings gap, and equation (14.2) to estimate the import–export gap. Suppose that the target rate of growth (r) set by the government over a five-year planning period 2015–20 is 5% per annum and the capital–output ratio is 3. The investment requirements in time t may be written as:

$$I_t = crY_t = c\Delta Y = 3\Delta Y$$

Table 14.1 Estimates of investment–savings and import–export gaps assuming a 5% growth of GDP, 2015–20 (\$ million)

	Y_0	Y_1	Y_2	Y_3	Y_4	Y_5
	Base year 2015	2016	2017	2018	2019	2020
GDP	1,000	1,050	1,102.5	1,157.6	1,215.5	1,276.3
Savings	100	105	110.2	115.8	121.5	127.6
Investment	140	150	157.5	165.3	173.7	182.4
Investment–savings gap	40	45	47.3	49.5	52.2	54.8
Exports	210	216.3	222.8	229.4	236.3	243.4
Imports	250	262.5	275.6	289.4	303.9	319.0
Import–export gap	40	46.2	52.8	60.0	67.6	75.6

Note: The base level of investment and exports will be given by the country's national accounts and balance of payments statistics.

Now assume that 10% of income is saved, so that:

$$S_t = 0.1 Y_t$$

Given this information and the target level of income, Y_t , for each year ($t = 1 - 5$), obtained from applying the target rate of growth to the base level of income ($Y_0 = 1,000$), the $I - S$ gap can be calculated for each year in the future. The results are shown in Table 14.1. All values are in dollars at constant (base year) prices.

For import requirements, let us assume that the incremental output–import ratio (m') is 0.2. Therefore:

$$M_t(r/m') Y_t = i^* Y_t = (0.05/0.2) Y_t = 0.25 Y_t$$

Finally, assume a forecast exponential rate of growth of exports of 3% a year, namely:

$$X_t = X_0 e^{0.03t}$$

The calculated import–export gap is also shown in Table 14.1. The results show that while the two gaps are equal in the 2015 base year from the national accounts, the forecast gaps, *ex ante*, diverge through time, with the import–export gap dominant. For the target rate of growth of 5% per annum to be achieved, there would have to be foreign borrowing each year to fill the larger of the two gaps. The analysis here is brief and mechanistic, but it illustrates the principle and what can be done in a simple way as a first approach to calculating foreign resource requirements for growth and development. (See El-Shibley and Thirlwall (1981) for a case study of Sudan. Chenery's pioneer study of dual-gap analysis is in Chenery and Bruno, 1962).

Models of capital imports and growth

In the simple case where there are no repayment obligations, foreign capital inflows will raise the growth of output *and* income (g), provided the foreign inflows do not reduce the domestic savings ratio or reduce the productivity of capital. To show this, we can write:

$$g = \frac{I}{Y}(\sigma) \quad (14.3)$$

where I/Y is the ratio of investment to GDP and σ is the productivity of capital (dY/I). Now, total investment is equal to domestic saving (S) plus foreign capital inflows (F), so equation (14.3) can be written as:

$$g = \frac{(S + F)}{(Y)} \sigma = \left[s + \frac{F}{Y} \right] \sigma \quad (14.4)$$

where s is the savings ratio (S/Y). Growth is now higher than it would be with domestic saving alone, unless foreign inflows (F/Y) reduce s and σ .

If foreign inflows have to be repaid, however, the condition changes for the growth of income and output to be higher. This can be shown from the model outlined below, which incorporates the terms on which capital imports are financed. It is shown that:

- **The rate of growth of output** will be faster with capital imports, provided new inflows of foreign capital exceed the loss of domestic saving to pay interest; if, however, interest charges are met by new borrowing, capital imports must always have a favourable effect on the growth rate of output.
- **The rate of growth of income** will be faster as long as the productivity of capital imports exceeds the rate of interest.

The model is as follows. Let:

$$O = Y + rD \quad (14.5)$$

where O is output, Y is income, r is the interest rate and D is debt. The difference between domestic output and national income is net factor payments abroad (including interest, profits and dividends). From equation (14.5), we have:

$$\Delta O = \Delta Y + r\Delta D \quad (14.6)$$

Now:

$$\Delta O = \sigma I \quad (14.7)$$

where σ is the productivity of capital, and:

$$I = sO + \Delta D - srD \quad (14.8)$$

where s is the propensity to save. Substituting equation (14.8) into equation (14.7) and dividing by O gives an expression for output growth of:

$$\frac{\Delta O}{O} = \sigma \left(s + \frac{\Delta D - srD}{O} \right) \quad (14.9)$$

Equation (14.9) shows that the growth of output will be higher than the rate obtainable from domestic saving alone as long as $\Delta D > srD$, that is, as long as new inflows of capital exceed the

amount of outflow on past loans that would otherwise have been saved. This is a fairly stringent condition unless it is assumed that the interest payments due are met by creating new debt. It can be seen from equation (14.9) that if $rD = \Delta D$, the rate of growth of output with capital imports will always be higher than without capital imports as long as $s < 1$ (which is the normal case to consider). It may be concluded, then, that if interest payments on past loans can be borrowed in perpetuity, there is a permanent gain to be had from running an import surplus. In practice, however, a country that continually reschedules its debts might ultimately be classified by the international community as uncreditworthy and therefore not be able to borrow continually.

Now let us consider the rate of growth of income as the dependent variable. From equation (14.5):

$$\Delta Y = \Delta O - r\Delta D \quad (14.10)$$

Substituting equation (14.8) into equation (14.7) and the result into equation (14.10) gives:

$$\Delta Y = \sigma(sO + \Delta D - srD) - r\Delta D \quad (14.11)$$

Now, since $Y = O - rD$, we can also write equation (14.11) as:

$$\Delta Y = \sigma sY + \Delta D(\sigma - r) \quad (14.12)$$

and dividing by Y , we have the following expression for the rate of growth of income:

$$\frac{\Delta Y}{Y} = \sigma s + \left(\sigma - r \right) \frac{\Delta D}{Y} \quad (14.13)$$

Equation (14.13) shows that the growth rate of income with capital imports will be higher than that obtained from domestic saving alone as long as the productivity of capital imports (σ) exceeds the rate of interest on foreign borrowing (r). This is a standard result showing that investment is profitable as long as the rate of return exceeds the rate of interest. In some circumstances, however, this condition may also be a fairly stringent one.

Capital imports, domestic saving and the capital–output ratio

From the discussion above, it would appear that import surpluses have great potential in the development process. It is sometimes argued, however, that import surpluses financed by foreign capital inflows increase the capital–output ratio (that is, reduce the productivity of capital) and discourage domestic saving; and that a large fraction of capital inflows is consumed rather than invested. The net result may be no extra growth at all or even a reduction in the growth rate. (The argument was first put forward by Griffin (1970) and has since been the subject of continual scrutiny; see the survey by White, 1992). In terms of equation (14.9) and equation (14.13), the inflow of capital ΔD may reduce s and σ and only a fraction of ΔD may be invested.

As far as the relation between capital imports and domestic saving is concerned, many studies find a negative relation. Care must be taken in interpreting the relation, however, because owing to the way saving is defined, a negative relation is bound to be found as long as a proportion of capital imports is consumed. As we said before, domestic saving is normally defined in developing countries as investment minus foreign capital inflows: $S = I - F$. If F rises and I rises by less than

F , S must fall for the equality to hold. Thus, a negative statistical relation between foreign capital inflows and domestic saving cannot necessarily be interpreted as a weakening of the development effort; it may simply reflect the fact that a proportion of foreign capital inflows is consumed. The important point is that no studies find a negative relation between capital inflows and the investment ratio. This means that capital inflows must finance some additional growth unless the productivity of capital falls drastically.

Some economists argue that foreign capital inflows do lower the productivity of capital and raise the capital–output ratio because of the tendency for international assistance to be used for prestige projects and a bias towards the use of international resource flows for infrastructure projects and social overhead capital. It should be remembered, however, that there is an important distinction to be made between the capital–output ratio of a particular project and the capital–output ratio for the economy as a whole, which is the ratio relevant to the model. It is quite possible for the overall capital–output ratio to fall even if projects financed by capital inflows are relatively capital-intensive, because the projects financed confer externalities on the rest of the economy and also relax a foreign exchange constraint on demand. There is no convincing evidence that countries with a high ratio of capital inflows to national income have a higher capital–output ratio than other countries, and no convincing evidence either that the productivity of foreign resource inflows is lower than the productivity of domestic saving.

Types of international capital flows

The main types of international capital flows to developing countries consist of:

- Official flows from **bilateral** sources and **multilateral** sources, such as the World Bank and its two affiliates, the International Development Association (IDA) and the International Finance Corporation (IFC), on concessional and non-concessional terms
- Aid provided by nongovernmental organizations (NGOs)
- Humanitarian and emergency aid
- FDI and portfolio investment
- Remittances from migrant labour.

Because of the different types of capital flow and the different terms of borrowing, there is an important distinction between the nominal value of capital flows and their worth in terms of the increased command over goods and services that they represent to the recipient. There is also a distinction between the **return** to international assistance, the **benefit** of international assistance (in a cost–benefit sense) and the **value** of international assistance:

- The **return** to international assistance is the difference between the nominal value of assistance and any repayments due, discounted by the productivity of the assistance in the recipient country. In other words, the rate of return to assistance is measured in the same way as the return to any other investment.
- The **benefit** of assistance is the difference between the nominal value of assistance and repayments discounted by the rate of interest at which the country *would have had to borrow* in the capital market. It is this calculation that we shall later refer to as the **grant element** or **aid component** of the capital flow, representing ‘something for nothing’ to the recipient country. Clearly, if the terms on which the country borrows from the donor are no different from those prevailing in the free market, there is no grant element or aid attached to the capital transfer and the benefit of assistance in this sense is zero.

- The **value** of the assistance may, in turn, differ from its benefit if the assistance is tied to the purchase of donor goods that differ in price from the world market price. If the prices are higher, this reduces the value of the grant element of assistance to below what it would otherwise have been (see below for calculations of the grant element).

Not all foreign resource inflows create **debt**; only those flows that involve a repayment obligation. The aid component of official flows, for example, does not create debt, nor do remittances from migrant workers or FDI, although the latter may involve an outflow of profits.

Now let us turn to a discussion of the various types of international capital flows, and the magnitudes involved. We start with a discussion of official development assistance, or international aid, and the motives behind it.

The debate over international assistance to developing countries

As indicated above, capital flows to developing countries come in many different forms: from grants or pure aid from bilateral and multilateral donors and NGOs, loans, portfolio investment and FDI by multinational companies. The magnitude of these various flows will be given later in the chapter. Donor countries and institutions provide aid, loans and investment, and developing countries accept the flows, for a mixture of reasons. But the motives of the donors and recipients, and the wider interests of developing countries as a whole, may not always coincide. The rationale and relevance of financial assistance to developing countries are very much a matter of subjective assessment, depending on the meaning and vision of the development process held by the protagonists. There is a substantial body of opinion on the right and the left of the political spectrum that argues that not only are financial resource transfers unnecessary for development, but may even be counterproductive and inimical to development by fostering dependence, weakening the domestic development effort, and leading to a distorted structure of consumption and production (as well as to debt-servicing problems and profit outflows). These criticisms are levelled at official assistance and private investment, particularly at the activities of multinational companies. We shall consider some of these concerns later, but first let us examine the motives for assistance and why developing countries accept the transfers.

The motives for official assistance

There are several motives (see Riddell, 2007 for a comprehensive text on foreign aid) that inspire financial assistance from bilateral and multilateral sources on concessionary terms, but they can be grouped under three headings:

- **Moral, humanitarian motive:** To assist poor countries, and particularly poor people in poor countries (see Opeskin, 1996). The same arguments that provide the basis for income redistribution within nations can also be applied at the global level, namely that absolute poverty is morally unacceptable and that if the marginal utility of income diminishes, total welfare will be increased by a redistribution of income from rich to poor. From a moral and welfare point of view, national boundaries are quite artificial constructions. Developing countries accept assistance with this concern in mind not only from national governments and international organizations as part of their regular aid programmes, but also from many voluntary and charitable NGOs, and from emergency and disaster relief funds.

- **Political, military and historical motives:** A large part of the US aid programme was originally designed as a bulwark against the spread of communism, and the regional and country distribution of international assistance can still be partly explained in these terms. British and French assistance tends to be concentrated on ex-colonial territories, reflecting strong historical ties and perhaps some recompense for former colonial neglect. Most developing countries are willing to accept assistance on this basis to assist their development effort, particularly when governments are threatened by hostile forces from within or without.
- **Economic motives:** Developed countries invest in developing countries not only to raise the growth rate of developing countries, but also to improve their own welfare. Hence, international assistance is seen as mutually beneficial. If the rate of interest on loans is higher than the productivity of capital in the developed donor country and lower than the productivity of capital in the developing recipient country, both parties will gain. If there are underutilized resources in the developed country that could not otherwise be activated because of balance of payments constraints, international assistance will be mutually profitable by adding to the resources in the developing country and enabling fuller utilization of the resources in the developed country. This is the strong Keynesian argument for international assistance, and forcefully recommended in the Brandt Report (discussed in Chapter 1). Developing countries accept these financial flows because most are desperately short of foreign exchange (see Chapter 16), and judge the benefits of international programmes and the projects they finance to be greater than the costs of servicing the borrowing and any unfavourable side effects.

The critics of international aid

Despite the many worthy motives for giving international assistance to developing countries, there are many critics of international aid. One extreme view is that aid has no effect on the growth performance of poor countries and can undermine development by fostering a dependency culture. This was the view of early critics, such as Bauer (1971) and Friedman (1958), and has recently been revived in polemical books such as *The White Man's Burden* (Easterly, 2006) and *Dead Aid* (Moyo, 2009). Both argue that aid to Africa has been wasted, and Moyo argues that there should be a programme of aid withdrawal from Africa and that all future capital inflows should come from the private sector, which would lead to a more responsible and efficient use of resource inflows.

It is true that international assistance may be wasted. If not directed wisely, it may help to support governments that are corrupt and profligate. It may encourage irresponsible financial policies; and if the assistance is free (pure aid), there may be no incentive to use resources productively. Critics argue that billions of dollars have been invested in Africa over the past half century, but still Africa is extremely poor.

There are several counterarguments, however, to this extreme view:

1. The amount of aid received *per head of population* in developing countries (and Africa) is very low, and poor countries have many depressive cumulative forces working against them, so that expectations relating to the impact of aid should not be exaggerated.
2. Much aid has been used for humanitarian purposes; for social investment in hospitals, public health and schools, the benefits of which are not disputed.
3. As far as corrupt governments and irresponsible economic policy-making are concerned, it is not clear that the same scenario would not prevail without aid. Indeed, the alternatives might be worse because international assistance brings a certain amount of 'leverage', which can be

used for the promotion of good governance and more enlightened policy-making. The challenge is not to stop aid, but to make it more effective.

The most valid criticism of aid is that it may lead to a weakening of the domestic development effort by supporting a culture of dependency. In particular, it may weaken a country's tax effort. In many poor developing countries, the value of aid exceeds tax revenue. To cope with this issue, Adrian Wood (2008), Oxford economist, suggests that donors collectively set an upper limit to the aid–tax ratio (say, 50%), above which aid would be phased out, but below which donors would give 50 cents more aid for every extra dollar raised in taxes. This would encourage developing countries to raise more tax, while encouraging governments to pay more attention to what their citizens want (because they are paying) rather than what donors want the aid used for.

