5

Meeting the Financing Needs of Poor Countries

THE WORLD'S POOREST COUNTRIES face severe challenges in their efforts to eradicate extreme poverty and meet basic human needs. Among the challenges is an external financing environment that is susceptible to sudden and sharp shifts.

From the United Nations Millennium Summit in 2000 emerged the Millennium Development Goals (MDGs), which established targets for progress on poverty, education, health, and sanitation. In March 2002, follow-up meetings in Monterrey addressed the challenges of *financing* the development priorities embodied in the MDG targets. Both conferences acknowledged that reaching the agreed goals would require actions by the developing countries themselves—such as pursuing sound domestic policies. But they also recognized the need for substantial *and stable* flows of external resources. Estimates of the additional resources that poor countries would require to reach the MDGs by 2015 vary widely, but all point to a dramatic shortfall unless current trends improve radically.[1]

The external financing environment facing the poor countries is more complex and fluid than generally recognized. In many cases official development assistance (ODA) is still the major external resource; in others, foreign direct investment (FDI) and private debt are also important. Private flows from nongovernmental organizations (NGOs) and migrants (transfers that are included in the current account) are sizeable in some countries. So-called South-South linkages among developing countries—and especially between larger middle-income countries and poor countries—are a growing source of trade, FDI, remittances, and development assistance.

This chapter examines broad changes in the pattern of development finance available to a sample of 28 poor countries (see note to table 5.1),[2] without explicit consideration of whether the available resources will be adequate to achieve the MDGs in individual countries or groups of countries. For a treatment of those issues, see the World Bank's *Global Monitoring Report 2005*.

The key messages of this chapter are:

- Aid flows to poor countries must increase significantly if the MDGs are to be met by 2015. ODA to poor countries has declined steadily over the last decade. Although other sources of finance have grown, the growth is not sufficient to fill the gap in official financing. Donors must scale up ODA and other resources substantially if developing countries are to achieve the MDGs. Current and impending fiscal pressures in donor countries and strategic factors that can influence the allocation of aid should not be allowed to curtail this effort.
- FDI to poor countries has increased significantly since the early 1990s, reflecting improving performance and a sounder investment climate. But much FDI to poor countries flows to enclave mining or natural resource projects, which may limit its benefits and add to volatility. Moreover, current flows fall far short of needs.
- Private transfers are much more important in poor countries than in other developing countries. The private sector component of grants from NGOs (mostly to poor countries) reached $10 billion in 2003, while workers' remittances reached $16 billion. Both are

Table 5.1 Net capital flows to poor countries, 1990–2004
$ billions

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004p
Current account balance	−7.1	−8.8	−12.4	−9.4	−11.1	−6.9	−3.6	−2.4	−0.3	−2.3	−8.7
as % of GDP	−4.3	−4.3	−5.6	−4.1	−4.8	−2.9	−1.5	−1.0	−0.1	−0.8	−2.7
Financed by:											
Net equity flows	0.7	3.9	5.4	6.5	5.3	5.0	4.2	4.0	5.9	7.7	**8.4**
Net FDI inflows	0.7	3.9	5.2	6.1	5.3	4.9	4.1	4.1	5.8	7.7	**8.4**
Net portfolio equity inflows	0.0	0.0	0.2	0.4	0.0	0.1	0.0	−0.1	0.1	0.0	**0.0**
Net debt flows	6.4	7.0	4.9	6.8	3.3	4.1	2.6	3.2	3.5	3.2	**4.3**
Official creditors	4.8	4.8	4.6	4.3	4.4	5.0	4.0	5.3	4.6	3.9	**4.2**
World Bank	2.2	2.1	2.6	2.7	2.2	2.6	2.2	2.9	3.1	3.0	**3.7**
IMF	−0.4	0.7	0.2	0.0	0.0	0.6	−0.1	0.6	0.2	−0.2	**−0.6**
Others	2.9	2.0	1.8	1.7	2.2	1.8	1.9	1.8	1.3	1.0	**1.1**
Private creditors	1.6	2.2	0.3	2.5	−1.1	−0.9	−1.3	−2.1	−1.0	−0.6	**0.1**
Net medium- and long-term debt flows	0.2	0.3	0.6	1.7	−0.1	−1.4	−1.1	−1.1	−1.4	−1.0	**0.3**
Bonds	0.0	0.0	0.4	0.5	0.0	−0.1	0.0	−0.1	−0.2	−0.4	**0.3**
Banks	−0.2	0.2	−0.1	0.5	−0.3	−0.9	−0.6	−0.8	−0.9	−0.3	**0.5**
Others	0.4	0.2	0.3	0.7	0.2	−0.4	−0.5	−0.2	−0.3	−0.4	**−0.5**
Net short-term debt flows	1.5	1.8	−0.3	0.8	−0.9	0.5	−0.3	−1.0	0.4	0.4	**−0.2**
Balancing item	0.3	−1.5	2.9	−2.4	2.1	0.7	−1.1	−0.6	−0.3	0.6	—
Change in reserves (− = increase)	−0.4	−0.6	−0.8	−1.5	0.3	−2.9	−2.1	−4.2	−8.8	−9.3	—
Memo items:											
Official development assistance	14.4	16.2	14.2	13.1	13.6	13.5	13.8	15.6	16.8	19.6	—
Grants (excluding technical cooperation)	8.4	7.4	6.5	5.9	6.7	6.6	6.7	7.7	8.2	10.4	—
Workers' remittances	5.5	5.4	5.2	6.0	5.6	6.1	6.7	9.6	13.9	15.0	**15.9**
Net private flows (debt + equity)	2.3	6.1	5.7	8.9	4.3	4.1	2.8	1.9	4.9	7.1	**8.7**
Exports	30.3	41.4	50.5	55.9	54.2	57.6	66.8	69.5	77.7	89.5	**106.6**
Imports	43.7	57.0	70.9	73.8	73.8	73.1	80.4	83.2	89.1	106.7	**130.0**

Note: — = not available. Country sample used in this table and throughout the chapter includes Azerbaijan, Bangladesh, Benin, Bhutan, Burkina Faso, Cameroon, Ethiopia, Ghana, Kenya, Kyrgyz Republic, Lesotho, Madagascar, Malawi, Mali, Mauritania, Moldova, Mongolia, Mozambique, Nepal, Nicaragua, Pakistan, Rwanda, Senegal, Tanzania, Uganda, Vietnam, the Republic of Yemen, and Zambia.
Sources: World Bank Debtor Reporting System and staff estimates; OECD; IMF, various years.

large, *stable* sources of foreign exchange for poor countries and may be more likely than other flows to reach poor households.

- To increase private capital flows to poor countries, the international community should support policies that lead to better market access for poor countries and encourage investment through the use of risk mitigation instruments. Financial instruments such as securitization (of flows of workers' remittances, for example) can expand the access of poor countries to international capital markets. Most important, poor countries should continue efforts to improve their investment climate, which remains crucial not only for attracting more resources, but also for ensuring their effective use.
- Other developing countries can be instrumental in widening the pool of development resources in poor countries. Initiatives undertaken by these countries to advance development in their low-income neighbors should be supported by the broader development community.

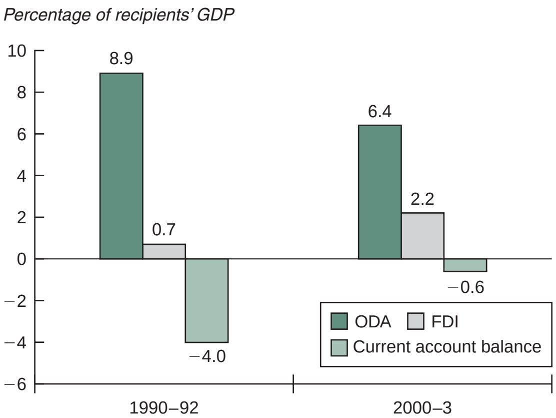
The external financing environment in poor countries

Foreign aid traditionally has been perceived as the primary source of external financing for poor countries. To some extent that view remains correct: poor countries rely on ODA more heavily than do other developing countries. Ratios of ODA to GDP are higher in poor countries than in the developing world as a whole. In 2003, ODA to the countries in our sample amounted to $19.6 billion (table 5.1).

Declining aid flows throughout the 1990s

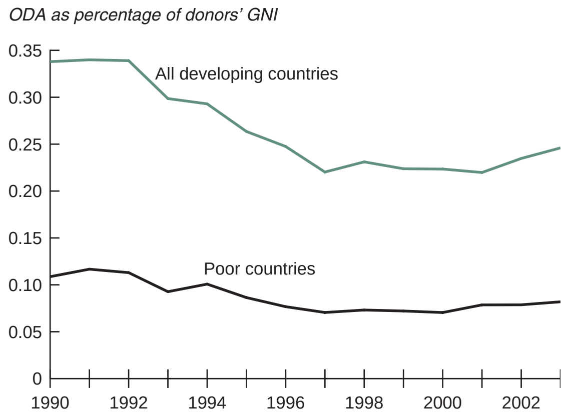
Despite the recognized importance of aid, poor countries as a group are receiving less ODA today

Figure 5.1 Shift from aid toward FDI in poor countries, 1990–2003



Sources: OECD; IMF, various years; UNCTAD; World Bank staff estimates.

Figure 5.2 ODA to poor countries relative to total ODA, 1990–2003



Source: World Bank staff estimates using data from OECD Development Assistance Committee.

than in the early 1990s (figure 5.1). In nominal terms, ODA to poor countries fell from $16.4 billion in 1992 to $13.8 billion in 2000, before recovering to $19.6 billion in 2003. As a share of GDP, ODA for the poorest countries declined by about one-third between 1990–92 and 2000–3. By contrast, FDI rose during the 1990s for the full sample, tripling its share to 2.2 percent of GDP. These aggregate movements mask significant country heterogeneity in the pattern of flows (box 5.1).

With the end of the Cold War came a decline in the strategic importance of aid, particularly its use in supporting "client states." But Cold War politics were not the only factor in the decline. The 1990s were a period of fiscal tightening in most donor countries. With the European Union's fiscal policy constrained by the terms of the Maastricht Treaty, and with political pressure in the United States for a balanced budget, cyclically adjusted fiscal positions of the OECD donors improved from an average deficit of 4.4 percent of GDP in 1992 to 0.8 percent in 2000, while ratios of ODA to GNI fell from 0.34 to 0.22 percent (figure 5.2).[3] The proportion of total ODA directed to the poorest countries has been remarkably stable since the early 1990s, at around one-third of the total, suggesting that ODA expenditures on this group by major donors are not protected from fiscal pressures. On a country-by-country basis, ratios of ODA to GDP declined throughout the 1990s in 63 percent of the poorest countries.

