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CAPITAL VOLATILITY AND LONG-TERM FINANCING FOR THE POOREST COUNTRIES

By Roy Culpeper

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Policymakers and analysts alike, concerned with the reform of the global financial architecture in the wake of the multiple crises of the 1990s, have focused on emerging markets rather than on the poorest countries (see Ahluwalia 2000, Williamson 2001, Ocampo 2001). To be sure, considerable attention has been focused on the heavily indebted poor countries, and some progress has been made in reducing the debt overhang of this sub-group of poor countries. But these initiatives amount, at best, to a partial clearing-away of the detritus from accumulated debt reschedulings over the past 20 years, and do not add up in any sense to a reform of the global financial system's inability to deal with the unique problems of the poorest countries.

In many ways, the poorest countries have been among the most serious casualties of the recent financial crises, largely because they have been ignored. Moreover, the pretext that financial volatility has left the poorest countries more or less untouched, on the supposition that they are barely integrated into the global system, does not stand up to scrutiny. Volatility has in fact negatively affected the poorest countries in ways that are still not fully acknowledged. Therefore, unless systemic reform goes beyond the debt-relief gestures of the late 1990s, to include substantial new initiatives to strengthen the poorest countries' growth and development, the likelihood is that they will continue to fall behind the rest of the world in the next few decades.

The historical record shows there is nothing particularly new in the international financial turmoil of the 1990s. Huge capital inflows followed by debt crises, financial panics, capital flight and contagion: previous generations going back to 1800 have seen them all before. But the international financial landscape did change significantly in the mid-20th century. By establishing a family of multilateral institutions and bilateral development co-operation agencies, the world for the first time had created an infrastructure of official financing.

In so doing, governments (to be sure, dominated by those of the most powerful industrial countries) had international public financing instruments at their disposal. No more would the investment flowing to developing countries be

subject to the whims and vagaries of financial markets. At last, long-term development financing could be put on an even keel, assuring the poorer countries a dependable flow of foreign capital for development.

Of course, in actuality it has not been so easy or simple. For one thing, to the extent that official flows through multilateral and bilateral agencies were on non-concessional (or even semi-concessional) terms, familiar problems of excessive indebtedness eventually arose (except to official, rather than private creditors). For another, the volume of official flows was typically not free of the economic cycle. Far from being put on a stable footing, such flows shared the cyclical swings characteristic of private flows, and indeed reinforced rather than offset those swings. Finally, official concessional flows have been stagnant or declining in the past decade in absolute terms; and relative to private non-concessional flows, they have become almost marginal. Their ability to offset cyclical swings of private finance has shrunk commensurately.

In other words, the system put in place a half-century ago to strengthen development in the world's poorest countries is no longer working, and in need of a major overhaul. This paper critically examines the hypothesis underlying the rationale for official development financing, namely, that it provides a stable and dependable flow of capital for poorer countries. In the next section, I situate the analysis in the context of the major international developments and discussions of the 1990s. I also relate it to some of the recent literature on how developing countries should cope with boom-bust financial cycles.

In the following section I examine the origins and evolution of the current policy debate. Why should official flows, in theory, be counter-cyclical and why, in practice, are they not? The discussion includes a survey of the actual flows over the past three decades. Particular attention is paid to the situation of the poorest countries, which are much more dependent on official flows. After reviewing the behaviour of official financing, I review the Heavily Indebted Poor Countries initiative as a rather inadequate contribution toward reforming the systemic problems faced by this group of countries.

In the final and concluding section I bring together the main results. The paper ends with some recommendations aimed at increasing the stability and growth of long-term capital flows for the poorest countries.

International Financial Reform: Parallel Tracks

The multiple financial crises of the 1990s spawned a series of policy initiatives, alongside a series of reports by various organizations and commissions (surveyed in Williamson 2000), to reform the global financial architecture. The policy initiatives, led by the Group of Seven Finance Ministers and Central Bank Governors, have given birth to two new deliberative bodies: the [Financial Stability Forum](#) and the Group of 20. The International Monetary Fund

and the World Bank were both given central roles in the implementation of the strategy emerging from these initiatives, along with financial-sector regulatory bodies (see Culpeper 2000 for a critical review).

These initiatives, as with the series of reports (including the Meltzer Commission; see Williamson 2000) have put greatest priority on addressing the problems of the emerging markets, no doubt because of the threat they pose to international financial stability. Accordingly, participation in the Financial Stability Forum and the G-20 has included (in addition to the G-7) “systemically significant” countries, notably, the emerging markets of Asia and Latin America (and only one African country—South Africa).

In contrast, the financial problems of the poorest countries have garnered attention primarily on account of their indebtedness, largely to official creditors. The [Heavily Indebted Poor Countries initiative](#) (launched in 1996 and enhanced in 1999; hereinafter referred to as HIPC I and HIPC II) has hardly been motivated by any threat to the stability of the global financial system (or, by implication, to the leading industrial countries), since collectively HIPC debt represents at most ten percent of outstanding developing-country debt. To be sure, the debt of this group of countries has posed awkward policy problems for some of their bilateral and multilateral creditors (particularly for the latter, since debt write-downs have never been part of their *modus operandi*). But these problems have hardly threatened their solvency¹. This explains why debt relief has been so long in coming, and why it continues to be such a tortuous process for the debtors involved.

If there is a “systemic threat” involving the poorest countries, it flows in the opposite direction to that involving the emerging markets. In other words, while instability in the emerging markets threatens the global system, the instability of the global system has undermined the growth of the poorest countries. This asymmetry among countries was recognized by [Jubilee 2000](#), an international coalition of Non-Government Organizations that waged a highly effective political campaign resulting in the HIPC initiative.