Another less extreme view of aid is that it can have a positive effect on growth and development on average, but not in every country, and is conditional on absorptive capacity, good governance and the policies of donor countries. Some countries may not have the administrative or technical capacity to absorb much aid, in which case there will be diminishing returns to aid. There is evidence on this, which will be discussed below. There is also evidence that aid only works in good policy environments, where there is good governance and sound macroeconomic policy-making. The practices of donor countries also make a difference to the productivity of aid, whether the aid is multilateral or bilateral, whether it is tied to the purchase of donor goods or untied, and how the aid is monitored. The consensus now is that recipient countries themselves should have 'ownership' of aid programmes, and that the heavy hand of donors can be counterproductive.

There are valid criticisms of aid and how it has been administered in the past, but the fact that it can be wasted, that it doesn't help the people it is meant to, and the recipients of aid still remain poor and underdeveloped is more a challenge to the use of aid than an argument that resource flows to poor countries cannot be productive. That would defy economic logic. Case example 14.1 discusses the impact of aid on growth in Sierra Leone.

Case example 14.1

The impact of aid on economic growth in Sierra Leone

Sierra Leone is characterized by high levels of aid dependence and unimpressive economic performance, as well as long-term political instability and armed conflict. Development aid has historically been a high proportion of Sierra Leone's GDP and surged when the civil war, 1991–2002, ended. Annual aid dispersed to Sierra Leone in the period 1970–2007 stands at an average of 14.2% of GDP, a figure much higher than the regional average of 3.7% for Africa as a whole. Despite this level of support, Sierra Leone's economic performance has remained wanting in terms of growth and poverty reduction.

A variety of econometric approaches have been used to assess the effect of aid on economic growth in the period 1970–2007 in Sierra Leone. There are two main findings:

1. Aid had a significant positive effect on economic growth over the period as a whole, but was weak or nonexistent during the civil war.
2. Aid had a greater positive impact on growth prior to the civil war than it has in the postwar period.

These findings are largely consistent with a great portion of the macro-level aid-growth literature. Indeed, Arndt et al. (2011) find that a similar positive link between aid and

continued overleaf

Case example 14.1

The impact of aid on economic growth in Sierra Leone – *continued*

growth is present on a more general, cross-country level. However, case studies on Bangladesh, Cameroon, Papua New Guinea and Pakistan have not found a statistically significant link between aid and growth. There are three main reasons why this relationship may be found in Sierra Leone, but not in the other case studies:

1. The differing motivations that lead to donors granting aid may well determine how effective that aid is in promoting growth. As one of the poorest countries in the world, Sierra Leone is likely to receive aid targeted towards generating economic growth and reducing poverty.
2. Aid is likely to have a positive impact on economic growth in countries like Sierra Leone, which require capital in order to fund foreign imports essential for growing the economy. Given the high level of imports, and the likelihood that exports will be much lower, a foreign exchange gap is inevitable. Inflows of foreign aid help to fill this gap and thus promote economic growth.
3. While there is a history of corruption in Sierra Leone, it is more associated with non-official aid from countries like China and Libya than with official aid.

Source: Kargbo, 2012.

The macroeconomic impact of aid

When a country receives aid, it can do one of two things, or a combination of both. It can either spend the aid directly on imports, in which case there are no serious domestic implications (e.g. there will be no change in the exchange rate or change in foreign exchange reserves), or the government can sell the extra foreign exchange to the central bank and then use the local currency to buy domestic goods. This does have domestic implications depending on the response of governments and the Central Bank. Aiyar et al. (2005) consider four responses:

1. **Absorb and spend:** the government spends on domestic goods and the central bank sells foreign exchange, which neutralizes the increase in local currency spent by the government and finances the current account balance of payments deficit due to rising imports.
2. **Neither absorb nor spend:** the government keeps the new foreign exchange in the central bank to add to reserves. This does not assist development directly, but can act as a buffer against aid volatility in the future.
3. **Absorb but not spend:** the government reduces the money supply while the central bank sells the foreign exchange. Aid acts as a substitute for the domestic finance of government budget deficits.
4. **Spend but not absorb:** the government increases its expenditure but keeps aid in the central bank as reserves. This is equivalent to a fiscal stimulus financed by selling bonds or printing money. There is no real resource transfer to the developing country because no aid has been used to import more. This policy can be highly inflationary and lead to the currency depreciating unless the central bank sells foreign exchange to stop it.

If aid is not spent directly on imports, the first best response is to absorb and spend, but according to Aiyar et al. (2005), it is surprisingly rare, at least in the five countries they studied in detail (Ethiopia, Ghana, Mozambique, Tanzania and Uganda). In four of the countries, less than one-third of aid was absorbed.

If aid is not spent directly on imports, there is the strong possibility of exchange rate appreciation, the so-called **Dutch disease**, after what happened to the Dutch currency after the discovery of natural gas in the Netherlands in the 1970s, which can have damaging effects on the tradable goods sector of the economy, by making exports more expensive and imports cheaper. To prevent appreciation, governments can buy up foreign exchange, which adds to reserves, but then the central bank has to sell bonds if it wants to absorb the excess liquidity arising from such purchases (to prevent inflation, for example). This may lead to a rise in interest rates, which can also damage the real economy. Some studies of the impact of aid find evidence of Dutch disease (see Rajan and Subramanian, 2005), but the important point to make is that it is not inevitable, if the aid is spent on the purchase of tradable goods, which, in principle, is the best policy. There are so many goods needed for development that poor developing countries cannot produce themselves. Aid gives the chance to import them.

Two main approaches are used to assess the impact of aid on growth and development. The first is to do detailed case studies, which is the micro-approach. As representative of this approach, a study by Cassen (1994) of seven countries (Bangladesh, Colombia, India, Kenya, South Korea, Malawi and Mali) shows that most aid achieves its development objectives, although in several instances, the performance could have been improved. The provision of aid played a major part in the Green Revolution in Southeast Asia, the building of infrastructure in southern Africa, and the direct provision of basic needs and the relief of poverty in many countries. The study also found, however, that aid performance appears to be least satisfactory where it is most needed, and that, above all, improved performance requires better collaboration between aid agencies. Most micro-studies find a positive impact of aid on development (Arndt et al., 2010).

The second approach to assessing the impact of aid is to conduct a detailed statistical analysis of the relation between the growth of GDP or living standards and the amount of aid (as a proportion of GDP) received by each country, controlling for other variables. This is the macro-approach. A typical estimating equation, taking a large sample of developing countries, would be:

$$y = a + b \text{ (AID)} + c_i (V_i)$$

where y is the growth of per capita income, AID is the ratio of official development assistance (ODA) to GDP and V_i is a vector of control variables ($i = 1 \dots n$). Hansen and Tarp (2001) review 131 cross-section studies and conclude that most of them show a positive relation between aid and growth. Their own research shows that aid has a positive effect on growth with a coefficient (b) of approximately 0.25, although not when investment is included in the equations as one of the control variables. The implication is that aid promotes growth by encouraging investment, and this is confirmed by equations relating the ratio of investment to GDP with the ratio of aid to GDP. Dalgaard et al. (2004) also show that aid has a positive effect on the growth of living standards, with a 1 percentage point difference in the aid variable leading to (approximately) a 0.5 percentage point difference in the growth of per capita income. The impact is lower, however, in tropical countries. Dalgaard et al. (2004) conclude: 'we have confidence ... that aid has a positive impact on growth, and that the impact depends on climate-related differences'.

Addison et al. (2005) survey studies conducted between 1997 and 2005 and conclude that developing countries' growth would have been slower without aid, and that the criticism of aid that it is counterproductive is not supported by the bulk of statistical evidence.

Clements et al. (2004) distinguish different types of aid, and focus on the impact of aid specifically meant for development purposes, as opposed to aid given for political and humanitarian reasons. They take a cross-section of 67 countries over the period 1974–2001, and use a nonlinear

specification of the aid–growth relationship to allow for the possibility of diminishing returns to aid. Their central estimate is that an increase in aid of 1% of GDP leads to a 0.31 percentage point increase in growth, and diminishing returns to aid seem to set in at about 8–9% of GDP (which implies 16–18% of total aid to GDP because only one-half of total aid is specifically for development purposes). These figures are three times the amount of aid actually given.

In a major study across more than 70 countries over the period 1960–2000 (and subperiods), Rajan and Subramanian (2005) conclude: ‘it is difficult to discern any systematic effect of aid on growth’. This conclusion has been challenged Arndt et al. (2010), who reanalyse the Rajan and Subramanian study and estimate a long-run elasticity of growth with respect to the share of aid in GDP of 0.13, so an inflow of aid of 10% GDP would increase GDP by just over 1 percentage point in the long run.

In a meta-study of 68 countries of the aid–growth relationship, Doucouliagos and Paldam (2008) also dismiss any positive impact of aid on growth. But Mekasha and Tarp (2013) have criticized this study on methodological grounds and argue that if the meta-study is done properly, there is a statistically significant positive impact of aid on growth of about 0.1 percentage point for every 1 percentage point increase in the ratio of aid to GDP, which means that a 10 percentage point increase in the aid ratio would raise the growth of GDP by 1 percentage point. This is a similar result to Arndt et al. (2010), who conclude their study by saying:

abolishing foreign aid, or drastically cutting it back, would be a mistake and is not warranted by any reasonable interpretation of the evidence. The challenge is to improve foreign assistance effectiveness so that living standards in poor countries are substantially advanced over the next three decades.

In recent years, the World Bank has been heavily involved in attempting to assess the impact of aid, and one of its major researchers is David Dollar. The World Bank (1998) and Burnside and Dollar (2000) take a panel of 56 developing countries over the period 1970–93 and try to disentangle the circumstances in which aid ‘works’ and in which it does not. The major findings are that, on average, aid has had only a minor impact on the growth of GDP per head (partly because aid as a percentage of GDP is so small), but that it can be extremely effective in promoting growth and reducing poverty in the right economic and political environment where there are democratic governments pursuing sensible macroeconomic policies. In countries with good economic management, a 1 percentage point increase in aid raises the growth rate by 0.5% and reduces poverty by 1%. The World Bank (1998) calculates that an extra \$10 billion of aid could lift 25 million people out of poverty if the aid is directed to countries that manage their economies well. In countries with poor management, aid is entirely wasted. There are also diminishing returns to aid. Even in good environments, the returns to aid peak when aid reaches about 10% of GDP.

The World Bank (1998) emphasizes five major points from its analysis, and indicates five policy reforms for making aid more effective:

Analysis:

- Financial aid works in a good policy environment.
- Improvements in economic institutions and policies are the key to reducing poverty.
- Effective aid and private investment are complementary.
- The value of development projects is to strengthen institutions and policies so that services can be delivered effectively.
- Aid can nurture reform even in the most distorted environments, but it requires patience and a focus on ideas, not money.

Reforms:

- Financial assistance must be targeted more effectively to low-income countries with sound economic management.
- Policy-based aid should be provided to nurture policy reform where needed.
- The mix of aid activities should be tailored to suit the needs of the country and sectoral conditions.
- Projects need to focus on creating and transmitting knowledge and capacity.
- Aid agencies need to find alternative approaches to helping highly distorted countries.

Two further reforms and improvements could make aid more effective:

1. Donors could cooperate more to pool resources for specific purposes, and to take politics out of the aid-giving process.
2. Aid should only be given if the outcomes of programmes are effective. This is referred to as 'cash on delivery', and some donors, such as Norway and Britain, are experimenting with this approach. This gives countries an incentive to achieve outcomes efficiently. Norway has promised aid for the preservation of forests, and Britain has agreed to pay Ethiopia £100 for each extra pupil sitting a school-leaving exam.

Research shows that the **unpredictability** and **volatility** of the flow of aid also affect the impact of aid on growth because they affect the composition and effectiveness of government expenditure and can deter private investment. Aid is unpredictable if recipients cannot be confident about the amount and timing of aid disbursements. Aid is volatile if it fluctuates significantly (predictably or unpredictably). Measuring the predictability of aid is not easy, but it can be done with detailed data on aid commitments and disbursements by donor agencies, such as the Development Assistance Committee (DAC) of the OECD. Celasun and Walliser (2008) found that, on average, over the period 1993–2005, disbursed budget aid differed from the amount expected by 30%, or roughly 1% of GDP. Total aid disbursements to sub-Saharan Africa deviated from aid commitments by 3.4% of GDP. Aid shortfalls cut investment, while aid windfalls encourage consumption. This aid unpredictability affects the composition of expenditure in favour of consumption. Celasun and Walliser (2008) find that an aid shortfall of 1% of GDP is associated with a cut of investment expenditure of about 0.1 to 0.2% of GDP, while a 1% aid windfall is associated with an increase in consumption of about 0.6% of GDP. In other words, more predictable aid would lead to more investment.

Aid volatility can be measured by the standard deviation of aid flows. Lensink and Morrissey (2000) take 75 countries over the period 1970–95 and find that volatility negatively affects growth performance, but when volatility is controlled for, aid itself has a positive and significant effect on growth performance.

Since the fundamental purpose of international aid is the relief of primary poverty, there is a strong case for arguing (as part of the reform of aid programmes) that assistance should be given only to countries that are committed to poverty reduction programmes and make progress towards certain targets, such as literacy, basic healthcare provision, reducing infant mortality and so on. As incentives for governments to embark on and continue the programmes, donor countries could, in turn, commit themselves to funding as long as the recipients continue to support them. This would improve the certainty of aid flows.

The World Bank (2000) is moving in these directions. In its *World Development Report 2000/2001*, it refers to the new consensus on how aid can be made more effective:

- by linking aid to policy reforms
- by improving coordination between donors

- by getting people in the recipient countries to believe that the projects or reforms will bring benefits, so that countries feel they 'own' the programmes (see below on the reform of World Bank lending).

In 1999, the World Bank launched its **Comprehensive Development Framework**, which addresses these various issues. One new approach is the sector-wide approach where donors sign on to finance a *sector* (not individual projects), and the country itself does the work. An example is given in Case example 14.2.

Case example 14.2

Sector-wide development cooperation, mid-1990s

To address problems of ownership, donor coordination, and fungibility, donors are experimenting with pooling their resources to support sector-wide strategies designed and implemented by the recipient government. The country, in consultation with key stakeholders, designs a sector strategy and a budget framework extending several years forward, and donors put their money into the central expenditure pool for the sector. The approach encourages country ownership of sector strategies and programmes. It also links sector expenditure with the overall macroeconomic framework. And it ensures coordination of donor and recipient activities.

Some benefits of a sector-wide programme are evident in the Zambian health sector. In 1994, the government presented its national health policy and strategy to donors and – to ensure equitable distribution of services and coherent implementation of the strategy – asked them not to fund specific provinces or projects but to fund the Ministry of Health centrally. Hesitant at first, donors began to comply. An independent evaluation in 1997 found that: 'health workers are better motivated; clinics are functioning; funds are flowing to the districts; some modicum of decentralization is in place; [and] an important part of the private sector has become formally involved'.

The approach ensures full ownership by the country and eliminates problems of donor coordination. With the country having more ownership and control over what happens, the use of resources can be much more efficient. But it also means great changes in donor–recipient relations and perhaps greater difficulties in implementation. Several sector-wide programmes have stumbled because of the recipient country's inadequate institutional capacity. Lack of consistency with the macroeconomic programme has been another problem. And donors often have too many requirements and thus too much of a problem (or too little interest) in harmonizing them. Furthermore, these arrangements greatly diminish donor control and monitoring of exactly how money is spent.

The changes required imply that gaining support for the approach will be difficult. The recipient government has to be very confident, because strict adherence to a sector-wide approach means donors that do not participate in common implementation arrangements are not allowed to act in the sector (that is, they do not have their own projects). The result may be less donor funding for a sector. Governments might therefore opt for less strict sector-wide programmes, choosing instead to allow donors to implement projects as long as they fit into the overall sector strategy.