There has been a shift in the sectoral distribution of ODA in the poorest countries away from physical infrastructure and agriculture (figure 5.3). While education and health recorded an increase from 8 to 13 percent over the decade, the biggest increment went to debt relief, which rose from 8 to 22 percent. The shift in part reflects the introduction of the Heavily Indebted Poor Countries (HIPC) Initiative, launched by the World Bank and IMF in 1996 (and enhanced in 1999) to ease the crippling debt burden of some of the world's poorest countries (see box 1.2).[4]

During the 1990s, infrastructure financing to all developing countries from bilaterals and multilaterals declined as private flows rose—predominantly from a wave of privatizations and liberalization in the 1990s that encouraged private investors with limited investment prospects at home to invest in power plants, roads, and telecommunication facilities in the developing world (World Bank 2004a). The decrease in spending for agriculture was predominantly due to changes in India, related in part to the end of external assistance for the Green Revolution (OECD 2004), although agricultural aid to Sub-Saharan Africa and other poor South Asian countries also fell.

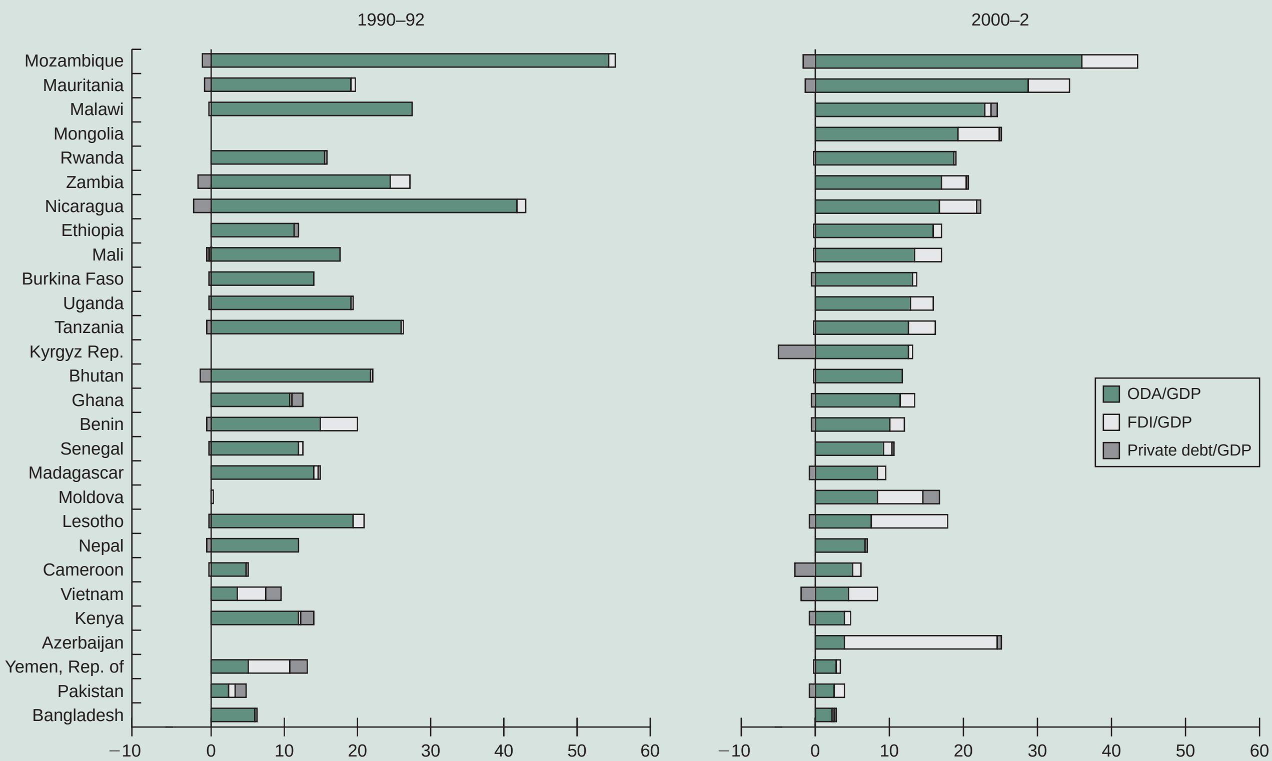
Some commentators find evidence of a more selective approach in the allocation of aid throughout the 1990s, with a better focus on poorer countries and better performers (World Bank 2004a; Dollar and Levine 2004). Dollar and Levine (2004) found that the giving patterns of

Box 5.1 Wide variations in the mix of external financing in poor countries

Average financing patterns mask enormous country variation. For example:

- Dependence on official development assistance (ODA) varies enormously in the countries of our sample—from a high of 36 percent of GDP for Mozambique to about 2.2 percent of GDP for Bangladesh and 2.7 percent for Pakistan. The pattern of allocation of ODA also changed over the past decade. Several countries (Kyrgyz Republic, Mongolia) that received no ODA during 1990–92 now receive significant amounts, whereas others (Nicaragua, Tanzania) have witnessed sharp declines.
- The size of and changes in the contribution of other financing sources—primarily foreign direct investment (FDI)—vary as well. FDI inflows were significant in just a few of our sample countries in 1990–92, whereas by 2000–2 many more were receiving substantial inflows. Few countries had significant private debt flows; for most that did, the net flows were negative.
- The picture that emerges is one of diversity and heterogeneity. Although these 28 poor countries share the challenge of reaching the MDGs over the next decade, the composition and level of external resources available to them differ enormously.

Country differences in importance of external financing as a share of GDP, 1990–92 and 2000–2

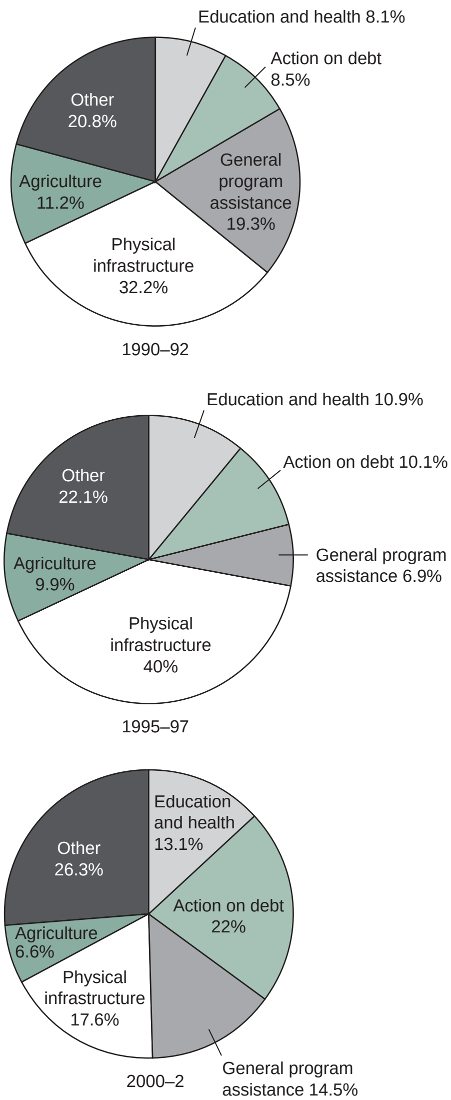


Sources: OECD DAC database; IMF, various years; World Bank Debtor Reporting System; staff estimates.

30 of 40 donors surveyed showed a positive relationship between aid allocations and the soundness of recipients' policies and institutions—a sharp improvement from a decade ago.

Partially compensating for the decline in ODA are nontraditional private resource flows. Classified as current account transfers (and therefore not as capital flows or external financing), these foreign

Figure 5.3 Sectoral distribution of ODA to poor countries, 1990–2002



Note: Data include Indonesia and India.
Source: World Bank staff estimates using data from OECD Development Assistance Committee.

exchange sources have grown steadily in importance in recent years. Grants from NGOs have emerged as a critical counterpart to official aid flows in some environments, just as NGOs have become key stakeholders and partners in many development programs and interventions (box 5.2). And the rapid growth in workers' remittances highlighted in previous editions of *Global Development Finance* has specific implications for some countries because of the pattern of their migrant flows (box 5.3).

FDI has grown in poor countries, and ratios of FDI to GDP are similar to those found in other developing countries

From an annual average of $0.5 billion in the 1980s, to $3.5 billion in the 1990s (before plummeting in 1998), FDI flows to poor countries rose to some $8.4 billion in 2004 (box 5.4). At present, the average ratio of FDI to GDP in poor countries is close to the developing-country average of 2.7 percent.

In absolute terms, FDI flows have been heavily concentrated in a few countries. In our sample, only Azerbaijan and Vietnam have annual FDI inflows exceeding $1 billion. However, relative to the size of the economy, FDI has been of considerable importance for some of the smaller poor countries, particularly Lesotho, Mauritania, Moldova, and Mozambique. FDI has also made a significant contribution to gross domestic capital formation in many poor countries. The share of FDI in gross capital formation averages 12 percent for the poorest countries (compared to 10 percent in middle-income countries); it is as high as 60 percent in some poor countries. This in part reflects a low savings ratio and limited access to international private debt flows.

The positive trend in FDI has emerged despite the existence of significant barriers to attracting external private finance. FDI and other types of private capital flows are strongly influenced by a country's investment climate, which is defined by its institutional and policy environment. Political and regulatory risks—among them the risk of confiscation, expropriation, nationalization, nonconvertibility of currency, losses to political violence, and lack of enforcement of regulatory rules—are believed to be higher in poor countries than in other developing countries and might be expected to discourage investment. Indeed, almost all poor countries score significantly lower than middle-income countries on measures of corruption, efficiency of bureaucracy, and law and order (OECD and AfDB 2003; UNCTAD 2003).

Inadequate infrastructure is cited as another key constraint to FDI. In most poor countries, foreign investors face unreliable and costly telecommunications services and electricity supply and also inefficient transportation links. Thirteen of the 28 poor countries are landlocked, so that goods produced for export must pass through another country as they travel to global markets, adding additional layers of cost and risk.

