Trends in Official Finance

THE PAST YEAR WITNESSED A SMALL UPTURN in aid flows from donors to developing countries. Another positive development was the agreement on an enhanced Heavily Indebted Poor Countries (HIPC) Debt Initiative to provide debt relief for some of the world's most impoverished countries. At the same time, however, official nonconcessional lending fell as the need for special financing packages for countries in financial crisis declined and as such financing itself came under much greater scrutiny. This chapter reviews the principal trends and developments in these three areas in the past year, and discusses some related policy and analytical questions. The main messages of the chapter are the following:

- A small increase in aid flows to developing countries from donors, as measured by net official development assistance from countries that are members of the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD), was evident in 1998. But this increase reflected temporary factors and did not signal a reversal of the trend decline in aid flows during the 1990s.[1]
- Aid flows have declined over the years for a number of reasons, but principally because donors have reordered their budget priorities, and because the effectiveness of such aid has been widely questioned. More effective use of development assistance is imperative to meet the challenges of growing numbers of the world's poor, sharply rising humanitarian and emergency needs, and an accelerated provision of global public goods. A new partnership between donors and recipients is needed to ensure that aid money is well-spent, to allocate aid toward more effective poverty-reduction programs, and to shift donor practices toward a capacity-building partnership with recipient countries. Some evidence of greater effectiveness of aid within a new climate for aid flows is beginning to emerge.
- An enhanced HIPC framework was endorsed by the international community during the annual meeting of the World Bank and the International Monetary Fund in September 1999. The enhanced program lowers the qualifying criteria for debt relief and speeds the delivery process, while also bringing poverty reduction to the center of the exercise. The program is likely to provide significant gains in external financing for a number of very poor countries (about 36 countries are eligible, mostly in Sub-Saharan Africa). It is expected that HIPC debt relief, together with traditional debt relief mechanisms, could cut in half the outstanding debt and significantly reduce the annual debt servicing costs. There is also now an explicit link between debt relief and a comprehensive program of poverty reduction in recipient countries. By early 2000, packages amounting to $7 billion in debt service relief ($3.4 billion in net present value terms), had been agreed to for seven countries—Bolivia, Burkina Faso, Côte d'Ivoire, Guyana, Mali, Mozambique, and Uganda. By end 2000, an additional 15 countries are expected to reach a decision point under the enhanced framework—Cameroon, Chad, Ethiopia, Guinea, Guinea-Bissau, Honduras, Laos, Malawi, Mauritania, Nicaragua, Niger, Rwanda, Sierra Leone, Tanzania, and Zambia. Greater country "owner-

ship" of programs, wider consultation with civil society, and closer monitoring of the poverty reduction programs associated with HIPC debt relief should achieve better results than under past debt-relief programs.

- Official nonconcessional lending has fallen as the need for immediate, crisis-related funding in developing countries abated in 1999. Questions have been raised about the role and effectiveness of official debt flows during times of global financial crisis. These questions came to the fore with the recent crises in countries as disparate as Ecuador, Pakistan, and Russia. The trend is clearly toward efforts to reduce the role of large official bailouts of countries in crisis, and thus to reduce the moral hazard they create for both borrowers and private creditors. As a related matter, the private sector is being asked to share in the costs of future bailouts. The effects are likely to be positive in the longer run: putting more of the burden of risk management back on the shoulders of borrowers and private lenders should reduce the incidence of such crises in the future. In the near term, however, it is likely to raise the cost of new borrowings or reduce access to new private capital flows for developing countries, or both, especially for countries with poorer credit ratings.

Recent trends and issues in aid flows

Aid flows as measured by official development assistance (ODA) from donors rose in 1998. Between 1992 and 1997, total ODA from DAC member countries[2] to developing countries and multilateral institutions fell steadily from 0.33 percent of their combined GNP to a record low of 0.22 percent. Data from the OECD[3] show a temporary reversal of this trend in 1998 when aid flows rose by $3.6 billion (8.9 percent in real terms) to $51.9 billion. This represented 0.24 percent of DAC members combined GNP (table 3.1).

The 1998 data seem to mark a temporary end to a five-year fall in ODA (usually explained in terms of "donor fatigue"). Fourteen of the 21 DAC member countries reported a rise in ODA in real terms in 1998; the most significant increases came from Italy, Japan, and the United States. Nevertheless, much of this increase is expected to be transitory, due in part to the timing of contributions to multilateral agencies and to other factors such as the Asian crisis. Japan reported a $1.2 billion rise in net aid flows, reflecting a surge of loans to countries affected by the Asian crisis. The United States likewise increased its aid budget by $1.9 billion, reflecting increased deposits of promissory notes with multilateral development banks and rises in food and emergency aid, especially to Africa. Italy reported a recovery of its aid outflows to $2.4 billion, partly reflecting increased flows to multilateral agencies. Some part of the rise in ODA, on the other hand, reflects the commitment by some countries to increase their aid flows. The firmest commitment seems to be that of the United Kingdom, which has pledged to raise its aid budget by 25 percent by 2001; its aid in 1998 rose by 7.8 percent in real terms. It remains to be seen, however, whether this year's increase in development assistance will be maintained, since several other countries are still in the process of tightening their budgets. Canada, France, and Germany, for example, reported a de-

Table 3.1 Net official development assistance (ODA) flows from DAC countries, 1990–98

(billions of U.S. dollars, except where stated otherwise)

Year	France	Germany	Japan	United Kingdom	United States	Others	Total	Percent of combined GNP
1990	7.2	6.3	9.1	2.6	11.4	16.4	53.0	0.33
1991	7.4	6.9	11.0	3.2	11.3	17.0	56.7	0.33
1992	8.3	7.6	11.2	3.2	11.7	18.9	60.9	0.33
1993	7.9	7.0	11.3	2.9	10.1	17.3	56.5	0.31
1994	8.5	6.8	13.2	3.2	9.9	17.5	59.2	0.30
1995	8.4	7.5	14.5	3.2	7.4	17.9	58.9	0.27
1996	7.4	7.5	9.4	3.2	9.1	18.5	55.1	0.25
1997	6.3	5.9	9.4	3.4	6.9	16.3	48.3	0.22
1998	5.7	5.6	10.6	3.9	8.8	17.3	51.9	0.24

Source: OECD Development Assistance Committee (DAC) 1999.

cline in aid outflows in real terms of 11.4 percent, 6.2 percent, and 4.1 percent, respectively. The reduction in Canada's aid was due to the prepayment in 1997 of some scheduled 1998 contributions to multilateral agencies.

The United Nations (UN) has advocated that donor countries set a target level of aid equal to 0.7 percent of GNP. The actual unweighted average country effort in 1998 was 0.40 percent, and the weighted average effort of DAC member countries was 0.24 percent. In 1998 only the Netherlands and the Nordic countries reached or surpassed the UN target: Denmark contributed 0.99 percent of its GNP in that year, Norway 0.91 percent; the Netherlands 0.80 percent, and Sweden 0.71 percent (figure 3.1). Only two other countries can claim aid efforts above the unweighted average: Luxembourg with 0.61 percent and France with 0.41 percent. The remaining 14 donors made allocations to aid ranging from 0.35 percent of GNP (Belgium) down to 0.10 percent (United States).

Aid flows received by poor countries, as measured by their receipts of concessional finance, increased in 1999 (see table 3.2). Thus, net concessional finance totaled $39.4 billion in 1999, an increase of $2 billion over the $37.3 billion in 1998, but some $7 billion below the 1994 level.