Source: World Bank, 2000.

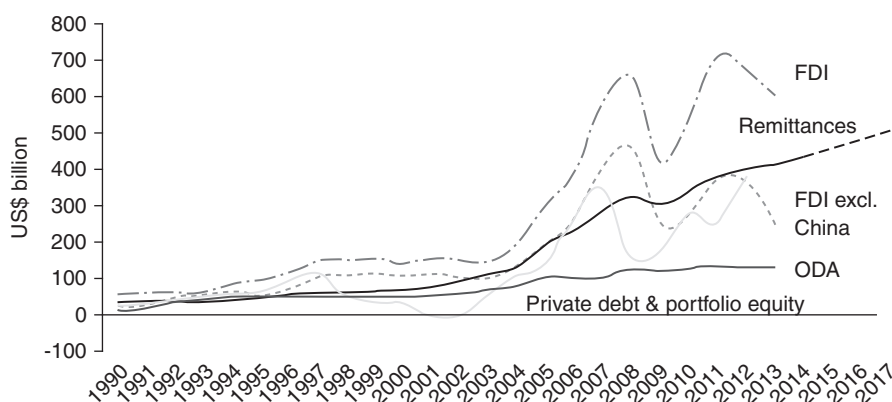
The total net flow of financial resources to developing countries

The total net flow of financial resources to developing countries is the total of all official and private flows to developing countries *net* of repayments of past loans (amortization). It includes flows given bilaterally by individual donor countries and multilaterally through international organizations, and includes flows both with and without concessionary terms. Most official flows are given on concessionary terms and are referred to as **official development assistance (ODA)**. To qualify as such, the concessional (or grant) element of the flow must be at least 25%. Only the concessional element of international financial flows really qualifies for the term ‘aid’. The major donors of ODA are the 22 developed countries that form the **Development Assistance Committee (DAC)** of the OECD, and the various multilateral agencies. In addition, OPEC countries have lent substantial sums on concessional terms in recent years.

Other developing countries themselves, such as China and Brazil, are also starting to distribute aid, and India has set up its own agency to distribute \$11 billion over the period 2012–17. The magnitude of types of flows, including FDI and remittances, is shown in Figure 14.1, and the total net flow of resources (excluding remittances) is shown in Table 14.2. Private flows at market terms (mainly FDI and export credits) are **non-concessional flows**. The total net flows of financial resource from DAC countries to developing countries and multilateral institutions in 2014 amounted to \$577 billion, of which \$137 billion was ODA and \$402 billion consisted of non-concessional flows, mainly FDI.

The aid targets set for the developed countries of 1% of their national incomes refer to the total net flow of financial resources, while the target for ODA alone is 0.7% of donor countries’ national incomes. Remember, the net flow of financial resources is not the same thing as the flow of *real resources*, since the former does not take account of interest payments and profit repatriation. If the terms of lending are steady over time, the net transfer of resources in any one year (that is, the gross capital inflow net of amortization *and* interest and profit payments) will be approximately equal to the estimated grant equivalent or aid component of assistance, the measurement of which is discussed later.

Figure 14.1 The magnitude of flows to developing countries



Sources: World Development Indicators and World Bank Development Prospects Group

Table 14.2 Total flow of financial resources from DAC countries to developing countries and multi-lateral organizations, by type of flow

	\$ million	Per cent of total
	2014	2014
I. Official development assistance	137 222	23.78
1. Bilateral ODA	94 663	16.41
of which: General budget support	624	0.11
Core support to national NGOs	2 070	0.36
Investment projects	13 788	2.39
Debt relief grants	462	0.08
Administrative costs	6 347	1.10
Other in-donor expenditures	6 912	1.20
2. Contributions to multilateral institutions	42 559	7.38
of which: UN	6 803	1.18
EU	13 269	2.30
IDA	8 916	1.55
Regional development banks	4 002	0.69
II. Other official flows	4 626	0.80
1. Bilateral	4 747	0.82
2. Multilateral	- 121	-0.02
III. Private flows at market terms	402 936	69.83
1. Direct investment	189 624	32.86
2. Bilateral portfolio investment	206 979	35.87
3. Multilateral portfolio investment	3 012	0.52
4. Export credits	3 321	0.58
IV. Net grants by NGOs	32 246	5.59
TOTAL NET FLOWS	577 030	100

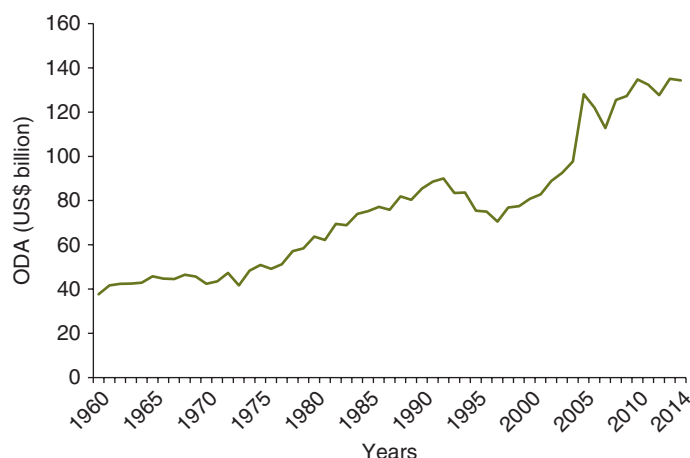
Source: OECD, 2015.

Official development assistance (ODA)

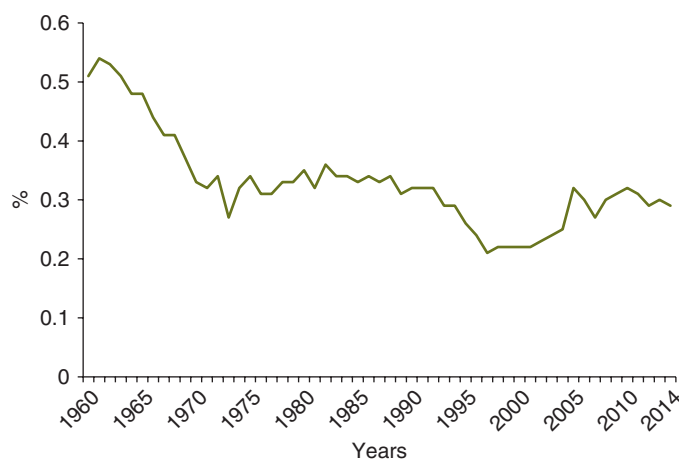
The total flow of ODA from the DAC countries in 2014 was \$137 billion, of which approximately \$94 billion consisted of grants, and \$42 billion was disbursed by multilateral institutions.

The evolution of ODA in current and constant (2004) prices, and as a ratio of national income, is shown in Figures 14.2 and 14.3. The total value of ODA rose from less than \$40 billion a year in 1960 to nearly \$140 billion today. On the other hand, the ratio of ODA to national income fell more or less continuously from 1960 to 2004, despite the commitment in the 1970s to the 0.7% aid target, and it has only started to rise in the past decade.

The 2014 record of individual DAC countries as providers of ODA is shown in Table 14.3, together with the flow measured as a proportion of the donor's gross national income (GNI). It can be seen that only the Netherlands, Denmark, Norway, Luxembourg, Sweden and the UK

Figure 14.2 Official development assistance (ODA), 1960–2014

Source: Based on OECD Data-Aid Statistics.

Figure 14.3 Ratio of ODA to GNI, 1960–2014

Source: Based on OECD Data-Aid Statistics

met the aid target of 0.7% of GNI. The USA is the richest country but contributes the lowest proportion of GNI. The ratio for all DAC countries now averages only 0.3%.

Total net flow of financial resources from DAC countries

As well as providing ODA, there are other official flows on non-concessional terms from DAC countries to developing countries, and DAC countries are the major source of the various private flows. Table 14.3 also shows the total net flow of financial resources by DAC countries to developing countries and multilateral agencies, together with the total flow as a proportion of the donor's GNI. Many of the countries that failed to meet the official development assistance target managed to meet the total net financial flow target of 1% of GNI by virtue of large volumes of private lending.

Table 14.3 ODA and total net flow of financial resources from DAC countries to developing countries and multilateral agencies, 2014

	ODA		Total net flows by DAC country	
	US\$ million	% of GNI	US\$ million	% of GNI
Australia	4 382	0.31	31 975	2.29
Austria	1 235	0.28	3 284	0.76
Belgium	2 448	0.46	8 726	1.65
Canada	4 240	0.24	18 175	1.03
Czech Republic	212	0.11	106	0.06
Denmark	3 003	0.86	4 194	1.20
Finland	1 635	0.60	3 027	1.12
France	10 620	0.37	19 222	0.67
Germany	16 566	0.42	54 375	1.37
Greece	247	0.11	- 438	-0.19
Iceland	37	0.22	37	0.22
Ireland	816	0.38	1 203	0.55
Italy	4 009	0.19	8 706	0.41
Japan	9 266	0.19	40 501	0.84
Korea	1 857	0.13	10 542	0.74
Luxembourg	423	1.06	423	1.06
Netherlands	5 573	0.64	68 874	7.85
New Zealand	506	0.27	667	0.36
Norway	5 086	1.00	5 040	0.99
Poland	452	0.09	452	0.09
Portugal	430	0.19	- 331	-0.15
Slovak Republic	83	0.09	83	0.09
Slovenia	62	0.12	62	0.12
Spain	1 877	0.13	13 669	0.98
Sweden	6 233	1.09	9 325	1.64
Switzerland	3 522	0.50	4 673	0.67
United Kingdom	19 306	0.70	31 809	1.16
United States	33 096	0.19	238 648	1.34
TOTAL DAC	137 222	0.30	577 029	1.24

Source: OECD, 2015.

UK assistance to developing countries

The total flow of ODA from the UK to developing countries and multilateral agencies in 2014 was over \$19 billion (see Table 14.4). Just over half the assistance is bilateral and the remainder goes to multilateral institutions. Of total bilateral aid, most goes into investment projects, including technical assistance, and for core support for NGOs working in poor countries. Recently, the UK

has closed its bilateral programmes in several countries and now concentrates on just 28 of the poorest countries. Some 30% of the budget is committed to states affected by conflict.

The UK aid programme is administered by the Department for International Development (DfID) and its mission statement is given in Case example 14.3.

Case example 14.3

DfID mission statement

The Department for International Development (DfID) leads the UK's work to end extreme poverty. We're ending the need for aid by creating jobs, unlocking the potential of girls and women and helping to save lives when humanitarian emergencies hit.

Responsibilities

We are responsible for:

- honouring the UK's international commitments and taking action to achieve the United Nations' Global Goals (<https://www.gov.uk/government/news/greening-britain-backs-the-global-goals-for-sustainabledevelopment>)
- making British aid more effective by improving transparency, openness and value for money
- targeting British international development policy on economic growth and wealth creation
- improving the coherence and performance of British international development policy in fragile and conflict-affected countries
- improving the lives of girls and women through better education and a greater choice on family planning
- preventing violence against girls and women in the developing world
- helping to prevent climate change and encouraging adaptation and low-carbon growth in developing countries.

Priorities

- Strengthening global peace, security and governance.
- Strengthening resilience and response to crisis.
- Promoting global prosperity.
- Tackling extreme poverty and helping the world's most vulnerable.

Source: www.gov.uk/government/organisations/department-for-international-development.

The focus is very much on poverty reduction through social expenditure on health and education. Part of doctors' salaries in Africa are paid out of the aid budget, as well as user fees for medicines and various forms of hospital care. The aid budget is also increasingly being used to improve security in 'fragile states' (see Chapter 9).

Perhaps the most significant recent development, however, is that DfID tries not to tell the aid-receiving countries what to do; rather, it listens to what countries want to achieve and tries to help them to do so by ensuring that aid strengthens a country's system for planning, budgeting and accounting. As much aid as possible is channelled through countries' budgets so that they can assess resources and plan spending. Aid conditionality has been abandoned (see Case example 14.4).

Table 14.4 Total net flow of financial resources from the UK to developing countries and multilateral agencies, 2014

Net disbursements	US \$million
I. Official development assistance (ODA) (A + B)	19 306
ODA as % of GNI	0.70
A. Bilateral official development assistance	11 233
of which: General budget support	87
Core support to national NGOs	394
Investment projects	916
Administrative costs	432
Other in-donor expenditures	226
of which: Refugees in donor countries	222
B. Contributions to multilateral institutions	8 073
of which: UN	855
EU	1 922
IDA	2 702
Regional development banks	464
II. Other official flows (OOF) net (C + D)	41
C. Bilateral other official flows (1 + 2)	41
1. Official export credits	–
2. Equities and other bilateral assets	41
D. Multilateral institutions	–
III. Grants by private voluntary agencies	–
IV. Private flows at market terms (long-term) (1 to 4)	12 462
1. Direct investment	–
2. Private export credits	299
3. Bilateral portfolio investment	12 761
4. Securities of multilateral agencies	–
V. Total resource flows (long-term) (I to IV)	31 809
Total resource flows as a % of GNI	1.16

Source: OECD, 2015.

Case example 14.4**Rethinking conditionality**

Traditional conditionality, under which donors link aid to the implementation of particular policies by developing countries, is not compatible with the guiding principles of the country-led approach. It limits governments' freedom to design poverty reduction plans suited to the circumstances of their countries, and it compromises their accountability to their own citizens. It also undermines efforts to make aid more predictable. Conditionality has been particularly criticized when applied to privatization and trade liberalization. But even where it has been less controversial, there is little evidence that conditionality

continued overleaf

Case example 14.4

Rethinking conditionality – *continued*

has been effective in promoting long-term policy reform. The UK has therefore adopted a new approach, in which the key purpose is to safeguard donor resources from misuse, rather than to promote policy change in partner countries. Good policy remains vital for development, and we will continue to discuss policy options with partner countries. But we will not attempt to impose policies on them by making aid conditional on specific policy decisions. Our aid relationships will be based on three shared commitments – to poverty reduction, to human rights and other international obligations, and to sound financial management and accountability. Only if countries veer substantially away from these commitments will we consider reducing or withdrawing agreed aid.

To specify what our aid is intended to achieve, and as a basis for measuring progress, we will agree on benchmarks with partner countries, drawn from national poverty reduction plans. They will focus on outcomes and results, rather than on particular policies, and will be the basis for both partners to be accountable to their citizens for the effective use of aid. Although aid will not be conditional on the achievement of any particular benchmark, the rate and pattern of a country's progress will contribute to our assessment of its continuing commitment to poverty reduction and may be reflected in our subsequent aid allocation decisions.

Source: DfID.

The recipients of ODA

We end this statistical section by showing the distribution of ODA across the regions and continents of the world. Table 14.5 shows the total amount disbursed, the amount per head of the population, the percentage of GNI of the recipient region, and the percentage contribution that

Table 14.5 The recipients of aid, 2013

	Net official development assistance			
	\$ millions	\$ Per head	% of GNI	% of gross capital formation
World	150,086	21.0	0.2	0.8
Low income	43,859	72.0	11.9	44.6
Middle income	61,288	12.0	0.3	0.8
Lower middle income	45,811	16.0	0.8	3.2
Upper middle income	14,475	6.0	0.1	0.2
Low and middle income	149,928	26.0	0.6	1.8
East Asia and Pacific	11,875	6.0	0.1	0.2
Europe and Central Asia	9,026	34.0	0.5	2.1
Latin America and Caribbean	10,202	20.0	0.2	1.0
Middle East and North Africa	25,682	73.0	1.6	5.5
South Asia	14,065	8.0	0.6	2.0
Sub-Saharan Africa	46,769	49.0	2.9	13.8
High income	159	0.0	0.0	0.0

Source: World Bank, 2015.