Box 5.2 Growing financing role for NGOs

Nongovernmental organizations (NGOs) play a growing role in funding development programs. The private-sector component of NGO grants to all developing countries increased from $5 billion in 1990 to $10 billion in 2003 (figure 1.16)—about 15 percent of the value of total ODA.[a] Although country breakdowns are not available, much of this assistance is directed toward poor countries. The number of global NGOs has increased by about half since the early 1990s (Union of International Associations 2002). In Bangladesh alone, the number of foreign-funded NGOs grew from 382 in 1990 to 1,652 in 2002. This rapid growth can be attributed to several factors:

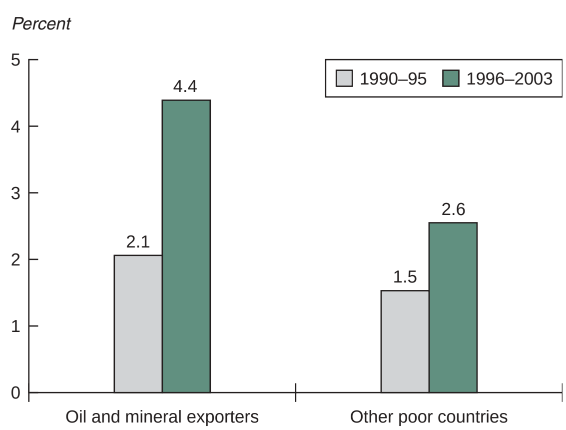
- Citizens of industrial countries are increasingly aware of events in the developing world, partly in response to more frequent and timely foreign news.
- Growing concern over the effectiveness of aid and limits to state-led development have encouraged more resources to be directed through nonstate actors. With greater emphasis on partnerships and shared ownership, NGOs are perceived to be in touch with the needs of the poor (Tevdt 1998). For official donors, international NGOs have become a means to improve aid effectiveness through their contacts with locals. Governments' increasing acceptance of NGOs as legitimate stakeholders has helped as well.
- Private philanthropy has increased sharply. International giving by the Bill and Melinda Gates Foundation to developing countries surpassed $1 billion in 2003. The Ford Foundation, the David and Lucile Packard Foundation, and the Rockefeller Foundation all provide more than $100 million annually in development assistance (OECD 2003a).

[a]ODA includes grants made by bilateral donors to NGOs, but not grants made by NGOs using private funds.

Countries that have taken steps to improve their investment climates and have opened up industries to privatization have been much more successful at attracting FDI (Pigato 2000). While FDI has been concentrated in the extractive sector—with major oil and mining exporters receiving significantly higher FDI relative to the size of their economy (figure 5.4) than other countries—the considerable difference in FDI performance between countries (even in the extractive sector) highlights that countries can influence, to some extent, the degree of inward FDI.

In recent years, a number of poor countries have improved their macroeconomic performance, with higher growth rates, lower inflation, greater openness to trade, and improved exchange-rate stability.[5] In addition, some countries have strengthened their foreign investment policy framework by expanding the number of industries open to foreign investment, easing sectoral restrictions and limits on foreign exchange, signing double taxation treaties to reduce tax burdens,[6] and improving corporate regulations. In addition, several countries established investment promotion agencies (UNCTAD 1998 and 1999; Collier and Gunning 1999), and signed multilateral agreements to resolve future investment disputes. The result has been an overall improvement in investment climate indicators for poor countries,[7] although risks are still higher there than in middle-income countries

Figure 5.4 Natural resource availability and ratios of FDI to GDP in poor countries, 1990–2003



Note: Oil and mineral exporters are countries in which oil and mineral exports accounted for at least 20 percent of total exports in 1996–2003. These countries include Azerbaijan, Bhutan, Cameroon, Ghana, Mauritania, Mongolia, the Republic of Yemen, and Zambia.
Sources: World Bank, *World Development Indicators* and *Global Development Finance*, various years.

Box 5.3 Workers' remittances to poor countries

After a dramatic rise in recent years, workers' remittances have emerged as a significant source of foreign exchange earnings for poor countries. Remittances are an "above-the-line" item feeding into the current account, not the capital account, of the balance of payments.

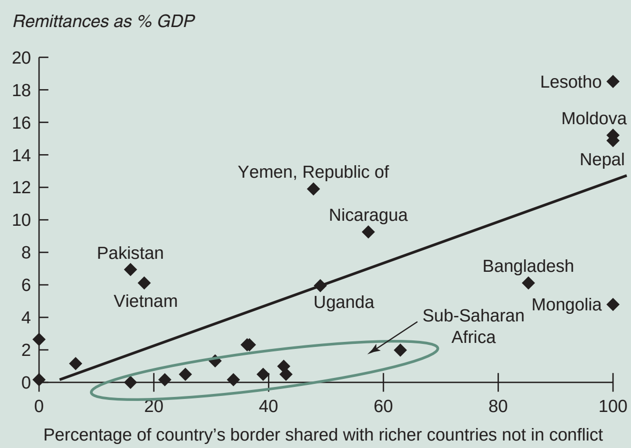
In 2004, remittances to poor countries reached $15.9 billion, averaging 5.1 percent of GDP in 2002/3, compared to just 2.8 percent in 1990/91. Because remittances generally flow from household to household (a private transaction), it is impossible to draw inferences from aggregate figures about their allocation between consumption and investment—or their eventual development impact. But their growth and relative size in poor countries provide ample justification for analyzing their determinants.

The surge in recorded remittance flows in part reflects better data gathering by central banks and statistical agencies in response to growing scrutiny of remittances flowing through alternative channels. But it also mirrors the rise in outward migration throughout the 1990s. Since the mid-1990s there has been an increase in temporary and permanent migrant workers across all skill and income categories, with OECD countries registering a 7.6 percent increase in migrant inflows from 1991 to 2000, and similar trends in many non-OECD countries (OECD 2003b). Finally, security concerns and heightened scrutiny by immigration authorities in rich countries may have encouraged some migrants who fear deportation or investigation to remit a larger portion of their savings back to their home country (World Bank 2004a).

Remittances sent to the poorest countries reflect the stock of emigrants, the work they undertake, and the links to their country of origin. Migration patterns are influenced by three key factors: the economic attractiveness of the destination country; the presence of family members or others of similar ethnic background in the destination country; and the distance between the destination and origin countries (OECD 2003b).

A large part of remittance flows to poor countries comes from other developing countries. Some countries with the highest ratio of remittances to GDP (Lesotho, Moldova, and Nepal) are those that are completely surrounded by richer neighbors that are not in conflict. In Lesotho, for example, 37 percent of households have a family member working in South Africa. Conversely, poorer countries receiving few remittances, such as Madagascar and Tanzania, do not share a common border with a significantly richer neighbor (see figure).

"Neighborhood" effect on remittances to the poorest countries, 2000–2



Sources: IMF, various years; World Bank staff estimates.

(figure 5.5). Mozambique and Uganda are two poor countries that increased FDI after improving their investment climate.

Trade policies and agreements have also played an important role in attracting export-oriented FDI by providing access to regional and larger markets (box 5.5). Recent initiatives to grant African manufacturers greater access to developed-country markets may lead to higher levels of FDI in affected sectors. The African Growth and Opportunity Act (AGOA) initiative by the United States and the European Union's Everything-but-Arms (EBA) program are expected to help in this respect. So far the impact of AGOA has been positive, but limited. According to AGOA progress reports in 2004, the Act continues to encourage new U.S. investment. In addition, it has stimulated African investments as firms work to access AGOA preferences through regional production. However, the effect of those investments may be temporary and limited to certain sectors. For example, the phasing out of Multi-Fibre Arrangement (MFA) in January 2005 may have repercussions for FDI flows to those

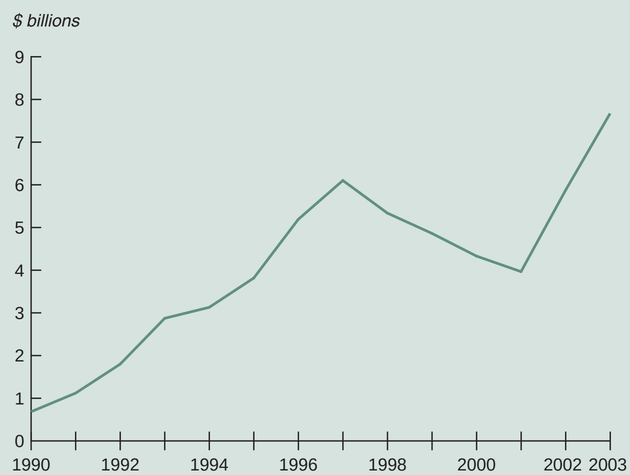
Box 5.4 The rise, fall, and recovery of FDI to poor countries, 1990–2003

The rise in FDI to poor countries in the early 1990s followed the pattern in FDI flows to all developing countries. A distinctive feature of the world economy in the past 15 years has been the growth in investments by multinational firms for the purpose of controlling assets and managing production in specific countries. Starting in the early 1990s, the poor countries, like many other developing countries, eased restrictions on foreign investments and liberalized their capital accounts. At the same time, the privatization process accelerated, particularly in the extractive and service sectors. Privatization stimulated FDI flows to poor countries, although to a lesser extent and more slowly than to middle-income countries. As macroeconomic and political conditions improved, governments undertook structural reforms to upgrade their investment climates. Some countries also made efforts to attract export-oriented FDI through export-processing zones, although with limited success.

Despite these developments, FDI in the poor countries fell sharply from 1998 to 2000 (see figure). The Asian crisis of 1997/98 had a significant impact on aggregate flows to the region. Of the poor countries in the region, Vietnam was hit particularly hard. The crisis also affected poor countries elsewhere, particularly in Africa, because a considerable portion of investments in countries such as Ethiopia and Malawi had come from Asian investors. In addition, FDI flows from the United States fell on the heels of an overall increase in dividend repatriation in 1998–99 (World Bank 2004a). Other reasons for the 1990s decline include deteriorations in the investment climate of countries such as Pakistan and Lesotho[a] and the end of large infrastructure and privatization projects elsewhere.

More recently, FDI flows to poor countries have increased, reaching an estimated $8.4 billion in 2004, up from $7.7 billion in 2003 and $5.8 billion in 2002. As a result, the share of the poor countries in FDI flows to developing countries rose to 8.3 percent in 2003. The rise can be attributed largely to the strong performance of FDI in the oil and gas sectors in Azerbaijan and Pakistan. That said, FDI flows to two-thirds of poor countries increased in 2003. All regions experienced an increase, except the Middle East and North Africa (largely because of ongoing disinvestments in Yemen).

FDI flows to poor countries, 1990–2003



[a]In Pakistan, a major dispute in 1997 between the government and the multinational energy company, Hub Power, led to a sharp decline in FDI. In Lesotho, political unrest following the presidential elections was instrumental in the FDI decrease.

Sources: World Bank, *Global Development Finance,* various years; World Bank, *World Development Indicators,* various years; UNCTAD, *World Investment Report,* various years; World Bank staff estimates.

poor countries that developed their garment industries in response to the MFA or other agreements. Their severity will be determined by a host of factors—among them labor productivity, the cost of labor, and proximity to large export markets. While preferential agreements are in force, it is essential that countries improve productivity and build the necessary infrastructure to advance international competitiveness.

The recent surge in outsourcing of business services to low-wage countries such as India may represent another opportunity to attract export-oriented FDI. Although poor telecommunications and an inadequate supply of skilled labor make it difficult to attract FDI in business services, poor countries can export low-skill services such as data entry. Recently, countries such as Ghana and Senegal have benefited from service outsourcing (UNCTAD 2004). Nevertheless, this type of FDI has limited linkages with the rest of the economy, despite a potentially significant impact on employment.