The regional allocation of concessional flows in 1999 (table 3.3) shows rising flows (in absolute terms) to East Asia, the Middle East and North

Figure 3.1a Net official development assistance flows from DAC countries

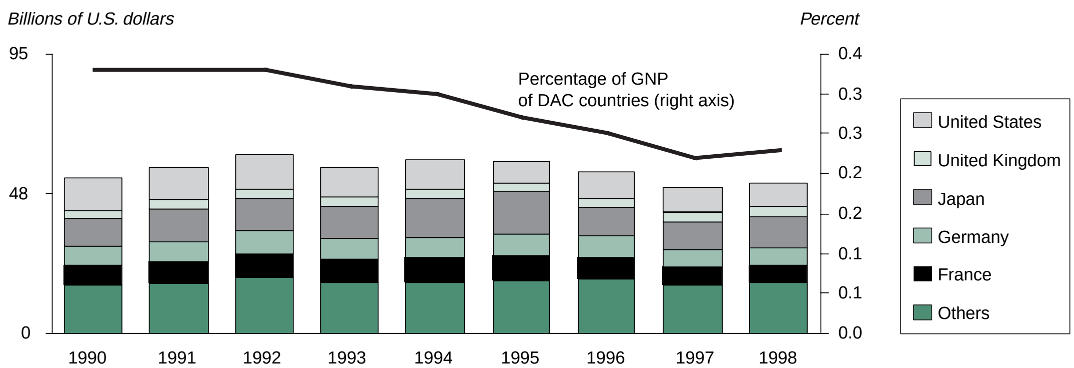
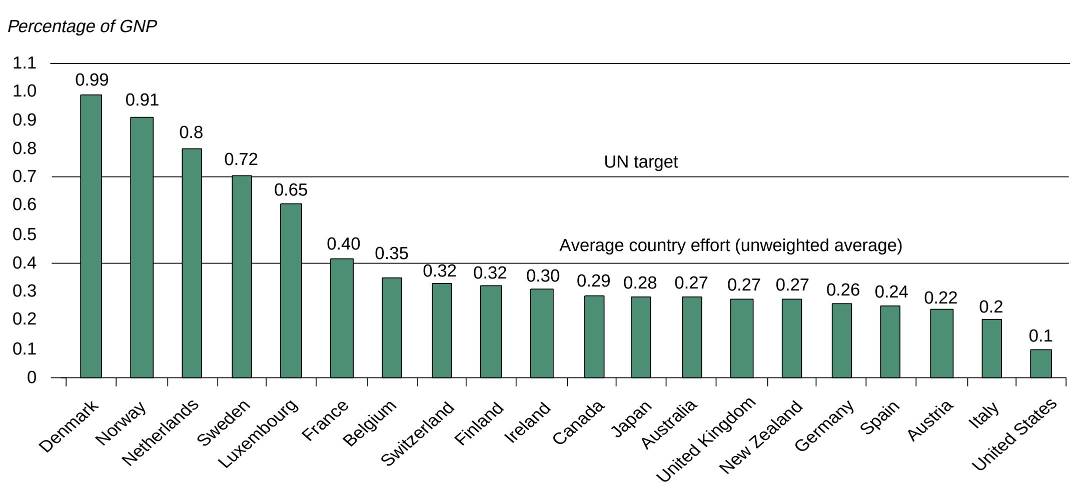


Figure 3.1b Net official development assistance flows in 1998 as a percentage of GNP



Source: Organisation for Economic Co-operation and Development.

Table 3.2 Concessional net flows to developing countries, by type, 1988–99
(billions of U.S. dollars)

Type of flow	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999[a]
Concessional finance	34.0	34.3	43.8	50.8	44.0	41.6	46.2	45.2	39.4	33.6	37.3	39.4
Grants (excl. technical cooperation)	18.2	19.2	28.2	35.1	30.5	28.4	32.7	32.7	28.0	26.0	27.1	26.4
Loans	15.8	15.1	15.6	15.7	13.5	13.2	13.5	12.5	11.4	7.6	10.2	13.0
Bilateral concessional	10.4	10.0	9.6	9.3	7.0	6.7	5.7	5.3	3.2	0.2	3.3	5.7
Multilateral concessional	5.4	5.0	6.0	6.4	6.5	6.5	7.8	7.2	8.2	7.4	6.9	7.3
Memo item												
Technical cooperation grants	12.2	12.1	14.2	15.5	17.6	18.2	16.8	20.1	18.5	15.5	16.1	15.9

a. Estimated.
Source: World Bank Debtor Reporting System and staff estimates.

Africa, and Latin America, and falling flows to Europe and Central Asia, South Asia, and Sub-Saharan Africa. The regional rises were driven by an upturn in flows from bilateral institutions to East Asia, by increased emergency aid to Latin America (after floods struck Central America), and by support of the peace process in the Middle East. In Europe and Central Asia, emergency assistance to the Balkans was offset by a continued shift to market-based financing in those countries that are not members of the Commonwealth of Independent States (CIS). Still, virtually every region has experienced a long-term trend decline in concessional aid flows relative to its GNP since 1990, and this is especially notable in the case of Sub-Saharan Africa. Past poor performance of aid to Africa has partly resulted in reduced longer-term aid flows and aid allocations to countries in that region. A reallocation of aid in favor of countries with better policy performance, accompanied by a large cutback to others, is indeed apparent (box 3.1). Another positive development in 1998–99 was renewed attention and effort at raising resource flows to those very poor countries in Sub-Saharan Africa and elsewhere that are implementing better poverty reduction programs through the HIPC Initiative (see discussion below).

Challenges facing development assistance

Despite some of the positive recent trends noted above, the future of development assistance today faces profound challenges from five principal, interconnected sources:

(a) Aid is declining for several reasons: the end of the Cold War has diminished the strategic importance of aid, public opinion in donor countries has become more skeptical about the effectiveness of aid, and governments in these countries are increasingly preoccupied with domestic issues and striving to tighten their general budgets.

(b) Even as the volume of aid has declined, the number of aid agencies has increased, from about 7 in 1960 to some 50 in the 1990s, as has the role of international nongovernmental organizations. This expansion in the number

Table 3.3 Regional allocation of concessional flows, 1990–99

	Percentage of total concessional flows				Percentage of regional GNP			
Region	1990	1997	1998	1999	1990	1997	1998	1999
East Asia	17.0	14.2	18.4	20.5	0.8	0.2	0.4	0.3
Latin America and the Caribbean	10.2	9.4	9.4	9.8	0.4	0.2	0.2	0.2
Middle East and North Africa	19.9	13.5	11.1	12.3	2.0	0.8	0.7	0.8
South Asia	12.2	8.1	12.6	12.1	1.3	0.5	0.8	0.8
Sub-Saharan Africa	37.2	37.5	33.0	31.2	5.8	3.8	3.9	4.2
Europe and Central Asia	3.5	17.3	15.5	14.1	0.1	0.5	0.6	0.6
All developing countries	100.0	100.0	100.0	100.0	1.0	0.5	0.6	0.6

Source: World Bank Debtor Reporting System and staff estimates.

Box 3.1 Reduced aid flows but more efficient allocation

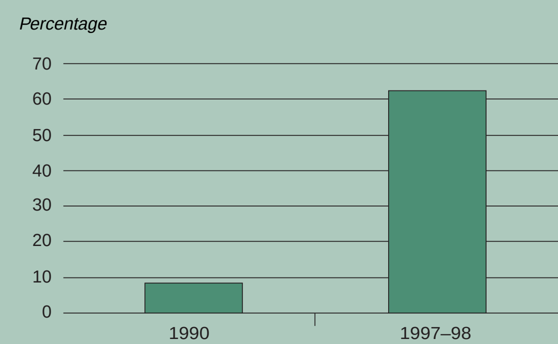
Many studies, including several by the World Bank, have concluded that aid in the past was often allocated to countries with poor policy performance, and that this pattern of allocation contributed to the ineffective use of such aid. Some recent research, however, points to more encouraging conclusions, even as aid flows have been falling (Dollar 2000). One finding is that the impact of both total ODA and International Development Assistance (IDA) aid flows on poverty reduction increased significantly over the 1990s, because funds were being allocated to countries with better policies. A second finding was that much of the improved allocation of aid between 1990 and 1998 came about through sharp cuts in aid to countries with poor policies.

Following a wave of recent reforms, a growing number of low-income countries now have reasonably good policies in place: examples are Ghana, India, Uganda, and Vietnam. Recent research finds that the 1990s saw a significant shift in the allocation of aid in favor of countries with “good” policies: whereas the statistical relationship between aid and policy was small and insignificant in 1990, it was strong and positive in 1997–98. The shift is summarized by the figure below, which shows that the responsiveness of aid to better country policies—measured in terms of the increase in marginal dollar of aid allocated to countries with better policies (corresponding to a 1 percentage point change in a overall measure of country policy that incorporates 20 sub-indicators)—increased from 9 percent in 1990 to 64 percent in 1997–98. The shift was even greater for IDA flows.

Much of the improved allocation of aid between 1990 and 1997–98 resulted from sharp cuts in aid to countries with poor policies compared to modest cuts in aid to countries with good policies. In the former, net ODA allocation fell from an average of $44 per capita in 1990 to $17 in 1997–98, whereas in the latter it fell only from $39 per capita to $28. Several countries, including Kenya, Nigeria, Pakistan, Togo, and Zaire (now the Democratic Republic of the Congo) experienced cuts of at least 50 percent in their aid per capita. On the other hand, countries such as Bolivia, Ghana, and Uganda saw only modest changes in aid per capita. As a result, by 1997–98 the overall allocation of aid favored the good policy countries, whereas it did not in 1990. For IDA aid, the allocation in favor of good policy countries was even stronger than in 1990.

The implication is that more people were being lifted out of poverty under the 1997–98 allocation of ODA than under the 1990 allocation. But there remains scope for further improvements, this time not through cuts in aid but by increasing the number of countries with better performance. Such improvements are needed to meet the international development goal of reducing world poverty by 50 percent over the next 15 years, especially in Sub-Saharan Africa (Collier and Dollar 1999).