ODA makes to total capital formation. As expected, most flows go to low-income and lower middle-income countries, but the amount per head is relatively small – \$72 per head in low-income countries and only \$16 per head in lower middle-income countries. On the other hand, the percentage of ODA to GNI in low-income countries exceeds 10%, and it finances 44.6% of gross capital formation. In short, the poorest countries of the world are heavily dependent on ODA for their growth and living standards. Of the continents, by far the largest recipient is Africa, where ODA per head is \$49 and ODA's contribution to capital formation is 13.8%.

Aid tying

About \$15 billion of DAC aid to developing countries (roughly one-fifth of total bilateral aid) is tied to the purchase of donors' goods. In this sense, capital inflows are not worth as much as they might be, as the recipients have to pay higher prices for goods and services bought with aid money than the prices prevailing in the free market. Tying tends to be of two kinds: restrictions on where the recipients can spend the aid money, and restrictions on how the aid is used. Spending restrictions take the form of tying assistance to purchases in the donor country – so-called 'procurement tying'. This reduces the real worth of aid because it prevents recipients from shopping around to find the precise goods they want in the cheapest markets. Use restrictions normally mean that the aid must be used to cover the foreign exchange costs of a defined project. Restricting the use of aid to particular projects as well as to the donor country's goods amounts to double tying. Tying can be expensive.

The price of tied goods can be 20% or more above the price of the same goods in the free market (see Jepma, 1991; Morrissey and White, 1993). Moreover, there are other costs of tying apart from the inability of the recipient to buy in the cheapest market. If there is double tying, the project for which assistance is given might not fit perfectly into the recipient's development programme, the technology might be inappropriate, the donor may raise the import content unnecessarily, the suppliers may engage in exploitation, knowing that they have a captive consumer, and servicing over the life of the investment may be expensive.

The excess cost of imported goods from the tied source represents a form of export subsidy to suppliers in the donor country, in the sense that if the aid was not tied and the suppliers had to remain competitive, the subsidy would have to be paid by the donor country itself. This subsidy to exporters in DAC countries through aid tying amounts to about \$2 billion a year, or 2% of DAC assistance.

The one mitigating factor in all this is that the project for which assistance is given in tied form may have been undertaken anyway using the same source of supplies, in which case the assistance releases resources for another purpose. In other words, assistance to a certain extent is fungible because of resource switching. The fungibility of assistance also means that the balance of payments gain to the donor from tying may be quite small in practice because one form of purchase is substituted for another. This could be used as a bargaining weapon to reduce the extent of tying, the major reason for which seems to be balance of payments protection of the donors.

Remittances

Remittances from migrant workers are a growing source of resource transfer to many poor developing countries, supporting their balance of payments, and allowing the countries to grow faster than would otherwise be the case. In 2015, nearly 300 million migrant workers across the world

Table 14.6 Estimates and projections for remittance flows to developing countries

	2012	2013	2014	2015	2016	2017
(US\$ billions)						
World	531	551	582	608	636	667
Low-income countries	33	34	37	39	41	44
Middle-income	367	380	398	415	434	455
High income	131	137	148	154	161	168
Developing countries	400	414	435	454	475	499
East Asia and Pacific	108	114	122	127	134	141
Europe and Central Asia	44	48	49	50	52	54
Latin America and Caribbean	60	61	64	67	70	73
Middle-East and North Africa	49	49	51	53	55	58
South Asia	108	111	117	123	129	136
Sub-Saharan Africa	31	32	33	34	36	38

Source: World Bank calculations based on IMF balance of payments statistics.

remitted back to their homelands (developing countries) over \$600 billion, more than four times higher than the volume of ODA, and more than FDI, excluding flows to China. And these are just official remittances; informal flows may be as high as formal flows. The estimated workers' remittances to developing countries by region are shown in Table 14.6. East Asia and the Pacific, and South Asia receive the most. Each migrant remits, on average, \$2,000, or 20% of their earnings. For over twenty countries in the world, for example Bangladesh, Jamaica, Nicaragua and Tajikistan, remittances account for over 10% of GDP. The largest country recipient is Mexico, with flows of \$30 billion. The largest remitter is Saudi Arabia (not the USA).

Remittances support the balance of payments of recipient countries and can be used either for consumption purposes or used productively to set up small businesses, to build houses, to invest in health and education. If remittances are consumed on domestic goods or imports, this increases the tax revenue of countries and enables them to spend more on socially useful purposes (see Chami and Fullenkamp, 2013). There is evidence that the children of families that receive remittances stay longer in school, and infant mortality is lower. In general, remittances help to reduce poverty.

The long-run growth effects are more controversial. The IMF (2003), using data for 100 developing countries for the period 1975–2002, finds that remittances boost growth in countries with less developed financial systems by providing an alternative way to finance investment, but remittances don't seem to impact on growth in countries with already well-functioning credit markets. Catrinescu et al. (2008) find in their study across 162 countries over 34 years that the impact of remittances on growth depends on the quality of a country's institutions; specifically: 'low level of ethnic tension; good governance; prevalence of law and order and good socioeconomic conditions are preconditions for a successful use of migrant remittances'. Their central estimate is that a 1% increase in the remittances/GDP ratio leads to a 0.04–0.05 percentage point increase in growth on average. Findings of a negative relation between remittances and growth are due to the failure to take into account the institutional structure of countries.

Multilateral assistance

The major sources of multilateral assistance to developing countries are the World Bank (the International Bank for Reconstruction and Development, IBRD) and its two affiliates, the International Development Association (IDA) and the International Finance Corporation (IFC), as well as the UN and various regional development banks.

The total disbursement in 2014 was \$92 billion, of which \$52 billion was on concessional terms. A detailed breakdown of the lending by the various multilateral agencies from 2010 to 2014 is given in Table 14.7. The disbursements by multilateral agencies to developing countries consist not only of the contributions of developed countries but also of funds raised on the international capital market and repayments of previous loans. As can be seen from Table 14.7, the World Bank is essentially a commercial institution lending on non-concessional terms, and it raises large sums of money on the world's capital markets.

The IDA is the 'soft' loan affiliate of the World Bank and dispenses loans at very low rates of interest with long repayment periods. It is the most important provider of concessional multilateral assistance. Since 1960, it has lent over \$200 billion to over 100 countries. Only countries with less than a certain level of per capita income are eligible to receive assistance but this currently includes at least 80 countries with over 3 billion people. The EU has also become a major provider of concessional assistance through the European Development Fund (EDF). In 2014, it dispensed over £18 billion – a little more than the IDA. The major providers of non-concessional assistance in recent years (apart from the World Bank) have been the two regional development banks – the Inter-American Development Bank (IDB), lending to Latin America, and the Asian Development Bank (AsDB).

Table 14.7 Concessional and non-concessional flows by multilateral organizations, US\$ million, at current prices and exchange rates

	Gross disbursements				
	2010	2011	2012	2013	2014
Concessional flows					
International financial institutions					
AfDB	2 414	2 355	2 548	2 420	2 148
AsDB	1 930	1 940	1 835	2 696	2 798
CarDB	75	72	64	92	113
EBRD	–	–	–	–	–
IDA	12 123	11 703	12 523	12 307	13 759
IDB Sp. Fund	1 994	1 703	1 619	2 169	1 938
IMF	2 973	1 455	1 506	1 212	832
Nordic Dev. Fund	65	70	56	49	50
Total IFIs	21 575	19 297	20 151	20 945	21 638
United Nations					
IFAD	520	621	631	612	531
UNAIDS	246	265	242	246	239

continued overleaf

Table 14.7 Concessional and non-concessional flows by multilateral organizations, US\$ million, at current prices and exchange rates – *continued*

	Gross disbursements				
	2010	2011	2012	2013	2014
UNDP	613	494	487	468	463
UNFPA	316	315	349	355	340
UNHCR	393	441	424	417	480
UNICEF	1 050	1 104	1 152	1 252	1 342
UNRWA	545	608	667	539	680
UNTA	–	–	–	–	–
WFP	244	345	355	365	309
WHO	366	452	397	475	471
Other UN	151	145	148	594	153
Total UN	4 443	4 792	4 851	5 325	5 008
EU institutions	12 638	17 947	18 082	17 166	18 454
Adaptation Fund	22	47	24	7	13
Arab Funds	1 864	1 599	1 569	1 671	1 717
CEB	42	133	95	122	77
CIF	–	–	–	151	350
GAVI	772	819	1 068	1 544	1 415
GEF	530	474	539	574	606
GGGI	–	–	–	16	16
Global Fund	3 031	2 647	3 359	4 009	2 887
Montreal Protocol	21	10	5	37	45
OSCE	150	151	135	134	131
Total concessional	45 085	47 915	49 878	51 701	52 356
Non-concessional flows					
AfDB	2 042	3 051	3 510	2 304	3 045
Arab Funds	1 983	2 297	1 752	2 134	2 205
AsDB	5 272	5 626	6 900	6 163	7 600
CarDB	247	83	36	54	49
CEB	147	440	171	297	285
CIF	–	–	–	70	56
EBRD	3 399	4 022	3 501	3 961	4 823
EU institutions	8 259	982	762	1 510	868
IBRD	26 511	15 971	15 136	16 234	15 858
IDB	10 175	7 187	6 447	9 828	8 789
IFAD	44	49	63	57	92
IFC	4 184	4 733	6 414	6 743	–
Total non-concessional	62 264	44 441	44 693	49 356	43 671

Source: OECD, 2015.

World Bank activities

The activities of the World Bank since its creation in 1946 have broadly reflected changes in thinking about development policy and development priorities – changes that the World Bank itself has played a large part in promoting. In the early years, and throughout the 1960s, its major emphasis was on financing infrastructure projects in the field of power generation and distribution, transportation, ports, telecommunications and irrigation. There was very little support for agriculture and rural development, or industry and tourism; and programme loans (as opposed to project assistance) were largely confined to countries outside those classified as less developed.

The World Bank began to realize, however, that investment in infrastructure was not enough; that it had a role to play in lending to support directly productive activities. It also recognized the need for investment in education and managerial skills, and became increasingly aware that the development taking place in the countries it was supporting was not trickling down to the vast masses of the poor. In the late 1960s and throughout the 1970s, it began to play a more active role in agriculture and in helping both the rural and urban poor. Robert McNamara, president from 1968 to 1981, inaugurated this radical change of emphasis in his annual address to the World Bank in Nairobi in 1973. He defined absolute poverty as: ‘a condition of life so degraded by disease, illiteracy, malnutrition and squalor as to deny its victims basic human necessities’, and he pledged that the bank would make a concerted attack on rural poverty in order to raise the productivity of the poor and improve the incomes of small farmers. The objective was to provide most of the benefits of lending to those in the bottom 40% of the income distribution. In 1975, the World Bank announced that it would also attempt to deal with the problems of the urban poor by promoting productive employment opportunities on labour-intensive projects, and by developing basic services to serve the poor at low cost, for example water supplies, sanitation and family planning services.

Successive presidents of the World Bank have reiterated its commitment to helping the poor. It was mentioned in Chapter 2 that Lewis Preston announced in May 1992 that poverty reduction will be the ‘benchmark by which our performance as a development institution will be measured’, and this was reaffirmed by his successor, James Wolfensohn, president from 1995 to 2005, who wrote in the *World Development Report 2000/2001*: ‘poverty amidst plenty is the world’s greatest challenge. We at the Bank have made it our mission to fight poverty with passion and professionalism, putting it at the centre of all the work that we do’ (World Bank, 2000). Robert Zoellich, Wolfensohn’s successor, said: ‘it is the vision of the World Bank Group to contribute to inclusive and sustainable globalization – to overcome poverty, enhance growth with care for the environment, and create individual opportunity and hope’. Dr Jim Yong Kim, the current president, has said: ‘our mission at the World Bank is defined by two goals – to end extreme poverty by 2030, and to boost prosperity among the poorest 40% in low- and middle-income countries’.

The World Bank sees four major challenges:

1. To spur growth and overcome poverty, particularly in Africa, by provision of infrastructure, tackling corruption and raising agricultural productivity.
2. To help countries coming out of conflict, and failed states.
3. To foster regional and global public goods, for example disease control, dissemination of technology and combating global warming.
4. To advance development and opportunities in the Arab world, and to reduce social tensions particularly among young people who cannot find jobs.

It is committed to the Sustainable Development Goal of eliminating poverty by the year 2030.

Table 14.8 Distribution of World Bank lending, 2014

	% of total multilateral finance
Social and administrative infrastructure	35.0
Education	7.4
<i>of which:</i> Basic education	4.1
Health	3.8
<i>of which:</i> Basic health	2.4
Population	0.2
Water supply and sanitation	7.1
Government and civil society	10.2
Other social infrastructure/service	6.3
Economic infrastructure	43.9
Transport and communications	13.3
Energy	16.2
Other	14.5
Production	13.7
Agriculture	6.7
Industry, mining and construction	6.3
Trade and tourism	0.7
Multisector	4.4
Programme assistance	0.4
Action relating to debt	0.0
Humanitarian aid	2.4
Administrative expenses	-
Other and unspecified	0.1
TOTAL	100.0

Source: OECD, 2015.

The distribution of World Bank assistance for various purposes is shown in Table 14.8. The largest bulk of lending goes on economic infrastructure, which includes transport, communications and energy. Agriculture is still relatively neglected, with only 6.7% of the budget.

Structural adjustment lending

Another initiative was introduced by the World Bank in October 1979: **structural adjustment lending** to countries in order to support their balance of payments. To qualify for structural adjustment loans, a country has to adopt policies that are acceptable to the bank and designed to secure external equilibrium in the longer run without sacrificing growth. The emphasis is on improving the supply-side capacity of the economy.

The World Bank defines structural adjustment loans as ‘non-project lending to support programmes of policy and institutional change to modify the structure of the economy so that it can maintain both its growth rate and viability of its balance of payments in the medium term’. The loans are geared to seven main areas:

- Supply-side reforms, for example improving the efficiency with which markets operate
- Price reforms
- Changing the price of tradable goods relative to non-tradables
- Getting the ‘correct’ terms of trade between agricultural goods and industrial goods
- Reducing the size of the public sector
- Financial reforms
- Tax reforms.

Governments must commit themselves to policy reform in order to qualify for a loan.

Balance of payments support has been the traditional preserve of the International Monetary Fund (IMF: see Chapter 16), but there is a difference of emphasis between the IMF and the World Bank. Whereas IMF policies focus primarily on balance of payments management, the World Bank is more concerned with promoting policies to increase efficiency and providing incentives to raise export earnings and reduce import payments. Clearly, however, the roles of the two institutions now overlap and will do so increasingly as the IMF itself insists on supply-side policies as a condition for assistance, as well as on the traditional demand-side policies of devaluation and monetary contraction. (See Taylor, 1997 for a trenchant summary and critique of IMF and World Bank policies in poor countries.) The distinct roles of the IMF and the World Bank are outlined in Case example 14.5.

Case example 14.5

The IMF and the World Bank: What’s the difference?

The IMF and the World Bank were conceived at the Bretton Woods conference in July 1944 to strengthen international economic cooperation and to help create a more stable and prosperous global economy. Although these goals have remained central to both institutions, their mandates and functions differ, and their work has evolved in response to new economic developments and challenges.