Box 5.5 Realizing the development promise of trade

Export earnings are an important source of foreign exchange for poor countries. Spurred by higher commodity prices, robust demand, better trade facilities, and more tightly integrated supply chains, the value of poor-country exports has tripled over the last decade, reaching $62 billion in 2003 from $21 billion in 1990. Even so, poor countries did not keep up with the explosion of international trade during the period: their global market share has declined over the years.

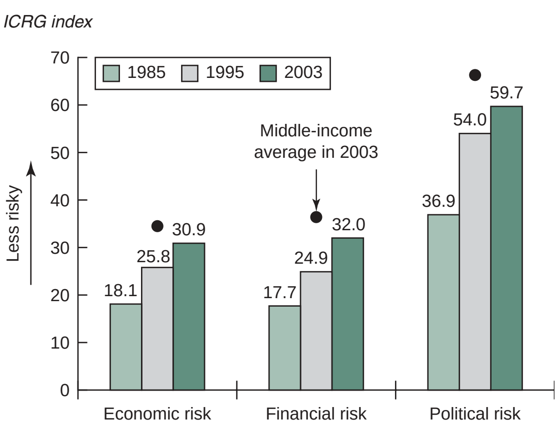
Trade has a significant potential to promote further development and poverty reduction in poor countries, as it has done in middle-income countries. A serious obstacle to the realization of that potential, however, are the restrictions and distortions that continue to hobble trade, notably the persistence of high subsidies for agricultural production and exports in rich countries. The potential gains for developing countries of reductions in those subsidies, accompanied by further multilateral liberalization of trade rules, are greater than those that could be obtained from any other source (World Bank 2003 and 2005).

The ongoing Doha Round of world trade talks offers an opportunity to increase the development potential of trade. Increasing market access for poor countries is especially critical: both developed and developing countries should reduce barriers to poor-country exports of food and agricultural products, labor-intensive manufactures, and services.

As a complement to further liberalization, "aid for trade" can help widen market access. Most poor countries suffer significant behind-the-border constraints such as poor trade-related infrastructure, lack of capacity in trade-related institutions, and poor access to information on new opportunities. Targeted aid can play a crucial role in strengthening critical trade-related infrastructure, such as transport, and making other improvements in trade logistics.

Poor countries can improve their competitiveness by eliminating trade restrictions and anti-export biases (such as export taxes and onerous administrative fees and procedures). In a broad sense, they can raise their productivity by improving their domestic investment climate. Improvements in investment climate and governance are essential in attracting export-oriented foreign direct investment, which in turn can improve trade logistics as world-standard technologies and know-how are applied to trade processes.

Figure 5.5 Improving risk conditions in poor countries, 1985–2003



Note: Economic risk index assesses current economic strengths and weaknesses (GDP per capita, GDP growth, inflation, budget and current account balance). Financial risk index reflects issues related to external debt (foreign debt, trade balance and exchange rate stability). Political risk index evaluates political stability (contract viability, profit repatriation, corruption, bureaucracy, and law and order).
Source: International Country Risk Guide Index (ICRG).

Despite such examples, the concentration of FDI in the extractive sector of poor countries remains high, pointing to several problems:

- In addition to having limited linkages with the rest of the economy, high resource flows to the extractive sector tend to reduce the country's competitiveness in other sectors (through the so-called Dutch disease), increase rent-seeking behavior, and cause institutions to deteriorate (Sachs and Warner 1995; Sala-i-Martin and Subramanian 2003)
- FDI flows to these sectors tend to be volatile. Most investments are large, but also very sensitive to world commodity prices (figure 5.6).[8] Given the large share of such investments in gross capital formation and their influence on exchange rates, volatility may cause further economic difficulties in some countries. But such a negative impact is not inevitable. For example, with strong policy and a sound institutional framework, Botswana relied on large

Box 5.6 Collapse in international bank lending to poor countries

Poor countries have been affected by a reversal in bank lending. From 1991 to 1993, medium- and long-term net bank lending averaged $0.6 billion. By 2001–3 that figure had fallen to −$1.2 billion.

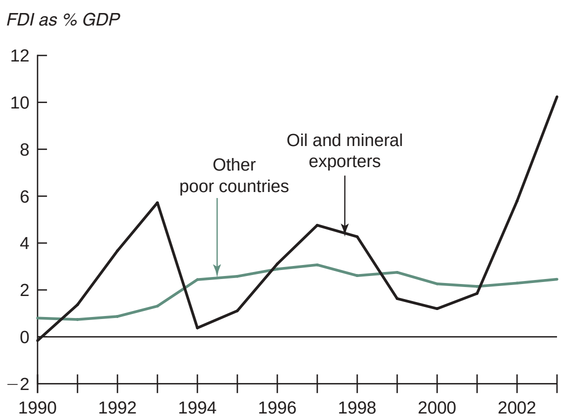
Bank lending collapsed across all developing countries in the years following the Asian crisis, but the decline was far deeper in poor countries. Behind this substantial retrenchment lay a heightened perception of the risk of lending to developing countries in the wake of the multiple crises of the 1990s and the 2001–2 slowdown in the global economy. Increased risk sensitivity has made lenders more cautious, especially toward poor countries, which tend to be perceived as high-risk borrowers. According to *Institutional Investor,* of the 28 poor countries, only four—Ghana, Kenya, Pakistan, and Vietnam—obtained an average risk rating during the 1990s of more than 25 (on a scale of 0 to 100, with 100 representing the highest credit quality). This is far below the ratings of developing countries that received significant capital inflows. Between 1990 and 2003, most bank lending to poor countries went to countries rated higher than 20 on the *Institutional Investor* scale.

The privatization of failed financial institutions and the removal of entry barriers for foreign banks in the wake of recent crises drew international banks into poor countries, thus reducing international lending. Although local-currency lending could potentially be additional to international lending, recent trends suggest that banks have substituted in-country lending for traditional cross-border lending. The share of local currency lending in total foreign claims nearly doubled between 1990–2003, from 23 to 44 percent. There is a strong incentive for foreign banks not to make cross-border lending on a significant scale, especially as local-currency lending largely eliminates exchange-rate risk and facilitates penetration of the local retail market.

Part of the reason for the decline in international bank lending also lies on the demand side, with poor countries reacting cautiously in the wake of financial crises. Some countries have acted to limit short-term bank lending and lengthen the maturity of bank loans. Since 1999, declining interest margins and lower syndicated loan volumes also suggest that demand for loans by poor-country borrowers has declined.

Source: World Bank staff.

Figure 5.6 FDI in oil- and mineral-exporting poor countries, 1990–2003



Note: See note to figure 5.4.
Sources: World Bank, *World Development Indicators* and *Global Development Finance*, various years.

FDI flows into its diamond and other mining industries to become a middle-income country in one generation. Export receipts and government revenues boosted by FDI were invested wisely to create the momentum and the infrastructure for more broad-based economic growth (UNCTAD 2003).

With the limited exception of FDI, the worldwide expansion of private capital flows during the 1990s largely bypassed the poor countries. Private equity flows to all developing countries tripled from $55 to $192 billion from 1990 to 2004—yet the poor countries' combined 4.3 percent share of this total remains small (see table 5.1).

Most poor countries have few prospects of attracting private debt flows or portfolio equity. In our sample, only Pakistan received sizeable non-FDI flows because Pakistan was the only country in the group, according to the S&P/IFC index, that had companies considered investment-worthy in the late 1990s—a key indicator for portfolio equity flows. The general collapse in international bank lending to poor countries in the course of the 1990s further limited flows of private debt (box 5.6).

Other developing countries as a source of finance for poor countries

Developing countries are often perceived as recipients and not providers of financial flows. The final report of the 2002 UN Conference on Financing for Development in Monterrey contained only a brief mention of the importance of encouraging cooperation between developing countries. However, with respect to poor countries, other developing countries (especially larger countries such as Brazil, China, India, Saudi Arabia, and South Africa) are becoming increasingly important financial players. With wealth increasing and capital controls lifted in the 1990s, developing countries have emerged as significant sources of FDI—and even of aid. (New aid donors include Brazil, China, India, and South Africa.) Finally, the developing South is the primary destination for poor country migrants and also the major source of workers' remittances. Below we examine what is known about the growing South-South financial interdependence. We suggest that South-South flows represent an under-recognized pool of development resources for the poor countries. The international community should encourage developing countries to develop policies to enhance the development of their poorer neighbors.

South-South FDI

South-South FDI appears significant in the poorest countries, although precise estimates of its magnitude are not available. Companies from China, India, Malaysia, the Russian Federation, and South Africa have become important investors in many poor countries. To minimize risk—and the cost of acquiring information—they tend to invest in resource- and market-seeking activities in neighboring countries before expanding on a global basis. Ethnic and cultural ties often play a role in the choice of trading partners, particularly for Asian companies (Aykut and Ratha 2004).

Privatization programs have been especially important in attracting FDI from these companies, in particular for Malaysian and South African investors, who contributed almost a third of the foreign exchange raised by privatization efforts in the poorest countries between 1989 and 1998. Regional companies also expanded their operations in retailing, banking, brewing, satellite television, and tourism. All the major players in the African telecommunications sector are from other developing countries.[9]

Proximity to larger economies has helped some poor countries such as Lesotho, Mongolia, and Nepal attract FDI. Nepal, India (in hotels and manufacturing), and China (manufacturing) account for more than half of FDI. Most FDI in Mongolia originates from China and Russia.

Companies from the South have comparative advantages when investing in poor countries. Such firms often have lower overhead costs and managers indigenous to the region. In addition, geographical proximity and cultural similarities can make coordination of foreign operations less expensive. Companies from the South may also have greater experience than companies from developed countries with the economic and political conditions of the host country (Wells 1983; Aykut and Ratha 2004). The relative success of the South African telecommunications company, MTN, in Uganda, compared to its competitors from developed countries, is traceable to its in-house expertise in managing pertinent economic and political risks (Goldstein 2004).[10]

Like FDI from the North, South-South FDI can raise productivity and tax revenue when the environment is favorable. Following South African Brewery's purchase of a controlling share of the state-owned Tanzanian Brewery Limited in cooperation with the IFC in 1993, productivity and capacity utilization increased dramatically while output tripled in five years (Pigato 2000). Following the privatization of one Mozambican state-owned company, taxes paid by the company rose more than fivefold and by 1998 provided about 5 percent of the country's total tax revenues.

However, firms from the South may have comparatively limited investment capacity, as their cost of capital is usually higher and affected by business cycles in their home country.

South-South development assistance

South-South development assistance has expanded in parallel with South-South FDI, although here, too, data are lacking.[11] But the potential relevance of South-South aid in generating economic growth in the world's poorest countries should not be underestimated.[12] Other developing countries can be instrumental in widening the pool of development resources—and in creating pressure on industrial-country donors to do more.