Responsiveness of ODA allocation to good country policy, 1990 and 1997–98



Source: Dollar 2000.

of players has come in response to increased public accountability and delivery needs, but it has also often resulted in administrative overload and in a proliferation of projects and donor issues in recipient countries.

(c) Aid flows need to be redirected to those countries and purposes where it can have the greatest impact on poverty and human welfare,[4] and greater attention needs to be paid to issues such as good governance. Yet the current allocation of aid by donors remains distorted, as do rewards for better policies in recipient countries.

(d) Many of the poorest countries in the world have become highly dependent on aid, which now accounts for very large shares of their government budgets and GNP. These countries cannot be quickly weaned from aid without forcing them into economic distress.

(e) Even as aid flows are falling, humanitarian needs are growing and becoming more complex.

Box 3.2 Why were donors less generous in the 1990s?

A study of trends between 1970 to 1996 in aid budgets in five major donor countries—France, Germany, Japan, the United Kingdom, and the United States—examined such factors internal to donor countries as fiscal balances, economic growth, current account balances, interest rates, and exchange rates (Dasgupta and Pezzini 1999). To reflect external structural factors shaping the aid environment, private capital flows and aggregate growth, as were variables reflecting the end of the Cold War and income growth per capita in Sub-Saharan Africa, to proxy for perceived effectiveness of aid. (For Japan, growth in Asia alone was included instead of aggregate developing-country growth.) For each donor, different factors turned out to be significant. Some general conclusions are possible but must be made with caution because of data and methodological issues:

- *Budget deficits, shrinking budgets,* or both were generally strongly associated with falling aid flows in France and the United States.
- The *end of the Cold War* (for Germany and the United Kingdom) and *a surge in private capital flows* (for France, Japan, and the United States) also appear to have played an important role in reducing aid budgets.
- There is also evidence of *some countercyclicality in aid budgets,* with respect to the growth cycle of Asian economies in the case of Japan and with respect to domestic growth in the United Kingdom.
- Fluctuations in *real interest rates* were positively associated with the size of aid budgets in France and Germany. Given the general trend toward lower interest rates in the 1990s, this may have reflected a reduced need for aid flows to refinance developing countries' budgets in order to allow them to service their external debt.

There is also growing demand for global public goods to address the spread of diseases and deterioration in the quality of the environment.

Declining development assistance in the 1990s. Several factors account for the shrinking of aid budgets. First, there has been a general tightening of government budgets in donor countries since the early 1990s. Second, past recessions in many of these countries have shifted the attention of public opinion inward to such issues as domestic unemployment and the social safety net. Third, public opinion is increasingly skeptical about the effectiveness of aid.[5] The public debate about aid is shaped by domestic conditions in donor countries, and aid budgets are often more a reflection of these internal conditions than a response to the needs of developing countries. Fourth, the end of the Cold War has brought about a decline in certain commercial and strategic interests that had previously bolstered aid flows. Meanwhile the simultaneous surge in private capital flows to developing countries may have reduced the perceived need for development assistance, even though few of the world's poorest countries have benefited from these flows (box 3.2).

Rising public accountability for aid flows and the role of NGOs. Two other fundamental changes over the past several decades have been rising public accountability and an increasing role of nongovernment organizations (NGOs) in aid projects. The pace of both of these changes accelerated in the 1990s. Donors and aid agencies are now working more closely both with local organizations in the recipient countries and with international NGOs. The greater participation of civil society brings many advantages, in recipient and donor countries alike. It promotes the perception, at least, that aid projects are being based on a more accurate assessment of need. It increases pressure on governments to be more accountable. It helps ease their human and financial resource constraints. And it builds recipient communities' capacity to prepare for and cope with emergencies.

NGOs differ in size, field of interest, and effectiveness. In 1995 a UN commission on global governance found some 28,900 active international NGOs, up from only 1,600 in 1980. More official aid is being channeled through these NGOs, and a falling share comes from personal contributions and donations. Whereas official sources accounted for less than 10 percent of NGO budgets in 1980, by 1990 that figure had risen to 35 percent, their share apparently stabilizing or slightly declining from then until 1997, according to OECD data. In some countries NGOs may provide or implement more than a fifth of total aid flows, compared with less than 1 percent 20 years ago.[6]

The greater involvement of civil society and greater public scrutiny in development cooperation are changing the rules of the game in a way that will ultimately be beneficial. NGOs have succeeded in bringing to public awareness and public judgment several development projects that proved to be inefficiently designed or implemented. The shift toward a greater proportion of funding being supplied by NGOs has also changed the relationship between them and governments, and between aid organizations generally and the media. Partly as a result, NGOs are now becoming more directly involved in broader aid effectiveness issues. But greater NGO involvement also raises problems, such as an increasing and more complicated role of special interests, limited accountability on the part of some NGOs themselves, and in some cases, weaknesses in technical capacity and an overburdening of government capacity to coordinate aid projects. In some Sub-Saharan African countries, for example, a single development project may sometimes involve 30 to 40 different donor aid agencies and some 75 to 125 NGOs.

The distorting influence of strategic and commercial interests. The end of the Cold War has diminished but not eliminated the importance of strategic and commercial interests that often dominated aid allocation decisions of donors in the past.[7] Distortions caused by these influences persist, and a number of studies point to the continued use of foreign aid as an instrument of foreign or commercial policy.[8] For example, Schraeder, Hook, and Taylor (1998) studied aid allocation to Sub-Saharan Africa by major donors between 1989 and the mid-1990s and found that humanitarian need does not appear to be a significant motive; commercial ties are often more important. A parallel effect is that aid recipients have less incentive to pursue better policies. Aid allocation decisions by donors, for example, have not only tended not to reward better country policies, but paradoxically, to reward worse performance.[9] Collier and Dollar (1999), for example, find that, after controlling for poverty levels, aid is lower in countries with better policies and that "aid is tapered out with reform when it should be tapered in with reform." Aid allocation decisions also need to deal better with needs in countries that face greater vulnerability to economic shocks. Guillamont and Chauvet (1999) suggest, for example, that aid should constitute not only a reward for good policies but also a form of insurance against large negative shocks such as terms-of-trade shocks and climatic shocks. The IDA has an important role to play in this regard (box 3.3).[10]

Dealing with aid dependency: the case of Sub-Saharan Africa. Foreign aid can become an important source of revenue for recipient governments, which may then come to rely on it indefinitely. Often such aid cannot be cut drastically without forcing the country into economic distress. For instance, in 7 of the 13 most aid-dependent countries,[11] aid in 1992 averaged 90 percent of government revenue. During 1995–96 aid was equivalent to more than a fifth of GNP in Eritrea, Tanzania, and Zambia (International Federation of Red Cross and Red Crescent Societies 1999, p. 103). Sub-Saharan Africa has the highest aid dependency (as measured by the ratio of aid to GNP) among a sample of mainly low-income countries in different regions (table 3.4) and receives three times more foreign aid per capita than other developing regions.