The IMF promotes international monetary cooperation and provides member countries with policy advice, temporary loans and technical assistance so they can establish and maintain financial stability and external viability, and build and maintain strong economies. The IMF’s loans are provided in support of policy programmes designed to solve balance of payments problems – that is, situations in which a country cannot obtain sufficient financing on affordable terms to meet international payment obligations. Some IMF loans are relatively short term and funded by the pool of quota contributions provided by its members. Others are for longer periods, including concessional loans provided to low-income members on the basis of subsidies financed by past IMF gold sales and members’ contributions. In its work in low-income countries, the IMF’s main focus is on how macroeconomic and financial policies can contribute to laying a basis for sustainable growth and poverty reduction. Most IMF professional staff are economists.

The World Bank promotes long-term economic development and poverty reduction by providing technical and financial support, including by helping countries

continued overleaf

Case example 14.5

The IMF and the World Bank: What's the difference? – *continued*

reform particular sectors or implement specific projects; for example, building schools and health centres, providing water and electricity, fighting disease, and protecting the environment. World Bank financial assistance is generally long term and is funded by member country contributions and through bond issuance. World Bank staff have qualifications that embrace a broader range of disciplines than those of IMF staff.

The IMF and the World Bank collaborate in a variety of areas, particularly in supporting governments in implementing poverty reduction strategies in low-income countries, providing debt relief for the poorest countries, and assessing the financial sectors of countries. The two institutions hold joint meetings twice a year.

Source: IMF, 2006.

Since the purpose of structural adjustment lending and the **structural adjustment programmes (SAPs)** is to improve the growth potential of countries, evaluations of these lending programmes by independent investigators and the World Bank itself have focused on the key macro variables of GDP growth, savings, investment, exports and the balance of payments. In a World Bank symposium on adjustment lending, Corbo et al. (1992) single out the following as indicators of country performance: real GDP growth, the ratio of savings to GDP, the ratio of investment to GDP, and the export ratio. Their methodology is to compare countries that have SAPs with other countries that have less intensive adjustment lending programmes and with countries that had received no adjustment loans. The performance of the three sets of countries is then compared relative to their performance in a base period before any loans were dispensed (that is, pre-1979). It appears that only the export ratio was superior in the SAP countries, and the investment ratio was much worse. This was also the conclusion of another World Bank study (1990), which found that structural adjustment lending had achieved a modest degree of success in helping countries to improve their balance of payments, but had failed to lead to an upsurge in investment or to enable countries to 'grow out of debt'. Another major study of 40 countries (Harrigan and Mosley, 1991) found that the effect on GDP growth had been negligible; export growth and the balance of payments had improved, but investment had declined. The main reason for the disappointing results appears to be the heavy requirements (or conditionality) placed on recipient governments, which have served to depress demand and confidence. There is a general consensus that the requirements should be less stringent and more selective, and more sensitive to each country's circumstances (see Mosley et al., 1991).

SAPs have particularly hit the poor in many countries. Cornia et al. (1987, 1988) called for 'adjustment with a human face', but the record is still not good. A major study by Noorbakhsh (1999), comparing the periods 1970–85 and 1986–92 in countries with SAPs and those without, found that virtually all the indicators of the standard of living – for example, infant mortality, life expectancy, adult literacy, primary school enrolment and per capita calorie supply – fared worse in countries with structural adjustment loans.

It would seem that much more care is required in the design of SAPs if they are to achieve growth with equity (see Bourguignon and Morrisson, 1992), and if the World Bank is to avoid the charge of being an anti-developmental institution, like its sister institution, the IMF (see Chapter 16). In fact, one of the most damning indictments of SAPs comes from Joseph Stiglitz

(2002), a former chief economist of the World Bank, in his powerful book *Globalization and its Discontents*, who attacks IMF policy-making at the same time. We leave the discussion until Chapter 16.

Joseph Stiglitz



Born 1943, Gary, Indiana, USA. Taught in several universities including MIT, Yale, Stanford, Princeton and Oxford. Now Professor of Economics at Columbia University. Former Chairman of the Council of Economic Advisers under President Clinton (1995–97), and Chief Economist of the World Bank (1997–2000). Most prolific economist of his generation, with major contributions to virtually every branch of economics. Highly critical of the global trade and financial architecture in such books as *Globalization and its Discontents* (2002) and *Making Globalization Work* (2006). Awarded the Nobel Prize for Economics in 2001.

The imposition of harsh conditionality, which has not worked, and the relative failure of SAPs, has led to calls for reform of World Bank lending. Gilbert et al. (1999) suggest that *ex ante* conditionality should be abandoned altogether. Instead, the World Bank should say to countries: 'If you get your own house in order you can borrow from us without conditions, and can continue to do so as long as sensible economic policies are pursued and good governance prevails.' This amounts to a form of *ex post* conditionality, but the countries would 'own' the policies rather than be dictated to by the bank. For countries without good governance and the ability to reform, it should stop lending. Instead, it should act as a knowledge bank for the dissemination of best practice techniques in economic management and policy reform. This would require more World Bank staff in the countries concerned, fulfilling a training role.

Poverty Reduction Strategy Papers (PRSPs)

World Bank policy is already moving in the direction suggested above. In a new approach announced by the World Bank and IMF in 1999, national governments are offered a role in shaping and implementing anti-poverty strategies as part of its new focus on tackling poverty directly and making debt relief conditional on countries producing **Poverty Reduction Strategy Papers (PRSPs)** (see Case example 14.6). According to the World Bank, the focus of PRSPs should be on 'identifying in a participatory manner the poverty reduction outcomes a country wishes to achieve and the key public actions – policy changes, institutional reforms, programmes and projects – that are needed to achieve the desired outcomes'. The idea is that the attack on poverty should be based on partnership between governments and all sections of society concerned with poverty reduction, with governments leading the process of setting the goals and monitoring the process.

Case example 14.6

Poverty reduction strategy in IMF-supported programmes

Poverty reduction strategies (PRS) are central to IMF-supported economic and financial programmes in low-income countries. Poverty Reduction Strategy Papers (PRSPs) assess policy challenges, describe how macroeconomic, structural and social policies and programmes can promote growth and reduce poverty, and outline external funding needs and the associated sources of financing. They are prepared by governments in low-income countries generally through a participatory process involving domestic stakeholders and external development partners.

The PRSP approach was initiated by the IMF and World Bank in 1999 in the context of the Heavily Indebted Poor Country (HIPC) Initiative (see later), and Annual Progress Reports as a basis for debt reduction. The same documents were subsequently used to anchor IMF-supported programmes for low-income countries to allow for the implementation of strategies to achieve sustained poverty reduction and growth.

The core principles of the current PRS policy in IMF-supported programmes are:

- Maintain the link between members' PRS and policies under IMF-supported programmes, with streamlined PRS documentation.
- Preserve national ownership of the PRS process.
- Provide flexibility in the scope and coverage of the PRS to reflect different country circumstances.

The authorities' PRS will be documented through an **Economic Development Document (EDD)**, and can take two forms:

1. Existing national development plans documenting countries' PRS.
2. New EDD focused on elements of the PRS that are macro-relevant under IMF-supported programmes.

These documentation requirements must be met in order for a low-income country to complete reviews under an Extended Credit Facility (ECF) arrangement.

EDDs must meet the following minimum requirements:

- A strategy or plan for poverty reduction and growth
- Specific policies, including macroeconomic and financial policies that would be pursued in the context of the strategy
- The launch date and timeframe for implementation, to ensure that the strategy underlying IMF-supported programmes is current.

In addition, they should provide a description of:

- Existing poverty situation and trends
- Factors influencing poverty, including barriers to poverty reduction
- A fiscal and debt framework, with a view to prioritizing development spending
- Spending effectiveness, that is, how well money is spent on poverty
- Safety nets and risk mitigation
- Outline of the participatory process.

Source: www.imf.org/en/About/Factsheets/Sheets/2016/08/01/16/32/Poverty-Reduction-Strategy-in-IMF-supported-Programs.

Estimating the aid component of international assistance

Because of the different nature of the various capital flows, a common procedure is required for measuring the equivalence of the different flows. Clearly, grants and loans are not equivalent since the latter have to be repaid and the former do not.

A standard procedure for making the flows equivalent is to estimate the **grant equivalent** or **aid component** of the different flows by taking the difference between the nominal flow and future repayments discounted by the free-market rate of interest, which was our earlier measure of the benefit of assistance. A capital inflow that is a pure grant (with no repayment obligations) is 'worth' its face value. A capital inflow that has to be repaid with interest is not worth its face value. How much less it is worth than its face value depends on the rate at which the repayments are discounted:

- If the rate of interest at which the country would have had to borrow in the free market is greater than the actual rate of interest it has to pay, the worth or benefit will be *positive*.
- If the rate of interest at which it would have had to borrow is less than the actual rate, the worth or benefit will be *negative* because the recipient would have had to pay back more than it need to have done (this is unlikely to happen).

The grant equivalent or aid component of assistance is measured in this differential benefit sense. The rate of return on the assistance may, of course, be much greater than the benefit if the productivity of the assistance is higher than the free-market rate of interest.

Two other factors determine the grant equivalent of a loan as well as the effective interest rate subsidy:

- The **grace period** between the disbursement of the loan and the first repayment. The longer the grace period for a loan of a given maturity, the less the present value of the future discounted repayments.
- The **maturity of the loan**. This is important because the longer the maturity, the longer the concessionary interest rate is enjoyed and the less the present value of the future discounted repayments. Through the technique of discounting, any combination of repayment terms can be brought to a common measure.

All three factors referred to – the interest rate subsidy, the grace period and the maturity of the loan – can be incorporated into a simple formula for calculating the grant equivalent of a loan. The grant equivalent or aid component of a loan (as a percentage of its face value) is called the **grant element** and is equal to:

$$\frac{G}{F} = \left[\frac{F - \left(\sum_{t=1}^T \frac{P_t}{(1+r)^t} \right)}{F} \right] 100$$

where F is the face value of the loan, P_t is the total repayment of principal and interest in year t , T is the maturity of the loan and r is the rate of discount. Since P_t includes interest charges, it can be seen that the lower the interest rate relative to the rate of discount (r), and the more that repayments can be delayed through time, the greater the grant element of the loan.

The grant element can be worked out for different combinations of interest rates, discount rates, grace periods and length of maturity. At the two extremes, if the financial flow is a pure grant, then $P_t = 0$ and the grant element is 100%. If the financial flow is at a rate of interest equal to the market rate of interest, and the grace period and maturity of the loan are the same as in the free market, the sum of the discounted future repayments will equal the face value of the flow and the grant element will be zero.

For combinations of conditions between the two extremes, Table 14.9 provides some illustrative calculations. For example, the grant element of a 10-year loan at 5% interest with a grace

Table 14.9 Grant element in loans at different discount rates

Rate of interest and maturity period	5%			6%			7%			10%		
	No grace period G = 0	5 years' grace G = 5	10 years' grace G = 10	G = 0	G = 5	G = 10	G = 0	G = 5	G = 10	G = 0	G = 5	G = 10
2% interest												
10 years	12.9	21.2		16.7	24.0		20.0	28.9		29.5	41.8	
20 years	22.1	27.1	31.3	27.8	34.0	39.0	32.8	40.1	45.7	39.8	48.0	53.7
30 years	28.9	34.0	37.0	35.7	40.6	45.4	41.5	47.5	52.4	54.7	62.3	67.3
40 years	34.2	38.0	41.2	41.5	46.2	49.4	47.5	52.7	56.6	60.5	61.6	73.0
3% interest												
10 years	8.6	14.1		12.5	18.0		16.0	23.2		25.8	36.6	
20 years	14.7	18.1	20.9	20.8	25.5	29.2	21.3	32.2	36.6	31.3	38.1	43.1
30 years	19.3	22.6	24.6	26.8	30.5	34.9	33.2	38.1	42.0	47.8	54.5	58.9
40 years	22.8	25.4	27.4	31.1	34.6	37.0	38.0	42.2	45.4	52.9	58.2	63.8
4% interest												
10 years	4.3	7.1		8.1	12.0		12.0	17.4		22.1	31.4	
20 years	7.4	9.0	10.4	13.9	17.0	19.4	19.8	24.2	27.5	34.1	41.1	46.0
30 years	9.6	11.3	12.3	17.8	20.3	22.8	24.9	28.6	31.5	41.0	46.7	50.5
40 years	11.4	12.7	13.7	20.7	23.0	24.6	28.6	31.7	34.1	45.3	50.0	54.6

Table 14.9 Grant element in loans at different discount rates – *continued*

Rate of interest and maturity period	5%			6%			7%			10%		
	No grace period G = 0	5 years' grace G = 5	10 years' grace G = 10	G = 0	G = 5	G = 10	G = 0	G = 5	G = 10	G = 0	G = 5	G = 10
5% interest												
10 years	0	0	0	4.2	6.0		8.0	11.5		18.4	26.1*	
20 years	0	0	0	6.9	8.5	9.7	13.1	16.2	18.3	28.4	34.2	38.4
30 years	0	0	0	8.9	10.2	11.3	16.6	19.0	20.9	34.2	38.9	42.0
40 years	0	0	0	10.4	11.5	12.1	19.0	21.0	22.6	37.7	41.6	45.5
6% interest												
10 years	a	a	a	0	0	0	4.0	5.8		14.7	20.9	
20 years	a	a	a	0	0	0	6.6	8.1	9.2	22.7	27.4	30.7
30 years	a	a	a	0	0	0	8.4	9.6	10.6	27.4	31.1	33.6
40 years	a	a	a	0	0	0	9.6	10.6	11.4	30.1	33.3	36.4
7% interest												
10 years	a	a	a	a	a	a	0	0	0	11.1	15.7	
20 years	a	a	a	a	a	a	0	0	0	17.1	21.6	23.0
30 years	a	a	a	a	a	a	0	0	0	20.5	23.3	25.2
40 years	a	a	a	a	a	a	0	0	0	22.6	25.0	27.3

Notes: a indicates negative aid value. * Illustrative calculation referred to in the text.

Source: Ohlin, 1966, appendix.

Table 14.10 DAC members' ODA terms, 2014

	Loan share of total ODA (%)	Terms of bilateral loans			
		Average maturity (years)	Average grace period (years)	Average interest rate (%)	Grant element (%)
Australia	0.5	33.2	3.2	0.0	75.4
Belgium	0.9	29.5	10.5	0.0	82.7
Canada	4.0	5.0	5.0	2.1	31.4
France	30.5	20.5	6.6	2.2	52.8
Germany	28.7	15.0	4.5	2.3	43.5
Italy	1.9	37.4	26.5	0.0	94.2
Japan	51.1	34.7	9.2	0.6	78.1
Korea	47.4	39.9	14.5	0.1	89.6
Poland	32.2	24.2	5.0	0.2	69.0
Portugal	31.9	29.1	10.4	1.8	67.7
Total DAC	15.0	26.9	7.7	1.3	64.9

Note: Not all DAC countries report information.

Source: OECD, 2015.

period of 5 years, with the recipient discounting repayments at 10%, would be 26.1%. It can be seen that the grant element is quite sensitive to small changes in the interest rate and the discount rate but relatively insensitive to variations in the grace period and the length of maturity. Long maturities and grace periods are mainly means of providing liquidity rather than aid.

The terms of ODA from DAC members in 2014 are shown in Table 14.10. The average rate of interest charged was 1.3%, the average grace period was 7.7 years and the average maturity of loans was 27 years. The discount rate normally applied is 10%, giving a grant element of approximately 65%. In 2014, the grant element of total official development assistance was 74%. The grant element of major forms of multilateral assistance is approximately 50%.