With many developing countries experiencing strong economic growth in recent years and seeking new markets, as well as new spheres of economic and political influence, it is logical that their role in providing development assistance should expand. India's minister of finance announced in his 2003/4 budget speech that India intended to increase its development assistance to other developing countries, including debt relief to HIPC countries. Grants and loans from India to other developing countries grew sharply in the past five years—from $83 million to $140 million.[13] China, too, has become increasingly involved in technical cooperation projects developed by the United Nations Development Programme (UNDP), becoming the first developing country to donate to the Voluntary Trust Fund for the Promotion of South-South Cooperation. In mid-2004, the Chinese government also offered $610,000 in humanitarian aid to the troubled Darfur region of Sudan. Other developments point in the same direction:

- In early 2005, developing countries pledged $173 million of emergency assistance in the wake of the Asian tsunami.
- Since 1976, Nigeria has promoted South-South cooperation through the Nigeria Trust Fund, operated by the African Development Bank, with current resources of $432 million.
- Brazil and Morocco sponsor extensive university scholarship programs and support technical and professional training for students of developing countries.
- The government of India has provided financial assistance for the construction of all major hydroelectric power plants in Bhutan.[14]
- South Africa cofinanced the $2.3 billion construction of the Mozal aluminum smelter in Mozambique.

Within developing countries, the Arab nations have long been an important source of development financing. By the end of 2002, the Arab national and regional development institutions together had extended $76 billion in development assistance.[15] Those resources have supported some 4,500 operations in more than 130 countries around the world, mostly in low-income countries. Half of the total went to Africa and most of the remainder to 36 Asian and Middle Eastern countries.

Cooperative exchange between two developing countries can help both countries in their development process. The capacities of the recipient are strengthened, while the donor country gains an understanding of the development challenges of the recipient—and possibly insight into challenges at home. The donor may also be able to identify future market opportunities. By increasing the national and collective self-reliance of developing countries, South-South development assistance can strengthen the voice of developing countries in negotiations with the North. But it also has features that make it a valuable complement to North-South cooperation. First, cooperation between countries with similar conditions of natural environment, culture, and economic development is likely to result in more appropriate technology transfer. Second, when a developing country offers assistance to neighboring countries, personnel and transportation costs, as well as other expenses, often are relatively low. Third, when developing countries take responsibility for development assistance and become donors in their own right, aid resources can expand.

Because the resources available for South-South cooperation will remain low compared to North-South flows, there is clear scope for coordinating South-South and North-South flows. Among the impediments to greater South-South cooperation are limited institutional capacity and lack of resources. One means to alleviate both constraints is to leverage potential projects with money from the North, an arrangement called triangular cooperation. Triangular cooperation occurs when a group of developing countries working together to address a common problem obtains additional financial, technical, and logistical resources from a developed-country partner or group of partners. The actors involved are various: traditional donors, multilateral agencies, private sector firms, academic institutions, and civil society organizations. In policy circles this approach is looked on as an important way to achieve the goals of South-South cooperation (Teheran Consensus 2001). Both the UNDP and Japan are active in South-South cooperation (box 5.7).

The collaboration between the South and the North has produced some success stories. One is the New Rice for Africa (NERICA) initiative. Collaboration among African, Asian, European, and North American scientists under the auspices of

Box 5.7 UNDP, Japan, and triangular cooperation

The Special Unit for South-South cooperation of the United Nations Development Programme (UNDP) plays an important role in financing South-South cooperation through UNDP country allocations and program resources and, indirectly, through the mobilization of funds from NGOs and the private sector. In the UNDP, two funds have been established to which developed and some developing countries have contributed: the Voluntary Trust Fund for the Promotion of South-South Cooperation and the Perez-Guerrero Trust Fund for Economic and Technical Cooperation among Developing Countries. Between 1996 and 2002, the Voluntary Trust Fund attracted $33 million, with most of the money coming from Japan. In 2002 the UNDP Executive Board approved an annual allocation of $3.5 million for technical cooperation among developing countries over the coming years.

Japan's support for South-South cooperation includes the following elements:

- Japan has partnership programs to encourage economically robust developing countries to become donors themselves. Since 1975 the Japan International Cooperation Agency (JICA) has sponsored third-country training programs to help developing countries become donors. Under the program personnel in developing countries who were previously trained in Japanese technical cooperation programs train technicians and administrators from other developing countries. In fiscal 2003, 2,335 people attended 151 third-country training courses. Developing countries offering eight or more courses under the program included Brazil, Indonesia, Kenya, Malaysia, Philippines, and Thailand. The costs of the program are shared between Japan and the host country.
- Japan expanded its assistance for South-South cooperation by introducing the third-country expert program in 1995. The program involves sending experts from countries with similar natural environments, languages, technical levels, and cultures to recipient countries to enable the smooth transfer of technology. There has been a steady increase in both the number of requests received and the number of countries expressing interest in either sending or receiving experts. In fiscal 2003, 117 new experts were sent to Africa, Asia, Latin America, and the Middle East.
- Since the establishment of the Human Resources Development Fund within UNDP in 1996, Japan has made special contributions to South-South cooperation by earmarking about half of the Fund for that purpose. In 2002, the Fund was integrated into the Japan-UNDP Partnership Fund, an important goal of which is to promote South-South cooperation.

Other developed countries have provided vital support for South-South cooperation. The Netherlands has cofinanced sectoral programs in 22 developing countries through multidonor basket funds, providing support for the use of developing-country technical resources in the programs. Sweden has financed knowledge networks, three in Asia (on renewable energy technologies, energy research, and environment) and two in Africa (on energy policy and biotechnology). Australia has set up training arrangements with ASEAN, Fiji, Papua New Guinea, Samoa, and Vanuatu. The Organization of American States, through the Inter-American Agency for Cooperation and Development (IACD), coordinates cooperation among the member states and forges partnerships with the private sector and civil society. Most of the IACD technical cooperation grants are supplemented by other donors.

the West Africa Rice Development Association (WARDA) developed new, high-yielding rice varieties for Africa by combining the best traits of African and Asian rice species. Growing demand for NERICA in turn led to the creation of the African Rice Initiative, a consortium of partners that includes the Government of Japan, UNDP, the World Bank, the Rockefeller Foundation, USAID, the UN Food and Agriculture Organization, and the African Development Bank (AfDB). According to the African Rice Initiative, nearly 210,000 hectares in West and Central Africa will be under NERICA cultivation by 2006, raising local African rice production and saving nearly $90 million per year on rice imports. By 2006, 1.7 million African farmers will have been exposed to the advantages of NERICA, increasing food security in dozens of African nations.

In another sign that the idea of complementing North-South with South-South development assistance seems to be gaining momentum, the Commonwealth Secretariat now advocates direct cooperation and support between Commonwealth countries without the involvement of the United Kingdom.

Four of the 10 largest economies today (measured using purchasing power parity weights) are developing countries that offer significant export markets to many poor countries. If larger developing countries (such as Brazil, China, India, and South Africa) were to reduce trade barriers against products from the poorest countries, the additional resources generated for meeting development needs and reducing poverty could easily dwarf aid and other flows.

The South as a source of workers' remittances

For developing countries overall, industrialized countries are the major source of remittance payments, but in the poor countries, other developing countries are most prominent. While comprehensive data are not available, estimates are that in poor countries in East Asia, South Asia, and Sub-Saharan Africa, more than two-thirds of emigrants migrate to a country in the same region, while in South Asia and Sub-Saharan Africa, most of them migrate to another developing country (OECD 2003b).

The substantial income gap between the poorest countries and their larger neighbors affects the decision to migrate. For the four poorest countries with the largest ratio of remittances to GDP (Lesotho, Moldova, Nepal, and Republic of Yemen), the income gap with their largest developing-country neighbors ranges from $281 per capita in the case of Nepal and India, to $7,230 per capita for the Republic of Yemen and Saudi Arabia.

Transport costs and restrictions on migration also have been important in encouraging migrants to remain closer to home. OECD countries have increased restrictions on the admission of immigrants over the last three decades (UN 2002b). Since 2002, 70 percent of all legislation on migrant workers has originated in OECD countries (ILO 2004), making other developing countries an easier destination, although restrictions are in place in the developing world as well.

As a result of the concentration of poor country migrants in other developing countries, events affecting richer neighbors can have a significant impact on the workers' remittances flowing to poor countries. Remittances to Burkina Faso have been adversely affected by conflict in neighboring Côte d'Ivoire, falling from 4.5 percent of GDP in 1990 to 1.2 percent in 2003. Lesotho has been affected by a decline in mining employment in neighboring South Africa. In 1990, an estimated 127,000 ethnic Basothos were employed in South African mines (providing some 20 percent of the work force). Since then, however, new recruitment for the mines has virtually ceased, and total mine employment started falling, mainly due to the declining profitability of gold mines. As the number of Basotho emigrant workers declined to 60,000 by 2003 (Cobbe 2004), remittances fell from 69.6 percent of GDP in 1990 to 18.5 in 2003. In the Republic of Yemen, remittances as a share of GDP fell from 31.0 to 11.9 percent over the same period, reflecting the regional situation in the aftermath of the first Gulf War.

Informal channels of remittances are extremely important in poor countries, as when migrants carry funds on trips home or when they call on hand couriers. Cost, speed, convenience, and trust are key in determining the channel through which migrants choose to remit money. Speed and convenience have favored more formal channels, including wire transfer agencies and banks. But as with remittances from industrial countries, lack of competition and inefficiencies in the regulatory framework for money-transfer operations raise costs to senders and recipients (Ratha and Riedberg 2004). South-South cooperation to address such issues could yield sizable gains to participants.

Meeting the Monterrey challenge—an agenda for donors and recipients

The South is becoming a more important partner for poor countries in financing development, and poor countries are less exclusively dependent on aid, but industrialized country governments continue to play the leading role in mobilizing finance and managing the vulnerabilities of these countries. Looking ahead, action is needed on four fronts if progress toward the MDGs is not to be derailed by a shortage of external resources. First, donors must scale up ODA and other resources substantially—overcoming the distractions of changing fiscal pressures and shifting strategic considerations. Second, they should strive to make aid more stable and predictable and less procyclical. Third, they should press for better donor coordination, selectivity, and country ownership to improve the effectiveness of aid and increase the focus on results. And fourth, they should seek opportunities to engage the private sector in development efforts. To justify and effectively absorb increases in aid and attract more private-sector finance, poor countries, for their part, need to pursue effective economic and pro-poor policies.