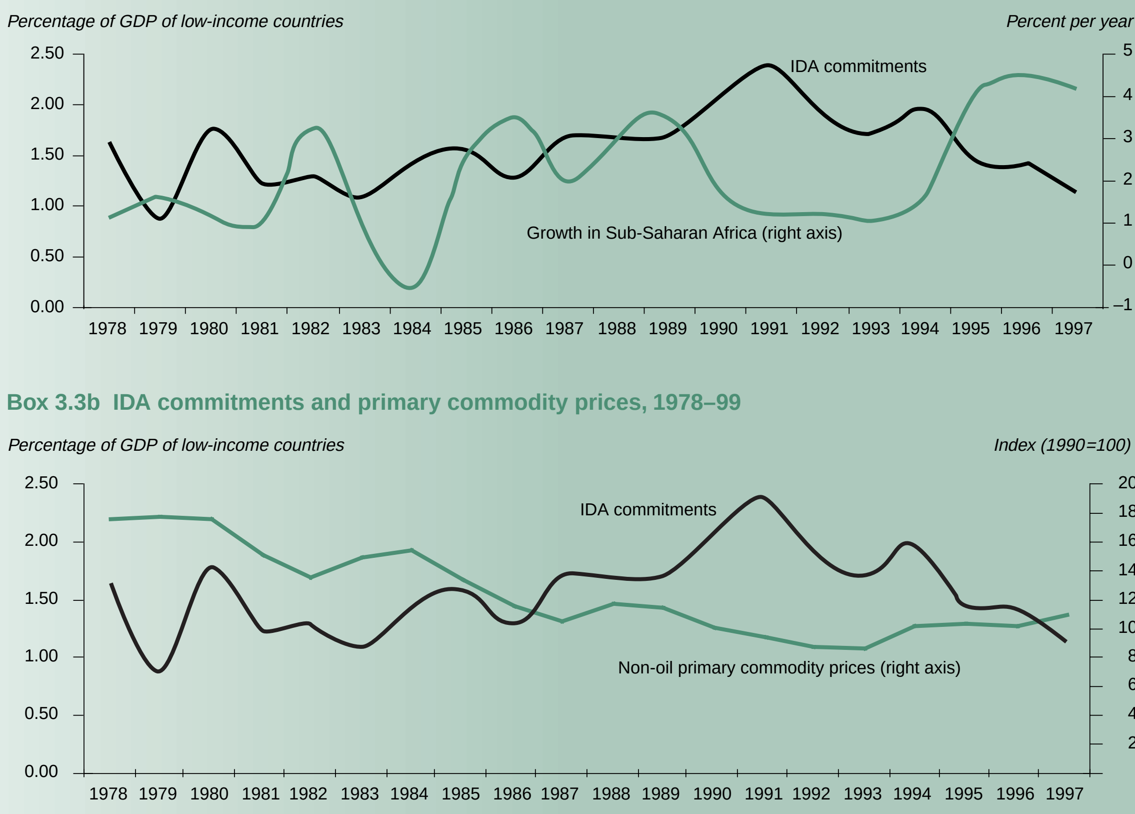
It is sometimes argued that cutting aid may not impose as great a burden as these numbers indicate, given the fungibility of aid and the fact that public spending in recipient countries is often unproductive. A dollar in net aid flows for a particular project in a desirable sector may, in this view, simply allow a dollar of unproductive government spending somewhere else or may replace efficient domestic tax revenues. But a recent study shows that there are limits to fungibility. Devarajan, Rajkumar, and Swaroop (1999) find little evidence that more aid leads to more tax relief in Africa. They also find that an additional dollar of aid leads to an increase in government expenditure of 90 cents, divided equally between current and capital spending, and that a notable portion of that expenditure goes toward repaying the principal on past loans. Aid to Africa is thus only partially fungible: "Governments do not spend all sectoral aid in that sector, nor do they treat such aid as merely budgetary support"[12] (Devarajan, Rajkumar, and Swaroop 1999). Cutting aid drastically in such circumstances could have significant negative repercussions and raise debt burdens. In this context, a targeted debt-relief program like those under the HIPC Initiative may be a better way to reduce longer-term aid dependency in these countries, by redirecting debt relief toward programs of poverty alleviation in countries that are improving their polices (the HIPC Initiative is discussed further below).

Rising humanitarian needs. Developing countries are becoming increasingly vulnerable to nat-

Box 3.3 IDA's role in counteracting economic shocks in poor countries

IDA is an important vehicle for transferring aid flows to poor countries through World Bank's operations. IDA annual commitments are driven primarily by the availability of resources within multiyear commitments of donors. Its efforts are targeted to the needs for external financing in the poorest countries of the world that have been determined to use such aid well. Within these settings, IDA lending also appears to respond positively to vulnerability to external economic shocks in poor countries. Two particular circumstances appear to elicit significant IDA lending: the need for countercyclical lending in response to changes in primary commodity prices, and (in Sub-Saharan Africa) the need for countercyclical lending in response to unexpected growth collapses (see figure). This suggests that external vulnerability and stabilization goals are important determinants, in practice, of IDA aid-flow decisions to the poorest countries in the world, which are often prone to external shocks.

Box 3.3a IDA commitments as countercyclical to growth collapses in Sub-Saharan Africa, 1978–99



Source: World Bank.

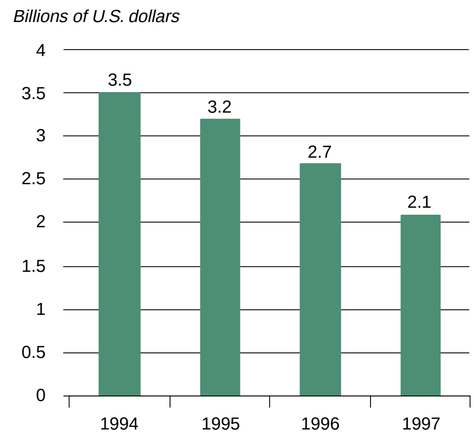
ural disasters simply because more of the developing world's population now lives in economically and environmentally marginal areas. UN estimates suggest that natural disasters have killed around 128,000 people and affected another 136 million every year in the past decade. The 1999 *World Disasters Report*[13] (International Federation of Red Cross and Red Crescent Societies 1999) finds that the number of natural catastrophes worldwide has tripled in the past decade, and developing

Table 3.4 Ratio of aid to GNP, 1976–95, in a sample of mainly low-income countries

Region[a]	1976–80	1991–95
Asia and Pacific	8.6	7.4
Middle East and North Africa	12.4	4.5
Sub-Saharan Africa	9.4	21.2
Latin America and the Caribbean	3.6	10.5

a. Asia and Pacific includes Bangladesh, Nepal, Pakistan, Papua New Guinea, and Sri Lanka; Middle East and North Africa covers the Arab Republic of Egypt, Jordan, Lebanon, Morocco, Oman, the Syrian Arab Republic, Tunisia, and the Republic of Yemen; Sub-Saharan Africa embraces 34 African countries; Latin America and the Caribbean includes Bolivia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Haiti, Honduras, Jamaica, and Nicaragua. Data are simple averages of the countries in the regional sample.
Source: Tsikata 1998.

Figure 3.2 Total humanitarian assistance from OECD countries



Source: International Federation of Red Cross and Red Crescent Societies *World Disasters Report 1998;* Organisation for Economic Co-operation and Development.

countries may be suffering the greatest costs: 96 per cent of all deaths from natural disasters occur in the developing world. Some poorer countries are becoming chronically vulnerable: disaster-prone areas often share a combination of low incomes, low agricultural productivity, inadequate infrastructure, and governments that lack the resources to invest in disaster prevention measures or provide basic social safety nets. The UN estimates that by 2025 eighty percent of the world's population will live in developing countries, over half of which will be "highly vulnerable" to floods and storms (the most frequent cause of natural disasters, accounting for about 40 percent of the total). Civil strife and wars also tend to be more common in poorer countries.

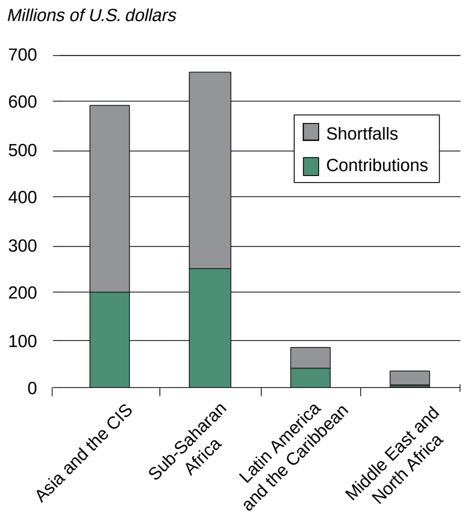
At a time when more emergency aid is needed, funding is becoming tighter: overall spending on such aid has been falling since 1994, mirroring the fall in overall development aid (figure 3.2). The seven largest donors of humanitarian aid,[14] which account for three-quarters of total assistance, have all seen a sharp fall in their assistance in recent years (International Federation of Red Cross and Red Crescent Societies 1999, p. 104 and 109).[15] Emergency assistance fell from 8.4 percent of DAC donors' bilateral ODA in 1994 to 6.7 percent in 1997—a smaller slice of a shrinking pie.[16]

Food aid is the most common form of humanitarian aid. Shortfalls of relief food aid have increased by 300,000 tons since the beginning of 1999, however, as new emergency needs continue to outpace contributions (figure 3.3). The war in the Balkans, severe food shortages in the Democratic People's Republic of Korea, and continuing crises in Africa have combined to drive up the level of world hunger. As of May 1999, a total of 39 emergency operations of the World Food Programme were facing shortfalls of greater than 60 percent, and 20 operations were facing a 100 percent shortfall.