The moral of the foregoing discussion on the grant element of loans is that identifying the real worth of assistance depends on knowledge of the alternatives. Loans that look generous on the surface because they have a lower interest rate attached may be less valuable than the alternatives if they have shorter lives and grace periods. There is also the question of the freedom of the recipient country to use the loan as it wishes, which we considered earlier in connection with aid tying.

The distribution of international assistance

The distribution of international assistance will affect the comparative rates of growth of developing countries if aid is a positive growth-inducing force. At present, the distribution of assistance in relation to the population of developing countries is extremely unequal. Whereas some countries receive less than \$5 per head per annum, others receive over \$100 per head. Assistance as a proportion of national income also differs widely between countries.

Most bilateral donors refrain from making explicit the criteria on which they distribute assistance. In practice, the criteria employed often tend to be as much non-economic as economic, reflecting historical relations between countries, as well as military and political objectives. It is

often said that it pays a country to be a small island of ex-colonial status in a politically sensitive part of the world. High levels of per capita assistance seem to be closely associated with these characteristics. It is difficult to discern any significant relationship between the distribution of assistance and developmental considerations such as low per capita income, slow growth, balance of payments problems or even good governance. Dictators and corrupt governments also seem to be rewarded.

One recent comprehensive study by Burnside and Dollar (2000) takes a sample of 56 countries over the period 1970–93 and tries to explain the distribution of aid as a percentage of GDP in terms of variables, such as the level of per capita income of the recipient countries (as a measure of need), population size, various strategic (political and military) interests, and whether there is good governance. There seems to be no tendency for either total aid or bilateral aid to be related to the level of poverty, or to favour countries pursuing ‘good policies’, although multilateral aid is more ‘wisely’ distributed (see also Alesina and Dollar, 2000).

Collier and Dollar (2002) derive a poverty-efficient allocation of aid and compare it with actual aid allocations across 59 countries over the period 1974–97, and conclude that the allocation of aid was radically different from the poverty-efficient allocation. With the actual allocation of aid, about 10 million people had been lifted out of poverty annually, but with an efficient allocation to reduce poverty, nearly double the number of people would have been lifted out of poverty.

Individual donor countries will continue to pursue their own objectives and set their own criteria, although there is evidence that more and more donor countries are focusing directly on the attack on poverty and favouring poor countries with sound policies, in line with World Bank thinking.

The criteria governing the distribution of multilateral assistance through international agencies, to which rich countries contribute, are of wider concern. Since loans have to be repaid in foreign exchange, one obvious criterion for distribution would be a productivity criterion measured in terms of foreign exchange, but then all sorts of questions arise concerning the measurement of productivity, the time horizon to be taken, and whether this would lead to a distribution of assistance in relation to need. Without an economically objective and value-free criterion, need is as good a criterion as any and meets the main direct objective of the World Bank, which is the ‘attack on poverty’ (see Chapter 2). One possibility in this connection would be to distribute assistance on a per capita basis according to some target level of per capita income, which would operate rather like an **international negative income tax**. Certain graduated rates of per capita income assistance could be applied to the gap between the actual level of per capita income and the target level. A country that fell way below the target would receive a greater amount of assistance per head of the population than a country that was closer to the target or exceeded it. Given knowledge of the total amount of resources available, rates could be fixed to ensure a wide spread of assistance across countries while not making demands on resources in excess of supply. All this would be conditional, of course, on the new guiding principle of ‘good governance’.

Schemes for increasing the flow of revenue

There are two ways of increasing the net flow of financial resources to developing countries: either nominal assistance can be left unchanged and repayment obligations reduced, or nominal assistance can be increased, leaving the terms of repayment unchanged. Reducing repayment obligations means cutting interest rates, lengthening repayment periods, and generally increasing the grant element of international assistance. Other possibilities would be to allow countries

to repay in local currency rather than foreign currency and to reduce the level of aid tying, as discussed earlier. We shall concentrate here, however, on measures that might be taken to increase the volume of nominal assistance.

One quick way to increase the flow would be for *all* the developed countries to meet their development assistance targets of 1% of national income for total assistance and 0.7% of national income for ODA. A significant increase in the resource flow by a deliberate budget decision in developed countries is only likely to occur, however, if there is widespread public support for the programme. In recent years, there have been signs of diminished public support for aid, based on the belief that a good deal of assistance is wasted and misused. If there is disillusion with assistance – or **aid fatigue** as it has been called – an increased flow of assistance in the future is unlikely in the absence of some recognizable improvement in the efficiency with which current assistance is used. It is difficult to convince people in developed countries, whose standard of living is not that high, to acquiesce to programmes that transfer resources from themselves if these resources are then perceived to be wasted or end up in the hands of people in recipient countries who are richer than themselves. The major reasons for the waste and misuse of resources in the past have been inefficiency and corruption on the part of recipient governments and interference from donor countries in the administration of programme assistance.

Given the political difficulties of increasing aid budgets, what the global economy needs are schemes and forms of international taxation that would raise revenue automatically, free of political debate and budgetary pressure in donor countries. The 1980 Brandt Report first raised the issue of the need for automatic revenue to support global development needs, and the UN Development Programme (UNDP) has called for more work on global taxes. There is no shortage of suggestions as to how more global finance might be raised, particularly through the taxation of global transactions. The schemes can be divided into three (overlapping) groups:

1. Taxes and charges on various international transactions and external diseconomies that damage human welfare in various ways.
2. Taxes or charges on unexploited resources over which no state has sovereignty, for example deep sea minerals.
3. International income taxes earmarked for development purposes.

A useful and interesting list of the various suggestions made has been compiled by the Overseas Development Institute in London (ODI, 1996):

Twenty recent suggestions for raising global revenue:

- A tax on all or some international financial transactions (the 'Tobin Tax'); variants include a tax on bond turnover, or on derivatives.
- A general surcharge on international trade.
- Taxes on specified traded commodities like fuel.
- A tax on the international arms trade.
- Surcharges on post and telecommunications revenues.
- An international lottery.
- A surcharge on domestic taxation (usually expressed as a progressive share of income tax).
- Dedication of some part of national or local taxes, for example on luxuries (or surcharges on them).
- Parking charges for satellites placed in geostationary orbit.
- Royalties on minerals mined in international waters.

- Charges for exploration in, or exploitation of, Antarctica.
- Charges for fishing in international waters.
- Charges for use of the electromagnetic spectrum.
- A tax or charge on international flights (or alternatively, on flights in congested sectors); a variant is a tax on aviation kerosene.
- A tax or charge on international shipping.
- Pollution charges (for example, for dumping at sea).
- A tax on traded pollution permits.
- A voluntary local tax paid to a central global agency.
- A new issue of Special Drawing Rights (SDRs), distributed to the poorer developing countries (or used for peacekeeping or other global public goods).
- Sale of part of the IMF gold stock.

These are only suggestions and possibilities. There has been no sustained discussion of any of them at the intergovernmental level, and none of them has been taken up in a serious way by any of the major aid-giving countries. A \$100 billion increase in SDRs was announced in 2009 in the wake of the international financial crisis that erupted across the world in 2008 (see Chapter 16).

Apart from the idea of various taxes and charges, one of the most attractive ideas is to involve individuals in the spirit of international aid giving and to foster their interest in the challenge of development by allowing them to pay a proportion of their tax obligations in the form of donations to various development funds concerned with poverty eradication, the environment, education and so on. This already happens in a small way with tax relief on donations to charities and NGOs working in developing countries, but the principle needs to be expanded if the idea of voluntary taxation in support of development is to have a significant impact.

The proposal for new issues of SDRs and the sale of IMF gold for development purposes is discussed in Chapter 16.

Foreign direct investment (FDI) and multinational corporations

Apart from ODA, another major source of development finance is private capital flows that allow countries to import more than they export and to invest more than they save. Private capital flows are of three main types: FDI and portfolio investment, which are non-debt-creating flows, and commercial bank lending, which creates debt. In this section, we focus on FDI in developing countries. Bank lending, and the debt problems to which it gives rise, are considered in the final section.

There has been a vast increase in the amount of FDI going to developing countries in recent years, fuelled by three major factors: the rise of multinational corporations and the search for global profits, the liberalization of global capital markets, and economic liberalization within developing countries. For a comprehensive survey of the causes and effects of FDI, see de Mello (1997).

But these flows are highly concentrated in a few countries. Total flows of FDI into developing countries are now running at over \$500 billion a year, compared with under \$20 billion in the early 1980s, but 80% goes to only ten countries located in South America and Southeast Asia (including China), as shown in Table 14.11. Overall, FDI accounts for about 10% of total investment in developing countries and roughly 2% of GDP. In discussing the costs and benefits of FDI, the relatively small contribution of FDI to economic activity in the majority of developing countries needs to be borne in mind.

Research into the determinants of FDI shows that cost structures, differential returns, market growth, and the institutional characteristics of the host country are of prime importance. Companies wishing to invest overseas are looking for a favourable trade and investment regime, good infrastructure, property rights, political stability, macroeconomic stability, and an educated and committed workforce. Much depends on the capacity of the country to absorb the investment, which, in turn, depends on its growth prospects and ability to export.

FDI brings many advantages to recipient countries, but there are also many potential dangers and disadvantages from a development point of view. We shall first list the advantages:

1. FDI raises the investment ratio above the domestic savings ratio, which is good for growth if nothing adverse happens to the productivity of investment.
2. The investment brings with it knowledge, technology and management skills, which can have positive externalities on the rest of the economy. Foreign investment can often be a catalyst for domestic investment in the same or related fields.
3. It requires the training of labour, which is another positive externality. It is estimated that over 40 million workers are employed directly or indirectly by multinational corporations in developing countries.
4. A great deal of FDI goes into the tradable goods sector of the recipient countries, which improves the export performance of these countries and earns them valuable foreign exchange.

Recent research shows a positive relation between FDI, domestic investment and the growth of GDP. Bosworth and Collins (1999) take a sample of 58 developing countries over the period 1978–95 and find that FDI brings about a one-to-one increase in domestic investment, while capital inflows as a whole increase domestic investment by only half the amount. Coe et al. (1997) examine the empirical evidence between international research and development (R&D) spill-overs and economic growth for a sample of 77 countries. They find that the variation in total factor productivity growth between countries is related to the foreign stock of R&D capital, and that East Asian countries have benefited most from foreign R&D. It has been estimated by Borensztein et al. (1995) that a 1 percentage point increase in the ratio of FDI to GDP in developing countries over the period 1971–89 was associated with a 0.4–0.7 percentage point increase in the growth of per capita GDP, with the impact varying positively with educational attainment as an indicator

Table 14.11 FDI net inflows to top ten developing countries, 2014

	Total (\$ million)
China	289,097
Brazil	96,895
Singapore	67,523
India	33,871
Indonesia	26,349
Mexico	24,154
Chile	22,002
Colombia	16,151
Turkey	12,765
Malaysia	10,609

Source: World Bank, 2015.

of a country's ability to absorb technology. But there is also evidence of bidirectional causality (see de Mello, 1997). FDI affects growth positively, at least above a certain threshold, but growth also affects FDI positively; another example of a virtuous circle. Pacheco-López (2005) also finds evidence of bidirectional causality in a study of FDI in Mexico.

Now let us turn to some of the potential dangers of FDI. As we have indicated, investment by multinational corporations with headquarters in developed countries involves not only a transfer of funds (including the reinvestment of profits) but also a whole package of physical capital, techniques of production, managerial and marketing expertise, products, advertising, and business practices for the maximization of global profits. There is no doubt that such investment augments real resources directly; the question is whether such investment contributes to the broader aspects of development relating to the pattern of development and the distribution of income.

The activities of the multinationals come under attack on a variety of grounds. First, because they tend to locate in urban areas, they widen the income gap between urban and rural sectors, thus perpetuating dualism. This criticism, however, cannot be levelled exclusively against multinationals because any new industrial activity establishing in existing urban centres will have the same effect.

A second and more serious criticism is the way in which they encourage and manipulate consumption. Not only do they tend to cater for the tastes of the already well-to-do, which itself acts as a divisive force, but also they tend to encourage forms of consumption among the broad mass of people, particularly in urban areas, that are inappropriate to the stage of development and often nutritionally damaging. Prime examples are powdered baby milk and Coca-Cola. These tendencies are not only wasteful, but they encourage acquisitiveness, reduce domestic saving, and can worsen balance of payments difficulties by encouraging expensive tastes.

A third criticism, which we have already dealt with in Chapter 6, is that they may introduce inappropriate technology and retard the development of an indigenous capital goods industry. Related to this is the possibility that the multinationals may stifle indigenous entrepreneurship and destroy domestic firms, so that the net addition to capital accumulation is much less than the investment provided by the multinationals themselves.

Another aspect of the multinationals is that because of their large size and the power they wield, developing countries in which they operate lose aspects of their national sovereignty and control over economic policy. The companies may easily avoid the effects of domestic monetary policy because of easy access to foreign capital markets and their own internal resources. They can avoid tax by shifting profits abroad. Countries may wish a multinational company to do one thing, but it may not readily comply because the action may conflict with the global profit objectives of the company as a whole. Firms may exploit resources more quickly than is desirable, and exploit consumers and workers through the exercise of monopoly and monopsony power.

There is also the question of the repatriation of profits. FDI has the potential disadvantage, even compared with loan finance, that there may be an outflow of profits that lasts much longer than the outflow of debt service payments on a loan of equivalent amount. While a loan only creates repayment obligations for a definite number of years, FDI may involve an unending commitment. This has serious implications for the balance of payments and for domestic resource utilization if foreign exchange is a scarce resource. We can show with a numerical example that, in the long run, if profits are repatriated, the impact of continuous FDI on the balance of payments must be negative unless the *gross* inflow of foreign investment grows substantially from year to year. This, of course, then increases the power and influence of the foreign interests within the country concerned.

Table 14.12 Balance of payments effects of private foreign investment

Year	Gross inflow	Foreign investment at beginning of period	Foreign investment at end of period	Outflow of profits	Net inflow
1	100	100.0	110.0	10.0	90.0
2	100	210.0	231.0	21.0	79.0
3	100	331.0	364.1	33.1	66.9
4	100	464.1	510.5	46.4	53.6
5	100	610.5	671.6	61.1	38.9
6	100	771.5	848.7	77.2	22.8
7	100	948.7	1,043.6	94.9	5.1
8	100	1,143.6	1,258.0	114.4	-14.4

Suppose that there is a steady gross inflow of 100 units of foreign capital per annum, that the productivity of capital is 20%, and that one-half of the profits are reinvested and the other half are repatriated. Table 14.12 shows that, on these assumptions, the balance of payments effect turns negative after the eighth year. To keep the net inflow of resources positive requires a steadily rising gross flow of private foreign investment, with all the implications this may have for the pattern of development in the future.

It is extremely difficult to measure the full impact and real costs of multinational investment using economic calculus alone, but this is what developing countries must do. What would be the real income gains and losses of controlling the free mobility of FDI? Other ways of taking advantage of FDI might be actively explored, including **joint ventures** and **turnkey projects**, whereby the foreign investor pays for and builds the project in collaboration with the host country, which is then run by host country nationals. There is already evidence that this is the direction in which developing countries are moving. Developing countries must lay down very clearly the conditions under which they will accept multinational investments and monitor the companies' operations so that distorted development and exploitation are avoided.

International debt and debt service problems

Developing countries not only borrow from donor countries and multilateral agencies but also commercially from the international banking system. All borrowing, whether official or private, involves repayment obligations, unless the loans are gifts or written off. First, the loan has to be repaid over a certain number of years (**amortization repayments**), and second, **interest payments** will be charged on the loan. Amortization and interest payments constitute **debt service payments**. All loans that have to be repaid with interest are **debt-creating flows**.