Commitments to support the MDGs

Despite the decline in aid over the past 15 years that has only recently been reversed (see chapter 1), the outlook for aid flows is positive. There was agreement at the UN Conference on Financing for Development in Monterrey in March 2002 that ODA and other resources had to be increased substantially to provide developing countries with the financial resources required to meet the MDGs. Developed countries that had not already done so were urged to "make concrete efforts" toward increasing ODA to the UN target of 0.7 percent of GNP.

The OECD (2005) projects that total ODA disbursements (to all developing countries) will increase from 0.25 percent of GNI in donor countries in 2003 to 0.30 percent by 2006, still significantly less than the 0.34 percent level reached in the early 1990s (see figure 1.14). The projection assumes an average 9 percent annual increase in ODA in real terms over the period 2004–6, well above the average rate of real increases for the past two years (6 percent).

The case is strong for directing increased resources to poor countries whose economic and social policies allow them to make effective use of aid—because they have the greatest potential to reach the MDGs. In countries with low capacity to attract private investment, ODA is particularly important, both in itself and as an essential complement to other sources of development finance.

The G-8 Africa Action Plan announced at the 2002 G-8 Leaders Summit in Kananaskis (Canada) suggested that "in aggregate half or more of our new development assistance could be directed to African nations that govern justly, invest in their own people and promote economic freedom." Sub-Saharan Africa received 60 percent of increases in ODA disbursements over the five years from 1998 to 2003, raising its share of total ODA disbursements by DAC donors from 24 percent to 34 percent (see figure 1.15). (In 2003, one-third of ODA was allocated to the poorest countries, unchanged from its average share over the previous 10 years.) However, most of these funds were allocated to postconflict situations, leaving little for development aid.

A March 2005 report by the Commission for Africa urged a doubling of aid to Sub-Saharan Africa, including an investment of $150 billion in infrastructure over the next decade. The report calls for an additional $25 billion per year in aid through 2010 and, subject to a review of progress, a further $25 billion per year through 2015.

Raising resource flows to the world's poorest countries to levels required to support the MDGs requires donors to remain committed to financing for development, even in the face of fiscal pressures and strategic considerations, both of which have had an increasingly important influence on the distribution of foreign aid.

The budget deficit for the OECD countries as a group increased from 2.8 percent of GDP in 2002 to 3.4 percent in 2003. The gap is projected to widen to 3.5 percent in 2004. While countercyclical expansionary fiscal policies helped prevent the recent global slowdown from deepening, the same policies, by increasing deficits to unsustainable levels, have created risks with clear implications for developing countries—for example, the risk that real interest rates could be pushed higher globally, dampening capital flows to developing countries as the public sector in advanced economies competes with developing countries for global savings (see chapter 3). With aging populations expected to place a rising fiscal burden on advanced economies in coming years, the pressure for fiscal consolidation is not likely to wane anytime soon.

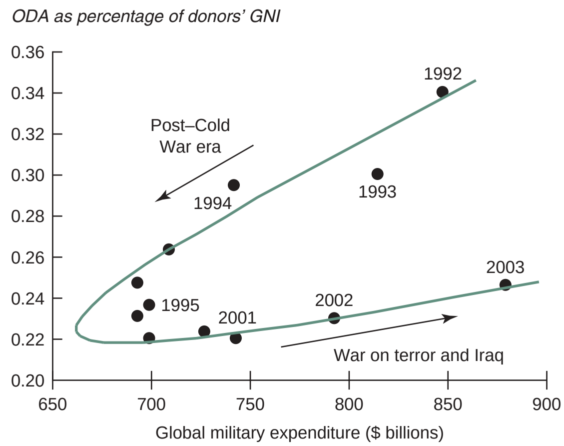
Historically, as donors' fiscal deficits have been reduced, the ratio of ODA to GNI has fallen in tandem. At a time of fiscal consolidation, in other words, foreign aid budgets appear particularly vulnerable. Cuts in foreign aid are often more palatable to the electorate than cuts in domestic programs. In the face of claims from domestic constituencies, donors may be tempted to overlook pledges made at events such as the Monterrey Conference, which are not legally binding under international law.

The threat to future aid flows appears even more serious when one considers that in 2003, eight DAC member countries reported budget deficits that exceeded 3 percent of their GDP. Those eight countries account for roughly three-quarters of ODA. Fiscal consolidation will be a key element of the policy agenda in many developed countries over the medium term. In this environment, increasing ODA and other resource flows to the poorest countries must be given high priority if the developed countries are to hold up their end of the Monterrey bargain by providing the financial resources required to support the MDGs.

The war on terror and the conflict in Iraq will continue to divert donor attention. While disbursements have fallen considerably short of commitments in Iraq and Afghanistan, they have been significant. The share of ODA allocated to Iraq increased from an average of 0.3 percent between 1980 and 2000 to 4.2 percent in 2003. Its share is expected to be significantly higher in 2004. More broadly, the share of ODA allocated to five countries—Afghanistan, Columbia, Iraq, Jordan, and Pakistan—increased from 3 percent over the period 1980–2000 to more than 11 percent in 2003. This pattern is consistent with the idea that "strategic considerations" are more important in determining aid flows than are development needs (McKinlay and Little 1979; Alesina and Dollar 1998).

Further evidence of diverted attention is shown by the link between aid and military expenditure. Since 2001, aid flows have not increased with military expenditures to the extent that had been expected. In the immediate post–Cold War world, global military expenditures fell from $847 billion in 1992 to $693 billion in 1998. During the same period aid fell from 0.34 to 0.22 percent of donors' GNI, a drop attributable to efforts to balance the budget and to the perceived decline in the strategic importance of aid following the end of the Cold War. However, since September 11, as military expenditures have increased from $743 to 879 billion, the ratio of ODA to GNI has not made up the decline suffered in the 1990s (figure 5.7).

Figure 5.7 Global military spending and aid, 1992–2003



Sources: Stockholm International Peace Research Institute; OECD Development Assistance Committee.

If the world is to meet the MDGs, substantial increases in ODA and other resources are certain to be needed (World Bank 2004b). Innovative methods of development finance may help to enrich the aid effort (box 5.8).

Most important of all, developed countries could spur development by reducing agricultural subsidies and trade barriers that discriminate against developing countries' exports. Industrial countries spend more than $300 billion each year to subsidize domestic agriculture, more than five times the amount they spend on foreign aid. Unless progress is made in the Doha round of trade talks on agricultural protection and subsidies, negotiations within the World Trade Organization (WTO) are likely to be stalled, to the detriment of growth and development.

Making aid more predictable and less procyclical

Aid can be better used if it is predictable. When aid flows wax and wane with international economic cycles or with unexpected shifts in donor policy, recipients often see aid decline when they need it most. If aid is used for domestic investment, volatility can generate uncertainty, discourage investment, and impede growth.[16] Aid volatility also complicates the conduct of fiscal and monetary policy. Tax increases and

Box 5.8 New sources of financing

Proponents of innovative financing mechanisms—such as the International Finance Facility, global taxes, and various voluntary giving arrangements—argue that such mechanisms can partly offset shortfalls in official development assistance (ODA).

International Finance Facility. As proposed by the British government, the IFF is designed to front-load aid flows in the short term to help reach the MDGs. Donors' multiyear aid commitments would be used to back AAA-rated bonds. Bond proceeds would be channeled through existing aid programs. Over time, the IFF would draw down the donor pledges to pay off its bonds. Future aid budgets would thus be used to support aid disbursements as and when they are needed in the short term. Critics of the proposal charge that bond repayments, as well as the transaction costs of issuing the bonds, would put pressure on aid budgets in the years ahead.

Technical aspects of the IFF proposal are being worked through in a pilot project. The IFF for Immunization (IFFIm) seeks to raise front-loaded, reliable funding over several years to expand global immunization and so help achieve the MDG on child health. IFFIm will use off-budget donor pledges of future aid increases as backing for AAA bonds, relying largely on the existing governance structure and country programs of the Global Alliance for Vaccines and Immunization (GAVI) and the Vaccine Fund.

Global taxes. Proposals have been made in the past to raise funds for development through new global tax instruments, but most have suffered from technical obstacles and all have faced varying degrees of political opposition. One prominent example is the proposed "carbon tax" on consumption of hydrocarbons. Such a tax could generate substantial revenue and help arrest climate change, but it would be very difficult to achieve politically. On a smaller scale, a recent proposal in the European Union would, for the first time, tax the jet fuel used in airliners and address the environmental harm caused by air transportation. Proponents observe that the revenues raised from global taxes could complement the IFF by generating aid funds in the medium to long term, as IFF flows diminish with repayment of bonds.

Voluntary contributions. Private contributions already fund development in various ways (see box 5.2) that could be expanded, encouraged, or made more effective. Some mechanisms, such as the establishment of affinity credit cards that provide funding for development through voluntary surcharges, could be undertaken by interested banks or companies. Others, such as the creation of a special-purpose global lottery or premium bond, would require regulatory action by participating countries, either unilaterally or acting in concert. As with global tax mechanisms, it would be important—and not easy—to ensure that voluntary contributions resulted in *additional* flows, rather than substituting for some portion of existing flows or overemphasizing some needs at the expense of others.

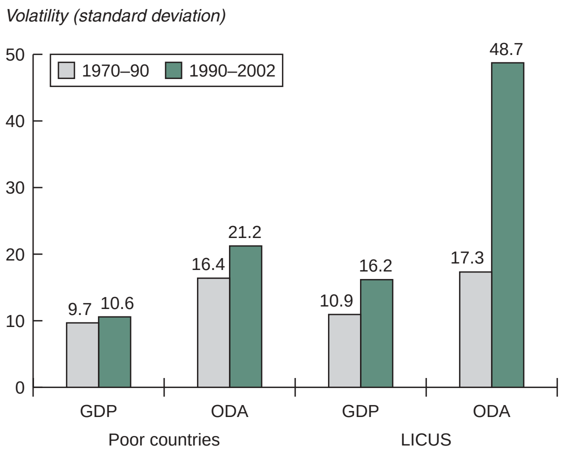
Although such innovative mechanisms offer some potential to expand the resources available to support development efforts, the legal and political obstacles to their implementation suggest that their practical significance in the short term will likely be limited.

government spending cuts frequently follow aid shortfalls (Gemmell and McGillivray 1998). Furthermore, aid-dependent countries are often unable to offset an unexpected aid shortfall by borrowing and must resort to unplanned and costly fiscal adjustment—especially damaging when aid flows are procyclical.