The other major and growing humanitarian need is for assistance to refugees. One in every 265 persons worldwide—more than 22 million people—are refugees, having fled or been forced out of their home countries by war or civil conflict. Women and children make up the majority in refugee camps: in 1993, for example, some 80 percent of the refugees who crossed from Burundi into Rwanda were women, children, and elderly people, according to data from the United Nations Development Programme (UNDP). The UNDP also reports that about 135 million people worldwide are in danger of becoming environmental refugees.[17]

Humanitarian assistance also suffers from problems of ineffectiveness. It is less costly to prevent and prepare for a disaster than to respond to one that has already occurred, but government budgets in poor countries are often too tight to finance serious disaster prevention. On the donor side, emergency relief may often involve the unloading of surplus products and an excessive preoccupation with short-term crises: disasters with high immediate death tolls (such as major earth-

Figure 3.3 Food aid needs vs. shortfalls, 1999



Source: World Food Programme.

quakes) often obtain a quicker humanitarian reaction than silent, ongoing calamities, such as droughts. The attention of the media often influences the generosity of aid allocation as well. For example, in August 1999, the United Nations High Commissioner for Refugees appealed to donor countries for $164 million to provide assistance to 6.5 million refugees of war and displaced people in Africa; the response amounted to $82 million. At the same time, an appeal to assist 3.4 million refugees in Bosnia and other countries of the former Yugoslavia (including the province of Kosovo) collected $350 million.

Meeting the challenges. Analysis of the five main challenges to development assistance underscores the fact that more effective utilization of these limited and falling resources is vital. More effective utilization would both free up resources for other needs—for humanitarian needs and the provision of global public goods—while helping to halt and reverse the decline in aid flows by favorably influencing public opinion in donor countries. Better utilization, in turn, will require reducing distortions in the ways that donors allocate and coordinate their aid, as well as policy improvements in recipient countries—including greater public accountability and a more effective role and contribution of civil society. Structured debt relief, as in the HIPC Initiative, is an important part of the longer-term solution to the debt trap in many low-income countries, to wean them away from aid dependency.

These solutions cannot be sought one country or one donor at a time. Instead, a renewed global partnership to harmonize programs, policies, and practices of donors and recipients alike (under the aegis of the DAC or another similar forum) may be required. Several proposals for reform are on the table. They range from a focus on a "common pools" approach (Kanbur and Sandler 1999),[18] to targeting aid by poverty and country performance (Collier and Dollar 1999),[19] to building implementation capacity in recipient countries, especially in Africa (Lancaster 1999). The enhanced HIPC arrangements for debt relief in the poorest countries are also encouraging a new approach to enhanced donor coordination and country policy improvements. None of these approaches are, of course, mutually exclusive, and some of the elements may need to be combined in different degrees, taking into account differing country circumstances and global priorities for poverty reduction.

Recent developments in the Heavily Indebted Poor Countries (HIPC) Debt Initiative

The Heavily Indebted Poor Countries (HIPC) Debt Initiative is an agreement by the international community designed to help poor countries with good policies escape from unsustainable debt by providing comprehensive debt relief. Unsustainable debt (conventionally identified when a country's ratio of debt service to exports exceeds 25 percent) has increasingly been recognized as a constraint on the ability of poor countries to pursue sustainable development. In response, in fall 1996, the World Bank and the International Monetary Fund (IMF) launched the HIPC program, endorsed by some 180 governments. In 1999 an enhanced HIPC program was adopted to provide debt relief that is "broader, deeper, and faster." A number of changes from the original framework were endorsed. As a result, the pace of implementation of HIPC debt relief has improved, more relief is being granted, and the link between debt relief and sustainable poverty reduction programs in recipient countries is potentially stronger.

Box 3.4 New challenges in international public goods and development cooperation

Financial contagion, commodity price volatility, the spread of disease across borders, and many environmental and security concerns have one aspect in common: they represent development challenges that cannot be efficiently addressed solely at the national level. For example, key determinants of health status cross national borders in part because more people do—over 1 million people travel across borders each day. International airline travel is up from 2 million passengers in 1950 to 1.4 billion a year today, potentially enabling the rapid spread of airborne and infectious diseases. Trade in harmful substances (tobacco, alcohol, psychoactive drugs, and contaminated foodstuff and feed) and unsafe or ineffective use of pharmaceuticals are similarly affecting health adversely. The overuse of the global commons in the form of depletion of the ozone layer allows more ultraviolet radiation to reach the planet's surface. Global warming may be nurturing ecosystems that are more hospitable to deadly diseases such as malaria. The rapid integration of developing countries through trade and investment, and their rising weight in world economic activity, has greatly increased the need to include them in the provision of international public goods.

Cooperation on transnational challenges is most needed in two interrelated types of situations: when coordination and harmonization of procedures lead to greater legitimacy, efficiency, and effectiveness than would spontaneous, uncoordinated national initiatives, and when individual countries lack sufficient incentive to act because they cannot capture the full rewards of doing so. Consequently, there are new implications for international cooperation—and for global governance. The most likely solution lies in flexible multicountry and multistakeholder partnerships, involving national governments, international organizations, civil society, and the corporate sector. Networks among these players increasingly influence development cooperation and outcomes, including the nature, magnitude, and direction of aid flows.

The World Bank group has been associated with several such initiatives involving a combination of lending, technical advice, and international coordination. One of the more successful past and current examples include the Consultative Group on International Agricultural Research (CGIAR) whose research has achieved major scientific advances in increasing crop yields, which has helped to make food available in developing countries at prices affordable to the poor. The Heavily Indebted Poor Countries Debt Initiative (HIPC) is another. The fight against HIV/AIDS includes cooperation under UNAIDS, an umbrella program providing information and technical assistance on AIDS prevention, and the International AIDS Vaccine Initiative (IAVI), a program promoting the development of vaccines that are affordable to the poor. Global Environment Facility (GEF) is a grant-funding mechanism that facilitates new initiatives to preserve biodiversity, prevent global warming and destruction of the ozone layer, and manage international waters. And the Consultative Group to Assist the Poorest (CGAP) is a multidonor initiative that aims to reduce poverty by increasing very poor households' access to financial services through financially sustainable microfinance institutions. All such global initiatives are multiactor endeavors, with increasing involvement of the private sector and civil society. New emerging priorities are communicable diseases; forest loss; and peace, security, and conflict prevention and management.

The earlier HIPC framework

The principal objective of the HIPC Initiative was to bring the poorest, most heavily indebted countries' debt burden to sustainable levels in exchange for better policies in those countries, so as to ensure that adjustment and reform efforts were not put at risk by continued high debt and debt service burdens. Under the original HIPC Initiative, countries were eligible for HIPC relief if, after full application of traditional debt-relief mechanisms, external debt remained above defined sustainable levels.[20] Countries underwent a three-year reform process before reaching a "decision point" on the sustainability of their debt and, if appropriate, on a debt-relief package. During those three years, countries were required to establish a good track record of implementing economic and social reform through programs supported by IMF and World Bank. Up to three more years of proven policy implementation would bring countries to their "completion point," when debt relief would actually be provided.

Much has happened in the three years since the initiative was launched. By early 2000, debt-relief packages amounting to $7 billion in debt-service relief ($3.4 billion in net present value terms), had been agreed to for seven countries—Bolivia, Burkina Faso, Côte d'Ivoire, Guyana, Mali, Mozambique, and Uganda. An effective coordination mechanism between official bilateral and multilateral creditors and the HIPC governments themselves is in place. Finally, and perhaps most important, an open and transparent dialogue with civil society has been developed. Today, HIPCs have their own champions. A dynamic network of church groups, NGOs, academics, and citizens in every part of the world has championed poor country debt relief onto the front pages, and government leaders have responded.

The external debt of all HIPCs combined was some $200 billion in external debt at end 1998. Although small in nominal amount compared with the more than $2 trillion owed by developing countries overall, the debt of the HIPC countries was, on average, more than four times their annual export earnings, and 120 percent of GNP. Behind these figures is a deep human dimension that cannot be ignored. HIPCs are among the poorest countries on earth. Of the 600 million people in HIPC countries, more than one-half live in absolute poverty, defined as living on less than one dollar per day. The average person in a HIPC lives some 13 years less than in developing countries overall, and 7 years less than in other low-income countries. Many more infants will die either at birth or before they reach the age of five than in other developing countries, and far fewer will go to school. Unlike much of the rest of the developing world, the vast majority of people living in HIPCs have seen no improvement in their lives for more than two decades.