There has been a massive increase in debt-creating flows to developing countries since the early 1970s, caused by growing payments imbalances between countries. The total volume of debt in 2014 and the debt burden measured by various indicators – such as the debt–export ratio, the debt to national income ratio, and the ratio of debt service payments to export earnings (**the debt–service ratio**) – is shown in Table 14.13 for various groups of countries. The total debt of low- and middle-income countries is now a colossal \$5,400 billion (or roughly \$1,300 per head of population) and debt service payments absorb \$250 billion of foreign exchange or nearly 10% of total export earnings. The debt–service ratio is particularly crucial because this measures the amount of

Table 14.13 The debt burden of developing countries, 2014

	Total external debt			Total debt service
	\$ millions	% of GNI	% of exports of goods and services	% of exports of goods and services
Low income	167,105	26.6	164.0	..
Middle income	5,224,360	22.1	79.7	8.9
Lower middle income	1,527,246	27.8	104.6	14.5
Upper middle income	3,697,114	20.4	72.5	7.4
Low and middle income	5,391,465	22.2	80.9	8.9
East Asia and Pacific	1,816,587	14.6	25.7	3.8
Europe and Central Asia	1,023,990	58.0	10.5	22.8
Latin America and Caribbean	1,346,821	29.5	95.5	15.6
Middle East and North Africa	187,878	15.3	12.5	5.5
South Asia	613,379	23.5	107.0	17.5
Sub-Saharan Africa	402,811	24.5	88.8	7.3

Source: World Bank, 2015.

foreign exchange earnings that cannot be used to purchase imports and is therefore some measure of the extent to which a country might decide to default on its repayment obligations. The greater the debt service payments, the more that development is thwarted. Some of the largest debtor countries of the world, such as Brazil and Turkey, have the highest debt–service ratios.

To judge whether a country's level of debt is sustainable, the World Bank takes a debt–export ratio of 220%. This is the main criterion for relief under the HIPC Initiative (see below). By this criterion, it is mainly African countries that constitute the severely indebted low-income countries with debt–export ratios of 200% or more in some cases.

Before turning to the origins of this massive volume of debt, however, let us consider in more detail the nature of the debt-servicing problem. At the beginning of the chapter, it was shown that it is profitable for a country to borrow as long as the rate of return on the borrowing exceeds the rate of interest. In these circumstances, the rate of growth of income is higher than it would otherwise be. This gives no indication, however, of whether the borrowing can be serviced or repaid, since the loan must be repaid with interest in *foreign* currency. Thus, the profitability of borrowing and the capacity to service debt are conceptually distinct. The ability to service debt depends on whether additional foreign exchange can be earned or saved by the borrowing. This depends on the domestic economic policy pursued by the country concerned and the ability to export, which depends, to a large extent, on world economic conditions.

The debt-servicing difficulties that have arisen in recent years have had as much to do with deteriorating world economic conditions, which have depressed the foreign exchange earnings of developing countries, as with the miscalculation of rates of return on investment, the misuse of investment funds, or the use of capital inflows to increase present consumption. There was a parallel in the 1980s with the Great Depression of the 1930s when the collapse of world prices of key commodities and a general shrinkage of world trade caused major debt defaults, which subsequently dried up the flow of private capital to developing countries for the next 40 years. The trouble started in 1982 when the volume of world trade fell by 2.5%, and the terms of trade for developing countries as a whole deteriorated by over 10%.

Not even the most prudent borrower or cautious lender can foresee such events, which may occur halfway through the life of a loan commitment that was entered into under quite different economic circumstances. Lenders and borrowers can allow for risk – that is, the statistical probability that the expected outcome will not materialize – but not uncertainty, and what happened in the world economy in the 1980s was a whole shift in the probability distribution of outcomes that could not be insured against. When such unforeseen events occur, beyond the borrower's control, which make it difficult for loans to be repaid and serviced without severe economic disruption, two questions arise: What is the optimal degree of debt rescheduling? Who should bear the cost?

It is naturally in the interests of private banks that loans be repaid on schedule, but it is not necessarily in the global interest if this leads to a contraction of imports by the borrowing countries, which then reduces the exports of other (lending) countries, leading to a deflationary spiral in the whole world economy.

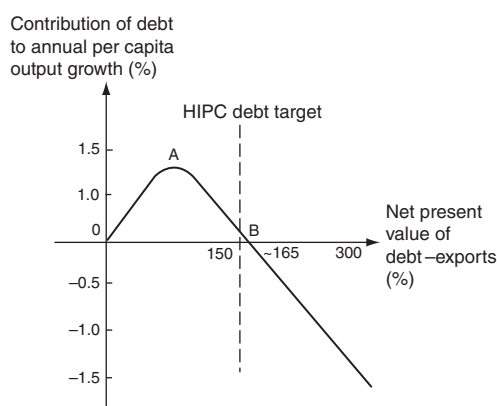
Optimal borrowing and sustainable debt

The benefits of borrowing to individual countries, and to the world economy at large, are clear. The question is: How far should borrowing go? Is it possible that after a certain point, even though a developing country still requires resources for development, the disadvantages of further borrowing outweigh the advantages? This raises the question of **optimal borrowing** and the **sustainability of debt**. Reasonable levels of debt are likely to enhance growth in countries short of capital if borrowing is used productively and earns foreign exchange so that debt can be serviced without deflating the economy to save imports. Debt becomes unsustainable when it accumulates at a faster rate than the borrower's capacity to service it. Expected debt service costs then discourage domestic and foreign investment, because potential investors fear the economy will be deflated or that they will be 'taxed' to service the debts.

Working out what level of debt is sustainable requires an assessment of how outstanding stocks of debt are likely to evolve over time, together with forecasts about the future interest rates, exchange rates and foreign exchange earnings. The IMF has recently developed a standardized framework for assessing debt sustainability, which takes account of a country's future growth rate, interest rate and exchange rate, and applies sensitivity analysis based on each country's history.

Several debt indicators and measures of sustainability can be used. One is the ratio of debt to GDP. There has been a progressive rise in the **ratio of debt to GDP** among developing countries, from less than 20% in the early 1970s to nearly 30% today, but it is not clear what economic significance should be attached to this ratio as a measure of the ability to service debt and therefore as a measure of debt sustainability. It is true that to service more and more debt, export earnings as a proportion of national income should rise, but this suggests more direct measures of sustainability: either the **debt–export ratio** or the **debt–service ratio**, which measures the ratio of amortization and interest payments to export earnings.

To answer the question of the sustainability of debt, Kraay and Nehru (2006) at the World Bank take 132 low- and middle-income countries over the period 1970–2002, and use probit analysis to predict debt distress defined as the inability to service debt from the Paris Club of OECD countries and from the IMF. They find that the debt–export ratio is one important factor, but that the level of debt that can be sustained depends on the quality of country institutions and policies. For a country with an average institutional/policy score, a 100% debt–export ratio would be sustainable, with a 39% probability of distress (the mean of the sample for low-income

Figure 14.4 Debt–export ratio and growth

countries), while for countries with very good institutions and policies, a debt–export ratio of 400% would be sustainable.

On the relationship between the debt–export ratio and the growth of per capita income, Patillo et al. (2002) find a nonlinear relation. They take a sample of 93 developing countries over the period 1969–98 and, controlling for other variables, find that the per capita income growth of countries is maximized when the debt–export ratio is approximately 80%, and debt impacts negatively on growth when the debt–export ratio exceeds 160% – as shown in Figure 14.4. The growth differential between countries with low indebtedness (with an export–debt ratio $< 100\%$) and those with high indebtedness (with an export–debt ratio $> 367\%$) is, on average, more than 2 percentage points. It appears that the relationship between debt and growth is nonlinear (an inverted U-shape) and that the level of sustainable debt is, on average, close to the ratio of 150% of export earnings, which is below the ratio at which countries become eligible for debt relief under the HIPC Initiative launched by the World Bank in 1996 (see later).

These results have been corroborated by Bhattacharya and Clements (2004), who take 55 low-income countries over the period 1970–99 and find a positive relation between the debt–export ratio and per capita income growth up to a ratio of nearly 200% (and for the debt–GDP ratio up to 50%). They calculate that if the net present value of debt–GDP ratio for the most heavily indebted countries was reduced from, say, 100% to 50%, this could raise the annual growth of per capita income by 2.8 percentage points. They also calculate that a 1 percentage point reduction in the debt–service ratio could raise the investment to GDP ratio of countries by about 0.2 percentage points.

The debt crisis of the 1980s

The world debt crisis (useful texts on this subject include Cline, 1984, 1995, Claudon, 1986, Lomax, 1986, Lever and Huhne, 1985 and Griffith-Jones and Sunkel, 1986) erupted in the summer of 1982, when Mexico became the first country to suspend the repayment of loans due to the private banking system and sovereign lenders. The crisis has smouldered ever since, with more and more countries, particularly in Africa, finding it difficult to service accumulated debts out of foreign exchange earnings. In 1987, Brazil became the first country to suspend interest payments to foreign creditors.

The 'crisis' aspects of debt can be looked at from different standpoints: from the point of view of the individual borrowing countries, the lenders (private and sovereign governments), or the entire world economy. As far as borrowers are concerned, when the crisis first erupted, there were essentially two types of 'problem' countries. First, there were a number of *poor commodity-dependent countries*, mainly in Africa but also elsewhere, where private banks were not heavily involved. It became a crisis for these countries when they had to cut back on essential imports in order to service their debts, but not a crisis for the banking system or the world economy, even if they had defaulted.

Second, there was a set of large *newly industrializing countries*, mainly in Latin America, which borrowed from the commercial banking system at floating rates of interest, but then their export markets became depressed. The sums of money involved were huge. In the early 1980s, 16 countries accounted for over half of the total debt of nearly \$1,000 billion and for nearly 90% of the debt owed to the private banking system. In this case, the non-repayment of debt would have caused a crisis for the private banking system (which, in retrospect, had clearly overextended itself), and a crisis for individual countries if the threat of default had dried up the flow of new capital. There would also have been a crisis for the world economy if there had been a major default that led to a massive contraction of bank lending throughout the system; but this did not happen. Lending did contract sharply in the early 1980s, but then rose again as the difficulties were resolved by various forms of international cooperation and the rescheduling of debt.

The origin of the current debt difficulties of many developing countries is no mystery. Massive balance of payments surpluses arose in the early 1970s in the oil-exporting countries, with counterpart deficits elsewhere. The factors that caused the supply of capital to increase created its own demand. Private banks were anxious to lend and there was no shortage of demand. Demand was particularly strong because commodity prices were generally high, exports were buoyant and inflation had reduced the real rate of interest on loans to virtually zero. Credit looked cheap and borrowers looked like good risks from the lenders' point of view. But these circumstances suddenly changed. Depression in the developed countries, mainly self-inflicted to reduce the rate of inflation, caused world commodity prices to tumble, exports to languish and real interest rates to rise. On top of this, nominal interest rates floated upwards and the dollar appreciated. At the height of the debt crisis (in 1986) the debt-service ratio reached a peak of 30%. This has since fallen back to under 20%, partly because of lower interest rates and debt rescheduling and partly because of increased export earnings following the recovery of the world economy.

The world debt problem is a foreign exchange problem. It represents the inability of debtors to earn enough foreign exchange through exports to service foreign debts, and at the same time to sustain the growth of output (which requires foreign exchange to pay for imports). Either debt service payments have to be suspended or growth curtailed, or a combination of both. Unfortunately, for many debtor countries, it is living standards that have suffered. Many indebted developing countries have stagnated under a total burden of debt that has now reached \$5,500 billion, with resource transfers to service the debt close to \$250 billion per annum.

All this is part of the **transfer problem** analysed by Keynes in 1919 in the wake of the controversy over the reparation payments imposed on Germany after the First World War by the Treaty of Versailles in 1919 (Keynes, 1919). Keynes mocked the folly and futility of the whole exercise on the grounds that it was likely to be self-defeating, and so it turned out to be.

There are two aspects of the transfer problem: the **budgetary problem** for governments of acquiring domestic resources for the repayment of debt, and the problem of turning the resources into foreign exchange – or the **pure transfer problem** as Keynes called it. The **transfer burden** is the export surplus that has to be generated to acquire the necessary foreign exchange, plus the possibility

of a deterioration in the terms of trade if, in order to sell more exports, prices must be reduced. Even if prices do fall, there is still no guarantee that export *earnings* will increase if the quantity sold does not rise in proportion to the fall in price. In these circumstances, the transfer becomes impossible without a contraction of domestic output to compress imports. There is substantial evidence that the indebted countries collectively are caught in this trap, since for a large part of their trade they compete with each other; and competitive price reductions leave total earnings unchanged. It is the contraction of living standards that generates the export surplus by reducing the import bill. This is not good for developing countries, or for the health of the world economy.

The debt crisis of the early 1980s has subsided, but the debt problem has not gone away. Lenders have been as irresponsible as borrowers. The developed countries must accept a large share of the responsibility for the world recession of the 1980s, as should the private banks for voluntarily overextending themselves. Shared blame requires shared solutions.

Debt relief

Debt, in many ways, is like a cancer, once it gets a grip on a country it is very hard to eradicate and may spread unless the rest of the economy can be reinforced to overcome it.

There are no easy solutions to the debt-servicing problem short of a massive programme of **debt forgiveness**, which leaves a manageable debt that the debtors can service. There has to be debt relief if there is to be any easing of the transfer burden. Without relief, further borrowing increases the size of the debt service payments and simply makes matters worse, creating what might be called a **debt trap**. Since lenders, borrowers and the whole world community have benefited from the debt creation process, there is a strong case for saying that the same three parties should share the burden of relief. It is not fair that the debtor countries (the borrowers) should bear the whole of the adjustment burden. Up to now, the world community (including the creditor countries) has done very little to ease the debtors' plight, although there are three reasons why it should:

1. The world community received an external benefit when the debt was created by the lending process in the 1970s, preventing output contraction in countries with balance of payments deficits, and thereby avoiding a world slump.
2. Much of the debt problem arose in the first place through no fault of the developing countries themselves, but as a result of events in the world economy – rising oil prices, rising interest rates, world recession, and falling commodity prices.
3. Relief could actually confer a global benefit by easing the deflationary forces associated with the huge debt overhang.

Heavily Indebted Poor Country (HIPC) Initiative

The most recent and publicized global scheme for debt relief is the **Heavily Indebted Poor Country (HIPC) Initiative** launched by the World Bank in 1996, designed to help the world's poorest indebted countries. The World Bank has always been hostile to the write-off of debt, but the share of debt service payments going to multilateral creditors has increased in recent years and now accounts for over 50% of debt service payments by some African countries. This World Bank initiative therefore marked a radical departure in thinking and attitude. At the time, James Wolfensohn, president of the bank, described the initiative as 'a breakthrough – it deals with

debt in a comprehensive way to give countries the possibility of exiting from unsustainable debt. It is very good news for the poor of the world.' To qualify for debt relief, a country had to have a debt–export ratio in excess of 220% or a debt to government revenue ratio of more than 280%. Forty-one countries, mainly in Africa, originally met the criteria, with a combined debt of nearly \$200 billion. In the first three years of the initiative, however, progress was painfully slow. Only seven countries satisfied the stringent conditions laid down by the World Bank in order to receive help, and only \$10 billion of relief was dispensed.