Despite these damaging effects, aid to poor countries tends to be volatile.[17]

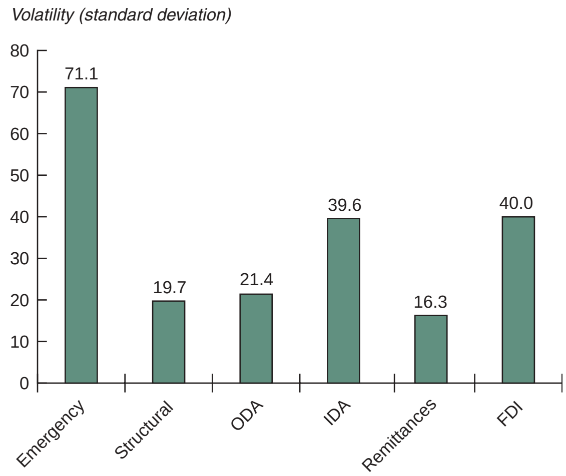
- Aid has been more volatile than GDP (figure 5.8) in virtually all of the poor countries in our sample. Earlier studies showed similar results. Pallage and Robe (2001) showed that aid was highly volatile compared to recipients' output. Bulir and Hamann (2003) found that it was more volatile than fiscal revenues, particularly in highly aid-dependent countries. Gemmel and McGillivray (1998) found that aid was significantly more volatile than revenue. Only Collier (1999) found that aid (to Sub-Saharan Africa) was less volatile than tax revenues.
- Aid flows to poor countries have become more volatile over the 1990–2002 period (figure 5.8), although they are less volatile than for other low-income countries.[18] The increased volatility could reflect changing donor sentiments, better linkages with country performance, or other factors. For the

Figure 5.8 Change in volatility of aid, 1970–2002



Note: LICUS = Low-Income Countries Under Stress. Figure measures median volatility for each group of countries. Volatility is equal to the standard deviation of the cyclical component of the Holdrick-Prescott filtered indexed series. Only countries with data available for both periods are included.
Source: World Bank staff estimates.

Figure 5.9 Volatility of different components of aid, remittances, and FDI, 1990–2002



Note: IDA = International Development Association. Figure measures median volatility for each group of countries. Volatility is equal to the standard deviation of the cyclical component of the Holdrick-Prescott filtered indexed series. Only countries with data available for both periods are included.
Source: World Bank staff estimates.

other low-income countries, this rise in aid volatility may be explained by the fact that many of these countries experienced conflict in 1990–2002 period, which disrupts aid operations and disbursements.

- Among the several types of aid, humanitarian aid and emergency assistance are by their nature volatile (figure 5.9).[19] But even when emergency aid is excluded, aid disbursements are more volatile than other flows, such as remittances.

Greater predictability in aid flows is one of the touted benefits of the proposed International Finance Facility (IFF), sponsored by the British government. The IFF would require donors to outline their intended contributions to aid over the long term and would then issue bonds backed by those pledges (see box 5.8).

Volatility of aid need not seriously affect output or growth in developing countries, provided it offsets fluctuations in GDP. Intuitively, this makes sense—if flows of external finance are countercyclical to the business cycle (and thus help offset the downturns), they can help to smooth out fluctuations. But ensuring that aid will be countercyclical implies donor control over volatility, which, of course, has been lacking. In fact, there are good reasons why aid flows tend to be procyclical. First, when donors are unable to adequately monitor the recipient country's reform effort, aid disbursements may be implicitly tied to economic performance, thus making aid procyclical (Svensson 2000). Second, donors may try to link aid flows to country performance using measures that are independent of domestic economic cycles. When countries are hit by unforeseen adverse shocks, compliance with donor conditionality may be affected, which may reduce aid disbursements. Finally, some donors require matching grants by the recipient. If more matching resources are available during cyclical upturns, some procyclicality of foreign aid disbursements may follow.

In recent years there appears to have been a shift away from procyclical aid flows—which should be encouraged.[20] Ratha (2001) found that multilateral lending played a countercyclical (stabilizing) role relative to private flows, with rising official flows during periods of private credit reduction. Multilateral lending also complemented private flows with a time lag. Empirical work on the cyclical character of ODA flows in 1970–90 and 1990–2002 found less evidence of procyclicality in the latter period, although short estimation periods affect the robustness of these estimates.

Strengthening the framework for aid effectiveness

Improving the effectiveness of aid involves four key steps—donor coordination, aid selectivity, country ownership, and a focus on results.

- *Strengthening donor coordination.* Ongoing efforts to align and harmonize aid currently involve 60 developed and developing countries and at least 40 bilateral aid agencies and multilateral organizations. Harmonization initiatives may involve joint analytical work, joint preparation of country assistance strategies, and joint reviews of implementation. The benefits of successful coordination are to reduce duplication of effort among donors and to reduce the bureaucratic burden on recipients.
- *Improving aid selectivity.* A scarce resource, aid should be directed toward two classes of countries: those that need it most and those that can use it to best effect—in other words, the poorest countries and those with the best records of using aid to spur growth and reduce poverty. Good performers will use significant increases in aid to improve their prospects of reaching the MDGs and their own development goals (Dollar and Levine 2004). At present, donors differ widely in how they measure performance and select "merit-based" aid recipients. Initiatives such as the United States Millennium Challenge Account, which is intended to provide additional aid based on 16 economic and political indicators (including control of corruption, the rule of law, primary education completion rate, country credit rating, and trade policy), have the potential to improve the application of aid selectivity, but a proliferation of competing criteria among donors raises renewed concerns about harmonization.
- *Country ownership.* Countries that embrace development programs as their own will use aid more carefully and more effectively. With guidance from the World Bank and the participation of civil society, member governments now prepare poverty reduction strategy papers (PRSPs), which set forth an agreed program of action to reduce poverty with help from development partners.
- *Focus on results.* By targeting assistance to meet clearly defined goals—a practice known as "managing for results"—the international community can focus on national development needs and objectives under the ownership of the recipient country. Bilateral and multilateral development agencies agreed in Marrakech in February 2004 to a set of principles that include focusing on results at all stages of the assistance process, including planning, implementation, and completion; and keeping reporting systems simple, cost-effective, and user friendly.

Progress has been made in all these areas over the past decade, but more needs to be done to make aid more effective in supporting attainment of the MDGs (World Bank 2004a and 2004b). The ongoing replenishment of the International Development Association (IDA) also has stressed the link between new resources and effectiveness.

Leveraging private capital flows to poor countries

Most poor countries will remain heavily reliant on traditional financing sources for the next few years. A long-term challenge is to tap the potential of international capital markets to provide greater private participation in financing for the poorest countries. A key role for multilateral institutions is to devise frameworks for private sector involvement and to find ways to mitigate the risks associated with investing in poor countries.

Improving the access of poor countries to markets in developed and some large developing countries could help to facilitate investment in poor countries. Programs such as AGOA and EBA that provide preferential access to poor countries are one component of this story, but of greater long-run importance will be multilateral liberalization of trade, as is currently being pursued through the WTO-sponsored Doha negotiations (box 5.5). Curbing the use of antidumping and similar instruments of contingent protection, eliminating certain repatriation taxes, and liberalizing rules of origin have the potential to promote trade and investment in poor countries (World Bank 2005; Commission on Capital Flows to Africa 2003).

Loans and guarantees to mitigate political, contractual, regulatory, and foreign-exchange risks—as currently provided by the International Financial Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA)—are crucial, particularly for investment in infrastructure in poor countries (World Bank 2004a). Bilateral agencies from developed countries, such as the U.S. Overseas Private Investment Corporation (OPIC), Export Development Canada, and the U.K. Export Credit Guarantee Department should intensify their assistance to private investments in poor countries that support the development goals of the recipient countries. Easing restrictions (such as on sectoral coverage) and offering broader and more flexible risk insurance products could extend the impact of these programs.

Regional export credit agencies can also facilitate private sector access. One example is the African Trade Insurance Agency, established in 2001. The agency provides insurance for exports from and within Africa and imports to the continent and as such facilitate trade flows to Africa. The body was established with World Bank loans underwritten by Lloyd's of London. The member countries (originally Burundi, Kenya, Malawi, Rwanda, Tanzania, Uganda, and Zambia) are financially responsible for losses.

Poor countries need help in using financial innovations to improve their access to international capital markets. In recent years, the securitization of future resource flows, such as remittances and export receipts, has helped several middle-income countries to raise external financing and might also be implemented for poor countries (box 5.9). Among the policy hurdles to be addressed are the lack of legal infrastructure in many poor countries and the high fixed cost of necessary legal, investment banking, and credit-rating services.

Box 5.9 Securitization of future workers' remittances and other external flows

Developing countries can raise external capital on the strength of current account flows from workers' remittances, tourism receipts, and export receipts. Securities issued on such flows are typically structured to obtain an investment-grade rating, which allows issuers to pay a lower interest rate and obtain longer maturity. It also makes them attractive to a wide range of "buy-and-hold" investors such as insurance companies, which may face limitations on buying issues below investment grade. Because they are free of currency convertibility risk, a key component of sovereign risk, securities based on current account flows may be rated better than sovereign credit.

One important reason for governments to promote this asset class stems from the related externalities. Such deals bring closer scrutiny of the legal and institutional environment (for example, laws relating to property rights and bankruptcy procedures) than do unsecured transactions. Securitization transactions backed by governments can thus help usher in reforms of the legal and institutional environment.

Remittance-backed securities often work as follows. The borrowing entity, such as a bank, pledges its future remittance receivables to an offshore Special Purpose Vehicle, which issues the debt. Designated correspondent banks are directed to channel all remittance flows of the borrowing bank directly to an offshore collection account managed by a trustee. The collection agent makes principal and interest payments to the investors and sends excess collections to the borrowing bank. Since remittances do not enter the issuer's home country, the rating agencies believe that the structure mitigates the usual sovereign transfer and convertibility risks. Such transactions also often build in excess coverage to mitigate the risk of volatility and seasonality in remittances.

The first major securitization deal involving international migrant remittances occurred in 1994 in Mexico. Since then the volume of transactions has grown rapidly. Using this instrument, El Salvador, Mexico, and Turkey raised about $2.3 billion during 1994–2000.

As electronic transfers became more prevalent and made it easier to track complex transactions, remittances securitization gave way to securitization of diversified payment rights (DPRs) including mainly migrant remittances, but also certain payments related to exports and foreign direct investment. During 2000–4, a total of $10.4 billion was raised through securitization of DPRs by Brazil ($5.3 billion), Turkey ($4.1 billion), El Salvador, Kazakhstan, Mexico, and Peru. Following a sharp increase in borrowing costs in 2002, Brazil has raised more than $4 billion by issuing bonds backed by DPRs. These bonds resulted in a saving of more than 700 basis points compared with Brazil's sovereign spread.

As experience with DPRs broadens, and investors become more comfortable with them, it is possible that they could be used in a wider range of countries (including poor countries) and for a broader range of external flows (such as tourism receipts and commodity earnings).

Box 5.9 *(continued)*

It is not easy to estimate the potential of future-flow securitization. But preliminary calculations, using an overcollateralization ratio of 5 to 1 and migrant remittance figures for 2003, show that developing countries could potentially issue nearly $9 billion a year. Low-income countries could raise up to $3 billion annually.