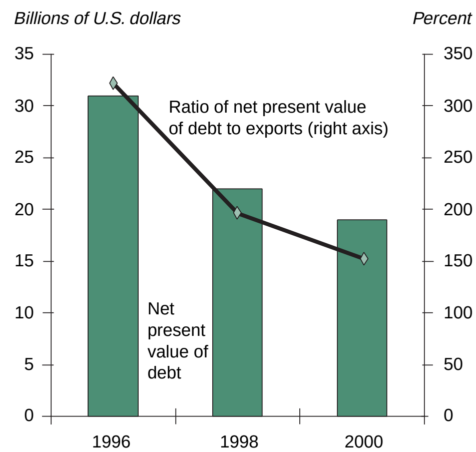
HIPCs had already been receiving substantial debt relief through traditional channels such as the Paris Club debt relief operations, forgiveness of aid debts, and commercial bank debt buy-backs (at discounts of about 85 percent). The HIPC Initiative reflected a decision to undertake deeper cuts, in a shorter time frame, and attached to significant policy redirection, yielding a significant reduction in debt burdens. In Bolivia debt service after the original HIPC Initiative (and additional Japanese ODA relief) fell from 28.4 percent of exports of goods and services in 1998 to an estimated 19.3 percent in 2001. Concomitantly, social spending rose from 13.9 percent of GDP in 1996 to 16.1 percent of GDP in 1999, largely thanks to debt relief. For Uganda total assistance under the original and enhanced framework combined will reduce the debt-service ratio to an estimated 6 percent in 2000–01 (compared to 18.7 percent before HIPC debt relief).

The enhanced HIPC framework

Encouraged by the progress made under the original HIPC, in 1999 the international community reaffirmed its support and encouraged a broader, deeper, and faster extension of debt relief. Accordingly, new enhancements were designed. The changes also shifted the focus of resources away from delivery of basic social services to comprehensive poverty reduction. Programs adopted under the initiative would be "owned" by the recipient countries, adopted after wider consultation, and would be outcome-oriented, with measurable goals. The improved HIPC Initiative incorporates the following principal enhancements and simplifications:

- The maximum ratio of net present value of debt to exports considered sustainable has been lowered from 200–250 percent to a fixed level of 150 percent. This increases both the amount of debt relief available to each country and the number of eligible countries. The sustainable level for the ratio of the net present value of debt to fiscal revenue was also lowered from 280 to 250 percent for countries meeting qualifying thresholds. These qualifying thresholds were lowered from 40 to 30 percent in the case of the export-to-GDP ratio, and

Figure 3.4 The effect of the HIPC Initiative on reducing the debt burden in seven countries



Note: The seven countries are Bolivia, Burkina Faso, Côte d'Ivoire, Guyana, Mali, Mozambique, and Uganda. These are estimates based on data from 1999 and are subject to change.

from 20 to 15 percent in the case of the public revenue-to-GDP ratio.

- The test date for debt sustainability and for the fixing of debt relief is now defined to be the latest date for which actual data are available at the decision point, instead of at the projected completion point.
- To allow faster implementation, a floating completion point process now allows debt relief to be triggered by actual policy performance rather than by a strict time requirement. That is, completion point is tied to the fulfillment of a set of reform commitments; if those commitments are met in less than three years, the country need not wait the full three years to receive debt relief.
- Multilateral institutions can now provide interim debt relief between the decision and completion points.

Progress with the HIPC Initiative. By early 2000, 16 countries had been reviewed for eligibility, and 14 had qualified for relief.[21] In 1998–99 relief has been agreed to for seven countries: Bolivia, Burkina Faso, Côte d'Ivoire, Guyana, Mali, Mozambique, and Uganda. These countries have qualified for debt relief totaling $3.4 billion in net present value terms (equivalent to nominal debt-service relief of about $6.8 billion). Under the enhanced framework, final decision points were reached in February 2000 by Bolivia, Mauritania, and Uganda, resulting in debt reduction packages totaling a further $2.1 billion in net present value (NPV) terms. By end 2000 the aim is to have prepared debt relief packages for a total of 23 countries, including reassessment under the enhanced framework for nine retroactive cases—that is, those countries that have already reached their respective decision points. The total cost of these retroactive cases could reach $7.7 billion in NPV terms.

Challenges ahead

The enhanced HIPC program faces several challenges. First, a large number of additional countries will need to be reviewed and supporting programs prepared to enable adequate progress on faster and deeper debt relief. Second, the principle of additionality of resources to be ensured in the HIPC program, as was agreed, would need the strong support of all donors. Third, paying for the HIPC Initiative still represents difficulties for some participants, especially the regional multilaterals. Fourth, and perhaps most important, the challenge of developing and designing effective poverty-reduction programs in the participating countries will need considerable attention by the countries themselves and by their partners. Some of these issues, especially the challenge of developing an effective poverty-reduction exercise, are discussed further below.

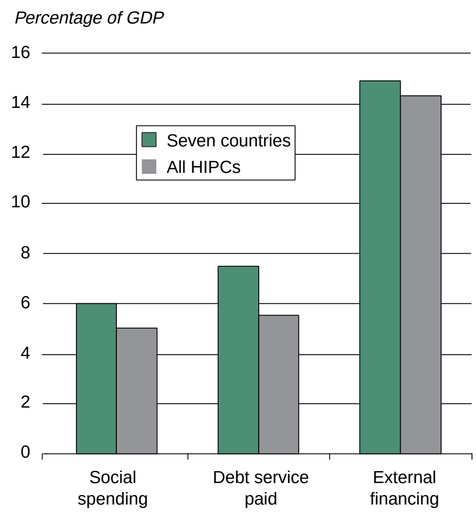
Paying for the debt relief. The enhanced initiative has more than doubled the cost of the HIPC Initiative. The total costs are now estimated at $28.2 billion in 1999 net present value terms divided approximately equally between bilateral and multilateral creditors. The increased costs of multilateral creditors reflect their rising share of new lending as bilateral creditors have shifted their official development assistance to grant funding. The World Bank's share of cost has risen to $6.3 billion in 1999 NPV terms. The funding of such costs has come in the case of the World Bank from special transfers from its net income, and in the case of the IMF, from similar transfers (and from proposed profits from a revaluation of its gold reserves). In December, the IMF undertook the first off-market gold sales necessary to meet its funding of the enhanced initiative. However, not all multilaterals (some 23 such institutions) will be able to afford the cost of these debt write-downs. To support these institutions' efforts, a HIPC Trust Fund has received substantial bilateral contributions and pledges totaling $2.1 billion from over 20 countries.

The poverty-reduction program. The original HIPC Initiative proposed three approaches: (a) tying the program to recipients that had established a track record of implementing structural and social reforms; (b) attaching some significant part of the financial gains to governments to make additional resources available specifically to strengthen social programs, especially in primary education and primary health; and (c) ensuring a high degree of participation and coordination between all actors involved—debtor governments, creditors, and donors—as well as NGOs, churches, and other groups.

In the enhanced HIPC Initiative, some major new changes have been incorporated. First, a *comprehensive and participatory poverty-reduction strategy* would normally be required to be in place in countries before a decision point. The implication is that instead of tying the HIPC to social programs, there is now an explicit link to a broader and more comprehensive poverty reduction strategy. Second, this poverty strategy paper and intent, to be updated annually, is to be *owned and developed by the country itself*, following wider consultations by governments. Third, because all countries may not be fully ready with their poverty-reduction strategies, interim poverty-reduction strategies are possible. Fourth, there is also an explicit intent to integrate the HIPC debt relief with other sources of external financing to fund the overall poverty-reduction strategy. Fifth, *monitorable indicators of intermediate and outcome indicators of poverty reduction* consistent with overall macroeconomic targets are to be developed.

Additionality of resources for poverty alleviation. An important buy-in of the HIPC program is therefore on freed resources (amounting to some 2 percent of GDP in the seven countries where decision points have been reached) being targeted at the poor in a comprehensive manner (figure 3.5). In potential HIPC countries, the incidence of poverty is more than 40 percent on average. The integration of debt relief with an overall country strategy for poverty alleviation is therefore a potentially important development. For example, Uganda is using the financial gains from the HIPC Initiative to help finance the country's universal primary education program, and has achieved a 37 percent increase in funding of the program in the 1997–98 budget, resulting in a significant increase in primary school enrollments. A specific Poverty Action Fund (PAF) has been established to direct funds made available from the debt relief initiative and donor resources more broadly toward the implementation of programs under poverty reduction (IMF and World Bank 1999). Some recent experiences with other countries that have also reached decision points in the HIPC Initiative also suggest progress: (a) targets for public spending for education and access to primary education were generally met in Mozambique, but quality problems have persisted while both health sector budgets and outcomes (vaccination coverage of 77 percent) were well ahead of targets (60–65 percent); (b) despite delays, Bolivia's progress has also been generally satisfactory; and (c) in Guyana, social spending has exceeded targets set at decision point, but weaknesses in implementation persist (as in Bolivia) (IMF and World Bank 1999).

Figure 3.5 Social spending and debt service in HIPC countries, 1993–97



Note: The seven countries are Bolivia, Burkina Faso, Côte d'Ivoire, Guyana, Mali, Mozambique, and Uganda. These are estimates based on data from 1999 and are subject to change.