Dissatisfaction with the original initiative led the Group of Seven (G7) rich industrialized countries to launch an **Enhanced HIPC Initiative** in Cologne in 1999, later endorsed by the World Bank and the IMF, which, according to the World Bank, was intended to be 'deeper, broader and faster'. Then, in 2005, to help accelerate progress towards the UN's Millennium Development Goals, the HIPC Initiative was supplemented by the **Multilateral Debt Relief Initiative (MDRI)**, which allows for 100% relief on eligible debts to the World Bank, the IMF and the African Development Bank.

To be considered for HIPC Initiative assistance, a country must fulfil the following four conditions:

1. Be eligible to borrow from the World Bank's International Development Agency (IDA), which provides interest-free loans and grants to the world's poorest countries, and from the IMF's Poverty Reduction and Growth Trust (formerly the Enhanced Structural Adjustment Facility) (see Chapter 16), which provides loans to low-income countries at subsidized rates.
2. Face an unsustainable debt burden that cannot be addressed through traditional debt relief mechanisms.
3. Have established a track record of reform and sound policies through IMF- and World Bank-supported programmes.
4. Have developed a Poverty Reduction Strategy Paper (PRSP) through a broad-based participatory process in the country (see Case example 14.7).

Once a country has met or made sufficient progress in meeting these four criteria, the executive boards of the World Bank and IMF formally decide on its eligibility for debt relief, and the international community commits to reducing debt to a level that is considered sustainable. This first stage under the HIPC initiative is referred to as the **decision point**. Once a country reaches this point, it may immediately begin to receive interim relief on its debt service falling due. In order to receive complete debt relief, a country must:

- Establish a further track record of good performance under programmes supported by loans from the World Bank and the IMF.
- Implement satisfactorily key reforms agreed at the decision point.
- Adopt and implement its PRSP for at least one year.

Once a country has met these criteria, it can reach its **completion point**, which allows it to receive the full debt relief committed at the decision point.

The total cost to the 39 countries currently eligible or potentially eligible for debt relief under the Enhanced HIPC Initiative is about \$75 billion at 2013 prices. Uganda was the first country to receive debt relief under the Enhanced HIPC Initiative in May 2000 based on several years of progress in implementing poverty relief programmes (see Case example 14.7).

The pre-decision point countries face common challenges, including preserving peace and stability, and improving governance and the delivery of basic services. Addressing these challenges requires continued efforts from these countries to strengthen policies and institutions, and support from the international community.

Case example 14.7

How debt relief fits into a poverty reduction strategy: Uganda's Poverty Action Fund

Improving the overall allocation of resources, including those from debt relief, through more poverty-oriented and transparent budgets, is fundamental in the fight against poverty. There are many ways of achieving this end, and in Uganda a special fund to use the savings from debt relief is proving useful.

The government created the Poverty Action Fund (PAF) as a conduit for the savings from debt relief under the HIPC Initiative (about \$37 million a year; the Enhanced HIPC Initiative is expected to double this amount). The fund has been earmarked to address the poverty and social conditions highlighted in the poverty eradication action plan adopted in 1997. The plan emphasizes maintaining macroeconomic stability while increasing the incomes and the quality of life of poor people by developing rural infrastructure, promoting small businesses and microenterprises, creating jobs and improving health services and education. The PAF focuses on schools, rural feeder roads, agricultural extension, and district-level water and sanitation. Specific outcome targets have been identified, such as the construction of 1,000 additional classrooms to support the primary education programme.

Two crucial features of the PAF are its integration into the overall budget and the Ugandan government's effort to create a transparent and accountable structure of management. Reports on financial allocation are released at quarterly meetings attended by donors and NGOs. The Inspector General's office monitors the use of funds at district and national levels. This self-imposed conditionality reflects the government's strong commitment to tackling corruption. But it is also an attempt to address creditor concerns about the capacity of a debtor country to link debt relief to poverty reduction. Several measures have been proposed for improving monitoring, ranging from including district-level officials in the quarterly meetings to having local NGOs do community-based monitoring of the poverty fund's spending.

Apart from bold, imaginative, global schemes of debt relief, there have been a number of piecemeal, case-by-case initiatives in which the burden on the debtor developing countries has been ameliorated.

Debt rescheduling

The initial US response to the 1980s debt crisis was to attempt to increase **liquidity**, to give developing countries more breathing space to 'grow out' of their debt problems. This was the thinking behind the so-called **Baker Plan** of October 1988, which made provision for \$20 billion of additional lending from the commercial banks and \$9 billion of multilateral lending to the 15 or so most severely indebted countries, contingent on market-friendly, growth-oriented structural adjustment programmes being adopted. There was no acceptance of debt reduction by banks, and the sums of money were a drop in the ocean. In the event, most of the money was not lent because of the continued vulnerability of the banks and the deteriorating external situation.

The abortive Baker Plan was followed by the so-called **Brady Plan** of 1989, which did accept debt reduction and was more successful. The two main elements of the plan were:

1. Providing funds via the IMF and the World Bank for various forms of debt relief to those middle-income debtor countries that were willing to adopt policy reforms.

2. Encouraging countries to buy back debt from banks at a discount, thereby reducing future obligations.

One possibility was for countries to swap old loans for new long-term (30-year) bonds at a discount of some 35% and an interest rate only marginally above the market rate – the bonds were guaranteed by the IMF. Agreements of this type were reached with Mexico, the Philippines, Costa Rica, Venezuela and Uruguay. The deal with Mexico relieved it of \$20 billion of debt service payments.

Other multilateral initiatives focused on the poorest debtor countries. The governments of OECD countries representing the so-called Paris Club adopted two major initiatives – the **Toronto Terms** in September 1988 and the **Trinidad Terms** in September 1990. These initiatives were related to official debt (that is, debt owed to governments) and made provision for the cancellation of a substantial proportion of the debt. For the remainder of the debt, substantial restructuring was offered.

Under the Toronto Terms, eligible countries were those receiving concessional assistance from the International Development Association, the soft loan affiliate of the World Bank, and a distinction was made between official development assistance (ODA) and non-ODA. For ODA, countries were given 25 years to pay with a grace period of 14 years, with no change in the interest rate. For non-ODA, three options were offered of different combinations of rescheduling, relief and interest rates.

Under the Trinidad Terms, heavily indebted countries with a per capita income of less than \$1,195 were eligible. For ODA, countries were given 20 years to pay with a grace period of 10 years. For non-ODA, countries were given 15 years to pay with a grace period of 8 years and a market rate of interest.

In 1996 and 1999, the HIPC Initiatives were launched, as discussed above, which concentrate more on debt relief than debt rescheduling.

Apart from these official initiatives, a great deal of other debt rescheduling has been arranged privately between individual countries and the creditor banks. These ease the short-term pressure but do not reduce future repayment obligations, unless the rescheduled debt is on softer terms.

Debt service capping

Several schemes have been suggested to prevent debt service payments becoming excessive. One is for **variable maturity loans** to be issued, so that debt service payments would remain unaltered as interest rates floated upwards on private debt (rather like mortgage loans are variable in the housing market). Alternatively, maturities could be varied automatically in order to keep the debt–service ratio unchanged. This would also accommodate fluctuations in foreign exchange receipts from exports. These schemes are equivalent to capping interest payments above a certain level. In 1985, Peru unilaterally imposed a 10% ceiling on debt service payments as a proportion of export earnings.

Another possibility is to offer **zero coupon bonds**, which would delay interest payments until a loan had matured. This would reduce the present value of interest payments, but, more importantly, it would allow investment to be fully productive before there was any commitment of foreign exchange. It would not insure, however, against the bunching of repayment commitments when foreign exchange earnings might be low.

Debt buybacks and debt swaps

Another solution to the debt service problem that has gained favour in recent years is for countries to buy back their debt at a discount, or to exchange the debt in various ways that fully or partially relieve the burden of interest and principal repayments. Developing countries' debt trades in a secondary market, where some countries' debts can be bought at a discount of more than 50%. At one time, Sudanese debt could be bought in the secondary market for \$2 per \$100. If Sudan had been able and willing to use its foreign exchange reserves to buy its own debt, it could have wiped out, say, \$1 million of debt for as little as \$20,000. The secondary market, however, is generally thin, and heavy buying is likely to raise the price considerably. Even so, the use of foreign exchange reserves to buy back debt at a discount of 20–30% can make a useful contribution to debt relief. In 1995, Peru spent \$600 million in the secondary market, buying \$1.2 billion of its debt accumulated in the late 1970s and early 1980s at an estimated saving of \$1 billion in interest payments.

Debt/equity swaps are a way of eliminating debt service payments altogether. In a debt/equity swap, the debt held by the creditor is converted into an equity stake in enterprises within the debtor country. The creditors have a claim on future profits, but the debtor countries are relieved of interest payments. Such swaps can be profitable to all parties involved. A classic example was the Nissan motor company's purchase of Mexican debt for investment in its Mexican subsidiary in 1982. Nissan bought \$60 million of Mexican debt held by the Citicorp Bank at a price of \$40 million – a discount of one-third. Nissan redeemed the debt certificates at the Mexican central bank for \$54 million in Mexican pesos, which were then invested in its subsidiary. The bank unloaded its debt at the 'market' price, Nissan made a profit in dollars, and Mexico was relieved of interest payments in foreign currency. There have been several other debt/equity swaps since 1986, and they are increasingly linked to privatization programmes in debtor countries, but the absolute magnitude of the sums involved is still relatively small in relation to the size of the debt burden.

Debt for nature and **debt for development swaps** work in the same way as debt/equity swaps, except the debt is bought by a governmental or charitable organization and the proceeds are used for environmental or developmental purposes within the debtor country. The World Wide Fund for Nature has bought developing countries' debt at a considerable discount and exchanged it for local currency for use on environmental projects within developing countries. In 1988, UNICEF bought Sudanese debt from the Midland Bank, and this was redeemed by the Sudanese government to finance water sanitation programmes in central Sudan.

Debt for bonds is a swap scheme whereby debtor countries offer fixed interest, long-term bonds in exchange for debt held by the banks. They can be advantageous if the debt can be exchanged at a discount at a more favourable rate of interest. In 1988, Mexico launched a scheme offering \$10 billion of bonds to its creditor banks, hoping to sell at a discount of 50%. The sale turned out to be disappointing, however. Only 100 out of the 500 banks bid for the bonds, and the debt was discounted by only 30%. Even so, some saving was made by the Mexican government.

Exit bonds are a particular type of bond that give a bank a lower rate of interest than on the original debt, but end the bank's liability to provide new money. One way of encouraging this type of arrangement would be for the IMF to guarantee interest payments on the exit bonds, which would encourage the banks to swap debt for this type of bond.

Long-term solutions

On a longer term basis, developed countries might set up machinery to guarantee loans from private sources (in addition to export credit guarantees) and establish a fund from which commercial interest rates could be subsidized. Such a scheme would mean that private lenders would not be deterred from lending through fear of default, developing countries would receive cheaper credit, and the donor's contribution in the form of payments to private lenders would not burden the balance of payments (if this was regarded as an obstacle to a higher level of official assistance).

Second, ODA might be given as grants rather than loans. The grant element of official assistance is already high, and this further step would not only give extra marginal help but would also eliminate the need to haggle over debt renegotiations if the need for rescheduling arose.

Finally, there is an urgent need to devise schemes to stabilize the price or terms of trade for primary commodities. A large part of the 1980s debt crisis resulted from the collapse of primary product prices, and large fluctuations in primary product prices continue to pose problems for poor countries today (see Chapter 15).

To stabilize the terms of trade, indexation may be appropriate for some commodities, for example oil. For other primary commodities, credit creation to finance merchants' stocks would assist. Special Drawing Rights (see Chapter 16) might play a useful role here for buying up surplus stocks of primary commodities that are storable, or for income compensation for commodities that are not. It seems incredible that so many years have passed since Keynes' wartime plan for an international agency for stabilizing commodity prices (see Thirlwall, 1987; and see Chapter 15 for partial schemes already in existence), yet the world still lacks the requisite international agreement and institutional structures for greater stability and a fairer deal for developing countries that live by exporting primary commodities.

Summary

- Domestic saving and investment for growth and development can be supplemented by various types of foreign resource inflows such as loans from bilateral and multilateral sources, pure aid, FDI and remittances.
- The amount of foreign resource inflows required to support a particular target rate of economic growth can be estimated using dual-gap analysis.
- Foreign borrowing will raise the growth of national income if the productivity of capital imports is greater than the rate of interest on loans, and will raise the growth of national output if new foreign borrowing exceeds the loss of domestic saving to pay interest on past borrowing.
- The total amount of foreign resource inflows into developing countries is approximately \$1000 billion, including \$140 billion of aid, \$400 billion of FDI and \$600 billion of remittances.
- The motives for aid giving are humanitarian and economic, but there are many critics of aid who argue that it weakens the domestic savings effort and fosters a 'dependency' culture.
- The macroeconomic impact of aid depends on whether it is spent directly on imports or whether the government sells the foreign exchange to the central bank and then uses the local currency to buy domestic goods.
- The World Bank is a major multilateral lender to developing countries, but its structural adjustment programmes have been criticized for being too deflationary and 'anti-developmental'.

- Foreign direct investment has benefits, particularly knowledge spillovers, but it also has costs in terms of continual profit outflows and the use of inappropriate techniques of production.
- Migrant remittances are now greater than official aid, and are non-debt-creating.
- Loans create debt that has to be repaid in foreign currency. The debt burden of developing countries is a foreign exchange problem. The volume of international debt is approximately \$5,500 billion.
- Empirically, the optimal level of country debt seems to be about 80% of the value of exports, and the impact of debt on growth becomes negative if debt grows to 160% of exports.
- The debt crisis of the 1980s, which still lingers today, was largely caused by unfavourable external circumstances, including a collapse of commodity prices and a doubling of interest rates.
- There is no solution to the debt burden of the highly indebted countries without debt forgiveness. Some poor countries qualify for the World Bank's HIPC Initiative, which allows debt to be written off if the proceeds are used for poverty reduction programmes approved by the World Bank.

Chapter 14

Discussion questions

1. What is the distinctive contribution of dual-gap analysis to the theory of development?
2. Under what circumstances will foreign borrowing raise the rate of growth of income, and raise the rate of growth of output?
3. What are the characteristics of the different types of financial flow to developing countries?
4. What factors determine the grant element of a financial flow?
5. How might the flow of resources to developing countries be augmented, and what criteria should govern their distribution between countries?
6. What is the purpose of World Bank structural adjustment lending, and how successful has it been?
7. What are the advantages and disadvantages of FDI to developing countries?
8. Discuss the view that foreign lending is merely a pernicious device for transferring resources from poor to rich countries.
9. Can countries borrow too much? What is the sustainable level of borrowing?
10. What is the nature of the debt problem in developing countries?
11. What imaginative schemes can you think of to relieve the debt-servicing burden of developing countries?
12. How successful have the World Bank's HIPC debt relief programmes been?

Websites on aid, remittances, debt and FDI

Aid

International Aid Transparency Initiative www.aidtransparency.net

International migration and remittances

International Organization for Migration www.iom.int

Global Commission on International Migration www.iom.int/global-commission-international-migration

Migration Observatory, University of Oxford www.migrationobservatory.ox.ac.uk

Debt

World Bank, Global Financial Development Report www.worldbank.org/en/publication/gfdr

OECD, Development Co-operation Directorate www.oecd.org/dac

HIPC Initiative www.worldbank.org/hipc

Make Poverty History www.makepovertyhistory.org/takeaction/

Foreign direct investment

UNCTAD www.unctad.org/en/Pages/Home.aspx

International Trade Centre, Investment Map www.investmentmap.org

Nongovernmental organizations

NGO Global Network www.ngo.org

Jubilee Debt Campaign <http://jubileedebt.org.uk>