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# Overview: International Finance and the Poorest Developing Countries

**T**HE INTEGRATION OF DEVELOPING COUNTRIES into the global economy increased sharply in the 1990s with improvements in their economic policies; the massive expansion of global trade and finance driven by technological innovations in communications, transport, and data management; and the lowering of barriers to trade and financial transactions. Many of the poorest developing countries<sup>1</sup> participated strongly in this process despite their limited access to capital markets. This report analyzes the interaction between the global expansion of finance and improvements in domestic policies in the poor countries over the 1990s, and the implications for growth and poverty reduction. Three main messages are developed: (a) a strong investment climate is critical to attracting foreign capital and using it productively; (b) poor countries' increasing integration in the global economy means that they face similar policy challenges as middle-income countries, including how to deal with capital mobility; and (c) achieving the Millennium Development Goals will require a substantial rise in aid flows, an increased allocation of aid to countries with good policies, and improvements in policies by both developing countries and donors.

## *A greater integration of poor countries and private capital—*

The surge in foreign direct investment (FDI) flows and the decline in aid have transformed external finance to the poor countries. FDI flows to the poor countries rose from 0.4 percent of the gross domestic product (GDP) in the late 1980s to 2.8 percent in the late 1990s in response to the globalization of production and improvements in domestic policies (see pages 59–61). Aid to these countries fell by 20

percent in real terms over the same period. The poor countries now receive about the same level of FDI as middle-income countries, relative to the size of their economies. In addition, the global expansion of international banks coupled with the liberalization of domestic financial systems in the poor countries increased the average share of foreign bank assets to more than 40 percent of total assets, more than double the share of 1995 and comparable to that of many middle-income countries that have recently benefited from increased foreign bank participation (see pages 64–66).

## *—good policies and governance, along with strong institutions, are critical to using private flows productively*

A rise in private flows can have a substantial impact on investment in the poor countries and, if productively used, on growth. However, the policy framework must be right. Improvements in the investment climate (a term that refers to the numerous ways in which government affects the productivity of investment, including policies, governance, and the strength of institutions) have boosted the impact of international financial transactions on productivity in the poor countries. Domestic firms in countries with strong investment climates are more able to absorb the foreign technology and skills that come with FDI (see pages 62–63). Better policies have enabled some poor countries to attract more diversified FDI flows—the share of countries that export natural resources in the poor countries' FDI dropped from half in 1991 to 20 percent toward the end of the decade. Countries that established the competitive conditions required to attract foreign banks experienced an improvement in the efficiency of their domestic banks

and thus a decline in the cost of financial intermediation (see pages 66–69).

### Poor countries face similar challenges from globalization as middle-income countries

The events of the past year underlined the risks of capital mobility for the middle-income emerging markets. The current global economic slowdown, exacerbated by the bursting of the high-tech bubble at the end of 2000 and the terrorist attacks in September 2001, is exceptionally deep and broad (see pages 7–11). Capital market flows once again proved to be procyclical: the growth slowdown in industrial countries reduced both emerging markets' export revenues and their access to external finance (see pages 32–36). By contrast, the level of FDI in 2001 was virtually unchanged from the previous year despite adverse global conditions, including a drop in global FDI flows (see pages 37–40). The crisis in Argentina illustrates how open capital accounts can compound the effects of unsustainable macroeconomic policies and high public sector debt, thus seriously complicating stabilization efforts (see pages 43–47).

The poor countries are also vulnerable to capital mobility. While most still impose restrictions on capital account transactions, controls have had only limited success in controlling capital outflows in the context of a weak investment climate, where domestic investment opportunities are limited and fears of confiscation or reduction in the value of assets provide considerable incentive to put money abroad (see pages 69–78). Poor countries with better than average policies (as measured by the World Bank) had more success in retaining domestic capital: a rough estimate of the stock of their capital outflows relative to GDP was about one-sixth the size in poor countries with worse than average policies. Capital outflows have been more volatile in the poor countries than in the middle-income countries, while volatility can be more costly (in terms of welfare) in poor countries because more people live close to subsistence and have little private insurance or public safety nets. Thus policymakers in poor countries need to recognize the potential impact of capital mobility on both stabilization policies and long-term development.

### Good policies and strong governance are also key to improving aid effectiveness

Earlier empirical studies consistently found a weak relationship between aid and investment, with even less of an impact of aid on growth. However, more recent research shows that aid makes an effective contribution to growth and poverty reduction in countries with good economic policies, sound institutions, and strong governance, but has little effect in countries with poor policies. A doubling of aid flows would help ensure that developing countries achieve the Millennium Development Goals, provided that this aid is allocated to countries with good policies and large numbers of poor people (pages 99–100).

Aid continued to decline in 2001, and the prospects for a substantial rise in the medium term are limited (pages 90–94). Most countries with good policies can continue to absorb additional aid resources without seriously impairing the effectiveness of that aid (see pages 96–99). Aid does not, in general, increase the volatility of government resources, and appropriate policies can ensure that aid does not contribute to inflationary pressures or cause excessive exchange-rate appreciation. It is true that even in many countries with good policies, lack of administrative capacity lowers the marginal productivity of aid as aid levels rise. However, recent research indicates that aid levels to most countries with strong economic programs are well below the threshold where aid becomes ineffective.

### Better aid policies by donors also contribute to poverty reduction

There is evidence that donors have made progress in improving their own policies, through increasing resources to debt relief for good performers, easing complex administrative requirements that can strain limited government capacity, and reducing the share of tied aid (see pages 101–104). Modifications of adjustment assistance have helped to preserve the use of conditionality in channeling aid resources to good performers and supporting the credibility of government policies, while ensuring adequate government flexibility and domestic stakeholder commitment to the pro-

gram. Here also, recipient government policies are key: strong leadership and effective administration by the government can help promote aid coordination and make it easier for donors to adopt more flexible policies.

### Note

1. The poor countries are defined to represent developing countries with relatively low per capita income and almost no access to international capital markets. The group includes all IDA-only countries plus a few blend countries that have had few IBRD loans over the past few years. The countries included are Afghanistan, Albania, Angola, Armenia, Bangladesh, Benin, Bhutan, Bolivia, Burkina Faso, Burundi,

Cambodia, Cameroon, Cape Verde, Central African Republic, Chad, Comoros, the Democratic Republic of Congo, the Republic of Congo, Côte d'Ivoire, Djibouti, Eritrea, Ethiopia, The Gambia, Georgia, Ghana, Guinea, Guinea-Bissau, Guyana, Haiti, Honduras, Kenya, Kiribati, the Kyrgyz Republic, the Lao People's Democratic Republic, Lesotho, Liberia, Madagascar, Malawi, Maldives, Mali, Mauritania, Moldova, Mongolia, Mozambique, Myanmar, Nepal, Nicaragua, Niger, Nigeria, Pakistan, Rwanda, Samoa, São Tomé and Príncipe, Senegal, Sierra Leone, Solomon Islands, Somalia, Sri Lanka, Sudan, Tajikistan, Tanzania, Togo, Tonga, Uganda, Vanuatu, Vietnam, Republic of Yemen, Zambia, and Zimbabwe. These countries' average per capita income is under \$500 per year compared with \$2,900 for other developing countries. And most of them are small; only Pakistan, Bangladesh, Nigeria, Vietnam, Ethiopia, and the Democratic Republic of Congo have more than 50 million people.