At a narrow level, one question from these experiences is whether debt relief will get translated into improved social spending that is a key to overall poverty reduction. In general, external transfers in the past have only been weakly associated with better social spending. There also remain other broader questions and debates—ranging at one extreme from too little too late, to the moral hazard issues of bailing out failed policies.[22] There are also concerns that funding of debt relief may not provide true additionality of resources, as agreed, if donors cut back on new aid flows (other than the debt-relief component that may be agreed), and therefore strong and continued future support of donors to the countries will be essential. It is clear that debt relief is, however, not an end in itself, and during the HIPC review there was widespread support for a stronger link between debt relief and poverty reduction. This link is intended not only to strengthen the poverty focus of the reform programs pursued by HIPCs, but also to provide a framework for determining the most effective developmental uses of the additional resources that will be available as a result of debt relief, such as a framework that integrates debt relief with other external assistance as well as domestic resources.

Looking forward, the challenge is to support countries in developing poverty reduction strategies aimed at reaching the international development goal of cutting poverty levels in half by the year 2015. Realizing this ambitious agenda will require a commitment from all participants. Debtor countries will need to pursue and implement their economic and poverty-alleviation programs on a sustained basis, while the international community will need to remain committed to the poorest countries. This means commitment by donors not only to fully finance the HIPC Initiative, but also to reverse the declining trend of development assistance.

The new HIPC Initiative aims at a decisive break from the design of past relief programs and therefore past history may be a poor guide for the future. Both the explicit links to better policies and to poverty alleviation are promising, as the aid selectivity literature suggests. Therefore, in the end, much will depend on the specific successes or failures in implementation of policies—and since there is a significantly long lag between such policies and outcomes, the program's successes cannot be measured by quick outcomes but by a process of learning over a number of years. The HIPC Initiative also has some critical elements of country ownership, consultations, and monitoring of poverty-reduction efforts (through performance indicators) to assess progress—that have been some key elements of past successful programs (IMF and World Bank 1999).

Official nonconcessional flows

Nonconcessional flows from both bilateral and multilateral creditors declined in 1999 following the unusually high level reached in 1998, when rescue packages were assembled for the Asian countries, Brazil, and Russia (table 3.5). This decline is even more pronounced when flows from the IMF are taken into account: by this definition the net inflow of nonconcessional financing falls dramatically, to negative \$0.2 billion in 1999 from \$32 billion in 1998. The sharp turnaround in net inflows from the IMF (from \$19 billion in 1998 to negative \$13 billion in 1999) reflects several factors, including delays in implementation of the programs in Russia and Indonesia, and a large prepayment on the part of Korea.

Debt restructuring

In 1999 the Paris Club concluded multicountry rescheduling agreements with seven countries covering a total of \$16 billion. Five of these agreements were with low-income countries (Guyana, Honduras, Mozambique, Pakistan, and Zambia) and two were with middle-income countries (Jordan and Russia). The agreement concluded with Russia in August 1999 accounted for over half of all debt rescheduled in 1999. Under this arrangement Paris Club creditors agreed to reschedule \$8 billion in principal and interest falling due between July 1, 1999, and December 31, 2000, and arrears as of June 30, 1999, on loans contracted by the former Soviet Union. Repayment of the rescheduled amounts will be over a 20-year period on a graduated payment schedule.

The agreement reached with Pakistan in January 1999 covered \$3.2 billion in principal and interest payments falling due between January 1, 1999, and December 31, 2000, on medium-term loans contracted before September 30, 1997, and extended to or guaranteed by the government of Pakistan. A unique feature of this agreement was its comparability-of-treatment clause, which for the first time was extended to all categories of private creditors, including bondholders. Pakistan

Table 3.5 Official net nonconcessional flows to developing countries, 1988–99

Type of flow	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999[a]
Official nonconcessional	6.1	7.3	12.2	11.5	10.0	11.8	–0.3	8.7	–8.5	6.3	13.1	12.6
Bilateral nonconcessional	0.1	0.6	2.9	3.9	4.5	3.4	–2.6	5.0	–12.7	–7.1	–5.7	–0.1
Multilateral nonconcessional	6.0	6.7	9.3	7.6	5.5	8.4	2.3	3.7	4.2	13.4	18.8	12.7
Memo item												
Use of IMF	–5.0	–2.3	0.0	3.2	1.2	1.7	1.6	16.8	1.0	14.7	19.2	–12.8

a. Estimated.
Source: World Bank Debtor Reporting System and staff estimates.

was asked to restructure its $600 million of Eurobonds on terms comparable to those provided by the Paris Club. A bond exchange offer was successfully concluded in December 1999 to exchange existing instruments for 10 percent US$ notes due in 2002–05. The agreement concluded in May 1999 with Jordan covered $821 million in principal and interest falling due between April 1, 1999, and April 1, 2000. In this case the comparability-of-treatment clause did not extend to Eurobonds because they did not fall due within the consolidation period.

The four other low-income countries that concluded an agreement in 1999 are all countries eligible for concessional rescheduling arrangements. The agreements for Honduras and Zambia provided for a flow rescheduling on Naples terms (67 percent NPV reduction) and covered $0.4 billion and $1.1 billion, respectively. In the context of the HIPC Initiative, two more countries reached the completion point, and the Paris Club concluded stock-of-debt operations on Lyon terms with Guyana ($0.2 billion) and Mozambique ($1.9 billion).

Moral hazard and bailing in of private creditors in official financing packages. Two major and closely related issues arose during the past year with regard to official financing. They are, first, the issues concerning moral hazard with regard to large official financing packages, and second, the "bailing-in" of private creditors in official financing for crisis countries. In a small number of cases, private bondholders have been called upon recently to accept rescheduling and to contribute to the costs of financial restructuring. These departures from past practice reflect increasing concerns with respect to official financing for countries in distress and the moral hazards to which these might give rise on the part of lenders and after Mexico's 1995 bailout and the announcement of large official financing packages for several Asian crisis countries in 1997. A significant turning point was reached in Russia, where official financing was curtailed and an external payment crisis was allowed to develop (see *Global Economic Prospects 1998/99* for details).

Following on this much greater scrutiny, a case-by-case approach has now been outlined. Brazil received extended lines of credit and official financing, but these were conditioned on private creditors' rolling-over short-term debts and improvements in country policies. By contrast, in Ecuador no rescue package was agreed upon, and the country effectively defaulted on its international bonds. In the case of Pakistan, official creditors required comparable action on the part of private creditors—both banks and bondholders—and agreements have now been concluded with both (through the London Club in the case of the banks). For Ukraine, private creditors agreed to restructure existing bonds, but only after protracted negotiations.

The effects of these developments are likely to be positive in the longer run. By putting more of the burden of risk management back on the shoulders of borrowers and private lenders, they reduce the likelihood of such crises in the future. At the same time, however, they are likely to raise the cost of new borrowings or to reduce access to new private capital flows for developing countries, especially the less creditworthy, in the near term.

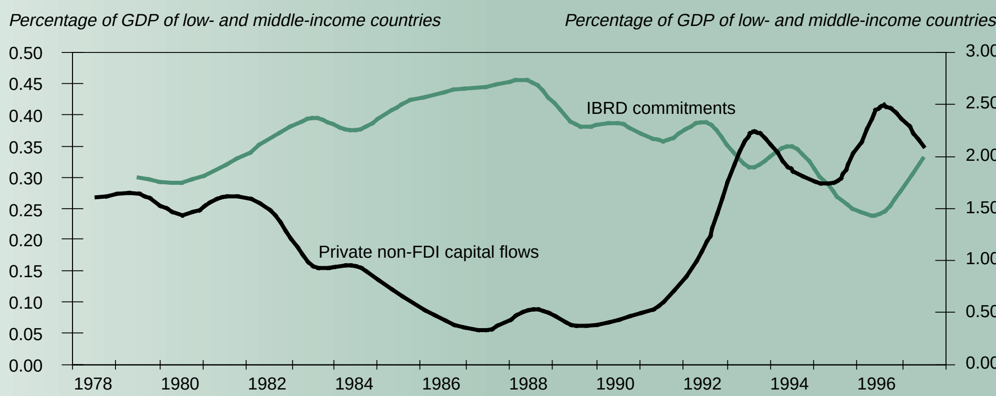
A recent examination of the effects of "collective action clauses" (Eichengreen and Mody 2000) supports this conclusion. One way to bail in private investors and lenders is to include collective action clauses in bond contracts like those typically included in syndicated commercial bank loan contracts. Proposals along these lines are now being discussed. Collective action clauses, in effect, allow for an easier rescheduling of debt—should the need arise—by allowing for less than 100 percent of bondholders to take decisions on behalf of all bondholders, by ensuring that the proceeds from recovery are shared (so that individual bondholders do not have an incentive to seek repayment on their own), and by providing for collective representation of bondholders.