Several policy hurdles remain to be addressed before securitization deals can approach that potential. Long lead times and the high fixed costs of legal, investment banking, and credit-rating services can pose difficulties for developing countries with few large institutions and high borrowing needs. A master trust arrangement can permit issuers to structure a large deal but tap the market in several tranches. Pooling receivables of several branches (or even several borrowers) could also help defray large fixed costs.

The absence of an appropriate legal framework for such transactions is yet another constraint on issuance. Overcoming it need not require a grand overhaul of the entire legal system, however. A more focused approach concentrating on bankruptcy law may suffice, by making sure that pledged assets remain pledged in the event of default. Finally, at a broader level, remittance securitization can potentially conflict with the negative-pledge provision included in the IBRD's (or other multilateral agencies') loan and guarantee agreements, which prohibits the establishment of a priority for other debts over the debts due to the IBRD.

But as the recent upsurge in securitization suggests, none of these hurdles is insurmountable, and there would appear to be ample opportunity for future growth in such deals, with corresponding benefits to a broad range of developing countries.

Sources: Ketkar and Ratha (2001, 2004).

Sound economic and pro-poor policies in recipient countries

The consensus reached in Monterrey in 2002 centered on a partnership between donors and recipients. Donors agreed to increase assistance to developing countries if the latter would pursue economic policies to improve the effectiveness of the additional resources. Moreover, by taking steps to improve their business and investment climate, countries could expect to attract private capital.

Many developing countries have held up their end of the partnership. The World Bank's Country Policy and Institutional Assessment—the CPIA—shows an upward trend in economic management, structural policies, policies for social inclusion and equity, and public sector management in the poorest countries since 1995. The broad improvement in the policies of the world's poorest countries is shown in the robustness of average annual GDP growth over the last decade (5.9 percent). Inflation rates, too, have declined by more than half and now stand at an average of 6 percent. The current account moved from a deficit of about 3 percent of GDP in the early and mid-1990s to a surplus of 1 percent in 2003. Fiscal deficits have been cut in half.

It is not surprising that those poor countries that have been most successful at undertaking economic reforms and creating a sounder climate for investment, such as Mozambique, Uganda, and Vietnam, have been among the most successful at attracting external finance in the form of FDI, ODA, and South-South financial flows.

The New Partnership for Africa's Development (NEPAD), launched in July 2001, is another positive step by the poorest countries. NEPAD is an expression of Africa's will to improve its own policies and institutions so as to justify a rise in aid levels. One especially critical focus of NEPAD is to strengthen economic, corporate, and political governance through targets and a peer review mechanism in which the peer reviewers come from other poor countries.

The poorest countries in the world remain vulnerable to external shocks, but they are discovering new ways to shape their own destiny. The donor community and other developing countries should be ready to help the poorest as they continue to move in promising new directions.

The G-8 Africa Action Plan announced at the 2002 G-8 Leaders Summit in Kananaskis aimed to "ensure that no country genuinely committed to poverty reduction, good governance, and economic reform will be denied the chance to achieve the Millennium Goals through lack of finance." More recently, the Commission for Africa urged a doubling of aid to Sub-Saharan Africa. A key theme of the 2005 G-8 Leaders Summit to be held in Gleneagles will be to strengthen international cooperation in support of greater progress on the MDGs in Africa. The next few years will determine whether developed countries will hold up their end of the partnership forged at Monterrey.

Notes

1. The Report of the High-level Panel on Financing for Development estimated that $50 billion in additional development assistance would be required to meet the Millennium Development Goals, in addition to humanitarian assistance and additional resources for global public goods (UN 2002a). According to the African Development Bank, Africa needs $20–25 billion per year in addition to current resources. A recently completed UN report comes up with even higher financing requirements (UN Millennium Project 2004).

2. The sample consists of low-income countries (with GNI per capita of $735 or less), but *excludes* two larger economies (India and Indonesia) that in many respects more closely resemble middle-income emerging-market economies. It also excludes countries that suffer from ongoing or recent conflict—the so-called LICUS group. Our 28-country sample thus includes countries in which concerted efforts are underway to reach the MDG deadline a decade from now (in 2015), and for which the availability of resources may be a binding constraint. About half of the countries in our sample are in Sub-Saharan Africa, with the remainder scattered throughout other regions.

3. For donors, the traditional means of representing ODA disbursements is as a percentage of donors' GNI, not GDP.

4. Twenty-seven countries have reached the HIPC decision point. The decision point is reached if countries are considered heavily indebted, once traditional debt relief mechanisms have been taken into account. To qualify countries usually must have a debt-to-export ratio of averaging 150 percent over the previous three years. Alternatively, countries considered to have an open economy (defined as an export-to-GDP ratio of over 30 percent) and a ratio of debt to government revenue of more than 250 percent despite a strong revenue collection system may also qualify. Countries need to have pursued World Bank and IMF adjustment and reform programs for at least three years. During this time they must have completed at least an interim poverty reduction strategy paper. Once the decision point has been reached, further satisfactory performance in World Bank and IMF reform and poverty-reduction programs leads to the completion point. At this point assistance is provided in the form of relief from up to 90 percent of the present value of debt.

5. The ratio of trade to GDP increased to 44 percent in 1996–2003. It was 35 percent in the first half of the decade.

6. According to the UNCTAD database, from 1990 to 2002, 161 national laws passed by eight poor countries in our sample were favorable to FDI (out of 168 total). During the same period, the poor countries signed 3,052 double taxation treaties and 2,465 bilateral investment treaties.

7. In addition to the ICRG indicator used for the discussion, the World Bank's Country Policy and Institutional Assessment (CPIA) indicator and the *Institutional Investor Rating* indicate significant improvements in many of the poor countries.

8. Another reason for high volatility is that this type of flow is highly skewed toward intercompany loans, which tend to be as volatile as private debt flows. In addition, many countries do not report reinvested earnings that might bring some level of stability.

9. South Africa's Vodacom and MTN, Orascom from Egypt, and Telekom from Malaysia have large subscriber bases in the region.

10. The main competitor is Celtel, controlled by Vodafone of the United Kingdom. South African MTN managed to develop a subscriber base 22 times larger than Celtel's despite the monopoly position of the latter prior to MTN's penetration of the market (Goldstein 2004).

11. South-South development assistance refers to aid from developing countries to poor countries. It is part of a concept referred to as South-South cooperation, a broad term used to describe a variety of strands of cooperation among developing countries. Included are economic cooperation among developing countries, technical cooperation among developing countries, cooperation among developing states in multilateral negotiations with the developed countries, promotion of South-South trade, and the development of regional political and economic associations.

12. Data are not available to capture the magnitude of South-South development assistance, but it is clear that the resources involved are small compared to total ODA. South-South resources appear to be growing. For example, grants and loans from India to other developing countries grew sharply in the five years from 1997 to 2002 (from $83 million to $140 million). During the same period, disbursements from non-DAC donors almost tripled, from $1.2 billion in 1997 to $3.2 billion in 2002, with the bulk of the money coming from Arab countries, followed by Korea. Other contributors are the Czech Republic, Latvia, Lithuania, Poland, the Slovak Republic, and Turkey. Figures on non-DAC ODA understate the true volume of resources flowing from developing countries to other developing countries, because some potentially important donors (Brazil, China, India, and South Africa) are not included.

13. Through its Technical and Economic Cooperation Program, India has spent nearly $2 billion on technical assistance to 130 developing countries in all regions over the past four decades.

14. Except for the Basuchu Project.

15. These include the Arab Bank for Economic Development in Africa (BADEA), the Special Arab Fund for Economic and Social Development, the Arab Gulf Program for United Nations Development Organizations (AGFUND), the Islamic Development Bank, the OPEC Fund, the Abu Dhabi Fund for Development, the Kuwait Fund for Arab Economic Development, and the Saudi Fund for Development.

16. Lensink and Morrissey (2000) show that uncertainty in aid flows, as measured by deviations from expected inflows, reduces the effectiveness of aid.

17. An important question in discussions of volatility is how to measure the "volatility" of a particular variable. Even though the measure is in principle built around the standard deviation of the variable in question, the correct standard

deviation may be difficult to determine, as a single best measure is not available. Several considerations can affect the choice. First, the standard deviation of any variable is determined both by the trend of the variable as well as the cyclical behavior around that trend. A strongly trending variable that shows no cyclical fluctuations will still have a relatively high standard deviation. If one is interested in the true volatility of the variable from year to year, it is necessary to correct for the trending behavior of the variable. Seminal papers, such as those of Lucas (1977) and Kydland and Prescott (1990), have defined business cycles as the deviations of output from trend. A well-established method to detrend a series is using the Hodrick and Prescott (HP) filter. Second, the standard deviation of a variable (whether the series is detrended or not) is a function of the level of the variable. To make a sensible comparison between the standard deviations of several variables, one has to standardize the series. One way to do that is to detrend the log of the series; another is to detrend the indexed series. Third, sample length will have an impact on the standard deviation measured. The appropriate length reflects a cost-benefit trade-off—a longer sample length increases measurement accuracy, but only if the underlying volatility has been stable over the sample period. If the sample length is too long the assumption of stable volatility is unlikely to hold, as transmission mechanisms are likely to change. The choice in volatility measure is important and needs to be driven by careful considerations, because results can be sensitive to the choice. Following Pallage and Robe (2001) and Bulir and Hamann (2003), we define volatility as fluctuations in the business cycles of the different flows defined as the deviation of the flow from its trend. To estimate the volatility, we first detrend each data series using the HP filter. To ensure that the volatility of the different series remains unaffected by differences in scaling, we use indexed series instead of levels.

18. The average volatility of exports and government revenues is lower in this group of countries. Our results are not driven by outliers. Of the countries in the first quarter of the distribution of GDP volatility, almost 80 percent belong to our group of poorest countries, while from the 75th percentile onwards, 35 percent of the countries are part of the group of poorest countries.

19. ODA consists of several different types of aid: balance-of-payments support, investment projects, food aid, emergency assistance, debt relief, peacemaking efforts, and technical assistance. There is no reason to expect that the volatility of each component is similar or, as pointed out by Clemens, Radelet, and Bhavnani (2004), that the impact on economic performance will be the same. Following Clemens, Radelet, and Bhavnani (2004), aggregate aid flows can be divided into three categories: short-impact aid, long-impact aid, and humanitarian/emergency aid. The first two categories consist of aid disbursements aimed at creating economic growth either in the short run or after a longer period. The latter category is aimed at very short-term consumption smoothing and is not intended to directly promote increases in income per capita.

20. Many studies have found evidence of pro-cyclicality of aid flows in developing countries. Pallage and Robe (2001) find that aid and output are procyclical. Bulir and Hamann (2003) and Gemmell and McGillivray (1998) find evidence of pro-cyclicality between aid and domestic revenue.

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