The concern with such provisions that permit rescheduling is that they may raise the costs of borrowing. However, this need not always be so. Two opposing forces operate. By making rescheduling easier and more predictable, collective action clauses may actually lower borrowing costs. On the other hand, they may increase the risk that borrowers will seek rescheduling when, in the absence of such clauses, the alternative would have been a reputed costly default that would have created the incentive to continue to service the debt. Eichengreen and Mody (2000) find that both forces operate, but their weight varies according to the creditworthiness of the borrowers. For borrowers with low creditworthiness, the risk of willfully engineered rescheduling dominates, and the costs of borrowing are significantly increased. However, for more creditworthy borrowers, even

Box 3.5 How countercyclical have official and World Bank lending been to private capital flows?

Results at an aggregate level tend to suggest that between 1978 and 1997, official flows (which do not include IMF) tended to be countercyclical to private capital (non-FDI) flows—falling when private flows are rising, and vice versa (see box figure). Multilateral lending (other than the IMF), a component of official flows, also tended to be strongly countercyclical to volatile private flows. The figure below shows the behavior of annual commitments of lending by the International Bank for Reconstruction and Development (IBRD) and of private non-FDI flows, with growing adjustment lending playing a large role. Of course, this is past behavior and not necessarily indicative of future behavior. Recent scrutiny is likely to reduce the countercyclical role of official lending (other than IMF).

IBRD commitments and private non-FDI capital flows, 1978–97



Source: World Bank.

though the risk of default is low, the prearrangement of orderly rescheduling has a positive value and the costs of borrowing may be lowered.

Many developing countries, unfortunately, are marginally creditworthy (see chapter 2): roughly 75 percent have less than investment-grade credit ratings. This suggests that many developing countries are likely to see increased borrowing costs (and reduced access to credit) if collective action clauses are introduced, although this need not always be so. Exact thresholds are difficult to determine. But these effects are likely to be especially significant for countries with poorer credit ratings.

Notes

1. Aid flows have two main measures, as discussed more fully in *Global Development Finance 1999,* annex 1, chapter 4. The first, *official development assistance (ODA)* by DAC members, principally measures donor country effort by counting their bilateral disbursements of concessional financing to developing countries and that to multilateral institutions, such as IDA. The second is *concessional finance from official sources* received by developing countries (World Bank Debtor Reporting System [DRS]), which counts bilateral disbursements of ODA plus actual disbursements of concessional finance by multilateral institutions. The latter differs from the former because: (a) concessional finance received from donor sources by multilateral institutions does not match those institutions' disbursements to developing countries in any given year; (b) the OECD definition of aid recipients is broader, and the data sources are also different; and (c) technical cooperation grants cover the provision of services and are counted as aid by the OECD, but the World Bank DRS does not include them in its measure of concessional resource flows (see *Global Development Finance 1999*).

2. They are grouped in the Development Assistance Committee.

3. OECD News Release, June 10, 1999.

4. In Burnside and Dollar (1997), the recipient country characteristics that are envisaged to enhance the impact of aid on growth are institutional quality, inflation, and trade openness.

5. This is not valid for all countries. In the Netherlands, for instance, the aid budget is set to be a fixed percentage of the total budget every year.

6. The greater channeling of official aid through NGOs is not, however, a factor in the decline in official aid, since the final accounting of official aid includes NGO-channeled official aid.

7. Alesina and Dollar (1998) find, for example, that each of five principal donors appears to follow a different distortion. The United States targets one-fourth of its aid to the Arab Republic of Egypt and Israel, strategically important partners in the Middle East, whereas France and the United Kingdom allocate most of their aid budget to former colonies (North Africa, and India and Pakistan, respectively). Japan's aid is largely directed to other Asian countries, and Germany evidently targets the economies of Central and Eastern Europe, mirroring its own commercial interests.

8. See Schraeder, Hook, and Taylor (1998). Alesina and Dollar (1998), for example, suggest that the motives that donors followed in the past in allocating aid were mainly strategic. They find that political, historical, and strategic connections play a bigger role in screening countries for aid than their economic needs or performance.

9. Alesina and Weder (1999), for example, using an independent measure of the extent of corruption across countries, found no evidence that the less-corrupt countries received more aid; to the contrary, the more corrupt countries received more aid, from both multilateral and bilateral sources. The term *corruption* and the use of cross-country comparisons need to be treated with great care, however. Burnside and Dollar (1997) find that aid has a positive impact on growth and poverty reduction only in countries with good fiscal, monetary, and trade policies, and no impact in countries with poor policies. They also find no evidence that foreign aid encourages the adoption of good macroeconomic policies. The commitment of governments to sound and appropriate policies thus appears independent of the eventual reward of more aid. Kaufmann, Kraay, and Zoido-Lobaton (1999) report findings that suggests a strong association between the quality of governance—popular voice and accountability, political instability and violence, government effectiveness, regulatory burden, rule of law, and graft—and development outcomes and a strong positive causal relationship from improved governance to development outcomes. These findings thus link aid to governance questions as well.

10. By negative shocks we mean here exogenous factors affecting negatively the economic environment, such as terms-of-trade instability, climatic shocks, and so on.

11. All seven—Burkina Faso, Madagascar, Mongolia, Nicaragua, Rwanda, Sierra Leone, and Zambia—received aid amounting to more than 15 percent of their GNP.

12. Devarajan, Rajkumar, and Swaroop 1999, conclusions.

13. International Federation of Red Cross and Red Crescent Societies 1999.

14. United States, the European Commission, the Netherlands, Norway, Sweden, the United Kingdom, and Japan.

15. *World Disasters Report 1999,* pp. 104 and 109. The single largest donor of emergency aid in 1997 was the European Commission, which provided assistance valued at $784 million. The other six of the top seven are Japan, the Netherlands, Norway, Sweden, the United Kingdom, and the United States. Despite the historical leadership of the United States, which has chaired the DAC since its foundation, U.S. aid, as a percentage of U.S. GNP, is now half what it was a decade ago. The 1990s have seen the European countries emerging as the most generous in the field of emergency assistance. In 1999 the DAC will be chaired for the first time by a European country.

16. Even at this level, emergency spending is substantially higher as a share of total aid than it was in the mid-1980s. It rose slowly from US$600 million in 1985 to just over a billion dollars in 1990, but it did not climb above 3 percent of bilateral ODA until 1991. This is a consequence of the increased number of disasters affecting poor countries in this decade.

17. UNDP data.

18. Under the common pools approach, recipient countries would own and develop their own plans and present them to donors, which would then fund them based on their own assessments. There would be no earmarking or specific donor monitoring and control of specific projects; rather, assistance would be built around a sector strategy designed by the recipient country itself. This would avoid the problems of lack of ownership and aid coordination. The common pools approach would also include special funding for programs such as disaster prevention and global public goods such as prevention of diseases, development of vaccines, and interventions against environmental problems.

19. Targeting by performance involves allocating more aid to those countries with greater numbers of poor people and better policies. Collier and Dollar (1999) estimate that 75 percent of the world's poor live in such countries but receive only 53 percent of total aid. These authors estimate that, under present allocations, aid flows bring about 16 million people per year sustainably out of absolute poverty. With a more efficient allocation, this could nearly double to some 30 million people. Even with the introduction of political constraints, a better allocation of aid monies could achieve sustainable annual poverty reduction of around 25 million. The same target could only be achieved under the present system of allocations by tripling the current aid budget. The 1997–98 experience suggests that aid allocations are becoming more efficient (see box 3.3).

20. To qualify, countries also must be eligible for World Bank and IMF concessional assistance, pursue an economic reform program supported by the World Bank and IMF, and face an unsustainable debt situation after the application of traditional debt relief mechanisms.

21. Two countries reviewed, Benin and Senegal, were deemed not to require assistance under the initiative. Debt sustainability analyses have confirmed that debt relief through existing mechanisms was sufficient for these countries to attain a sustainable debt position, but eligibility will be reassessed.

22. One recent study (Easterly 1999), for example, reviewed debt relief programs implemented over the last 20 years and found that the same countries are heavily in-

debted now. The author reports that total debt forgiveness for 34 HIPC-eligible countries over 1989–97 totaled US$31.5 billion, while over the same years their new borrowing was US$30.6 billion. The hypothesis is that waves of debt relief may have created moral hazard incentives, such that "countries borrow in anticipation of debt forgiveness and delay policy reforms waiting for the best deal." The evidence is apparently supportive, since many African countries did not abandon poor economic policies while receiving adjustment loans. At the same time, since these countries had not improved their policies, their creditworthiness on the private lending side has remained low. Gradually, private lending and foreign investment have flown out, being substituted by official lending. Fortunately, the evidence is that the more recent HIPC debt relief initiatives seem to have been more successful than earlier debt relief efforts—although there are too few years of data to draw definite conclusions.

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