The HIPC initiative can be viewed, however, as a very partial response to the real and long-standing systemic problems of the poorest countries. Most fundamentally, the real incremental benefits from debt relief afforded under HIPC are extremely low, since much of the debt being forgiven was in any case not being serviced (Serieux 2001). In other words, HIPC is a relatively costless gesture by creditors toward the poorest countries, at a time when ODA budgets slashed over the decade of the 1990s show little sign of recovering. This is not to say that debt relief under HIPC has not been beneficial to the recipients. Indeed, it is important to acknowledge that HIPC is the most comprehensive attempt to date to deal with the chronic and growing debt overhang of the poorest countries. Whether it has gone far enough, or whether it is comprehensive enough to

prevent similar problems from recurring, are the real questions, examined further below.

The relatively lower priority accorded to the problems poorest countries is also evident from their exclusion from the new deliberative fora examining the reform of the global financial system. The industrial powers offered the emerging markets a seat at the tables of the Financial Stability Forum (to a strictly limited extent) and the G-20, realizing both the emerging markets and their creditors had to be “part of the solution”. No such presumption exists, as yet, when it comes to the debt problems of the poorest countries. The chronic indebtedness of the poorest is not seen as a systemic problem in which both debtors and creditors stand to gain from a more consensual approach. Rather, they are seen (incorrectly) as a one-time correction for past mistakes that will put debtor countries back onto the road of “sustainability”.

It is possible to regard the Comprehensive Development Framework and Poverty Reduction Strategies as offering remedies for the systemic problems of the poorest countries. But the fact remains that both these initiatives were crafted in Washington by the World Bank and the International Monetary Fund, primarily in response to the need for better co-ordination among these bodies and other creditors, and not from a dialogue involving the poorest countries.

At the same time, it is not correct to suggest that the problems of financing for the poorest countries have been altogether ignored. Rather, they have been addressed on a parallel track, emanating not from the principal custodians of international financial stability, the G-7 Finance Ministers and Central Bank Governors, but principally from bilateral development co-operation agencies and the development agencies of the United Nations.

The series of international conferences of the 1990s held under the auspices of the United Nations (UN) have generated two important outcomes. The first was the growing consensus around a series of time-bound international development targets². These were first articulated by the Organisation for Economic Co-operation and Development (OECD) bilateral donors in the Development Assistance Committee (DAC) in 1996³. Gradually these targets were embraced by multilateral agencies and by developing as well as developed countries. Significantly, support for the targets was expressed both in the declarations of the G-8 leaders in July 2000, at the conclusion of their summit in Okinawa, Japan, and in the Millennium Declaration of heads of government at the UN General Assembly (the Millennium Assembly) in September 2000.

The second outcome arose from the need to deal with the plethora of action plans and recommendations generated by the conferences of the 1990s. It was realized that the world community was unlikely to implement a hugely ambitious and uncoordinated global development program; hence the “High-

Level Event” (ultimately the Conference) on Financing for Development was conceived and is currently planned to be held in Mexico in March 2002.

It is worth noting that, within the UN family, the UN Conference on Trade and Development (UNCTAD) has, for the past two decades, devoted considerable attention to the plight of the Least-Developed Countries, a category currently comprising 49 countries containing 610 million people⁴. Accordingly, UNCTAD has organized three decennial conferences on the least-developed countries (LDCs), in 1981, 1990 and May 2001 (held in Brussels). Despite the fact that these conferences have generated “programs of action,” (indeed, the 1981 Conference resulted in the “Substantial New Program of Action”), not much has changed in the past 20 years with regard to the LDCs’ problems or prospects.

Official Development Financing: Theory and Practice

Against this backdrop, a brief review of the rationale and history of official development financing is in order. A good starting point is to note the UN target for aid donors, established in 1970, namely a level of official development assistance equivalent to 0.7 percent of their GNP. Ignoring the fact that only three or four donor countries have achieved this target, the exhortation to provide ODA at a target proportion of GNP was motivated by certain assumptions with clear implications.

First and foremost, the target assumes that relatively richer donors (enjoying higher GNP) should provide more ODA. This assumption embodies notions of both affordability (as donor GNP grew, it was assumed that they could allocate more to ODA) and equity (richer donors would allocate more). It follows that, even if donors do not attain an ODA/GNP ratio of 0.7 percent, as long as they held steadfast to *any* ratio, in absolute terms their ODA expenditures would fluctuate with GNP somewhat through the business cycle, but would also exhibit the secular growth rate of GNP. In the aggregate, the DAC donors did adhere to an overall ODA/GNP ratio of slightly less than half of the UN target (around 0.33 percent) throughout the 1980s. This resulted in a rise in DAC ODA *pari passu* with donor countries’ GNP. However, a clear break occurred in the 1990s. While GNP growth continued through the first half of the 1990s, the level of ODA stagnated or fell (Chart 1).

This shift reflected the fact that the average ODA:GNP ratio among donors fell continuously from 1992 until 1997, from 0.33 percent to 0.22 percent, after which it recovered to 0.24 percent in 1999. However, DAC ODA fell again by 6 percent in 2000 to a level of \$53.1 billion, and the ODA:GNP ratio also fell back to 0.22 percent⁵. In other words, the donor aid “effort” fell by one-third during the 1990s, and the fall predated by four years the slowdown in DAC GNP that occurred after 1996 (Chart 2).

Chart 1: DAC GNP vs. ODA (USD billions)

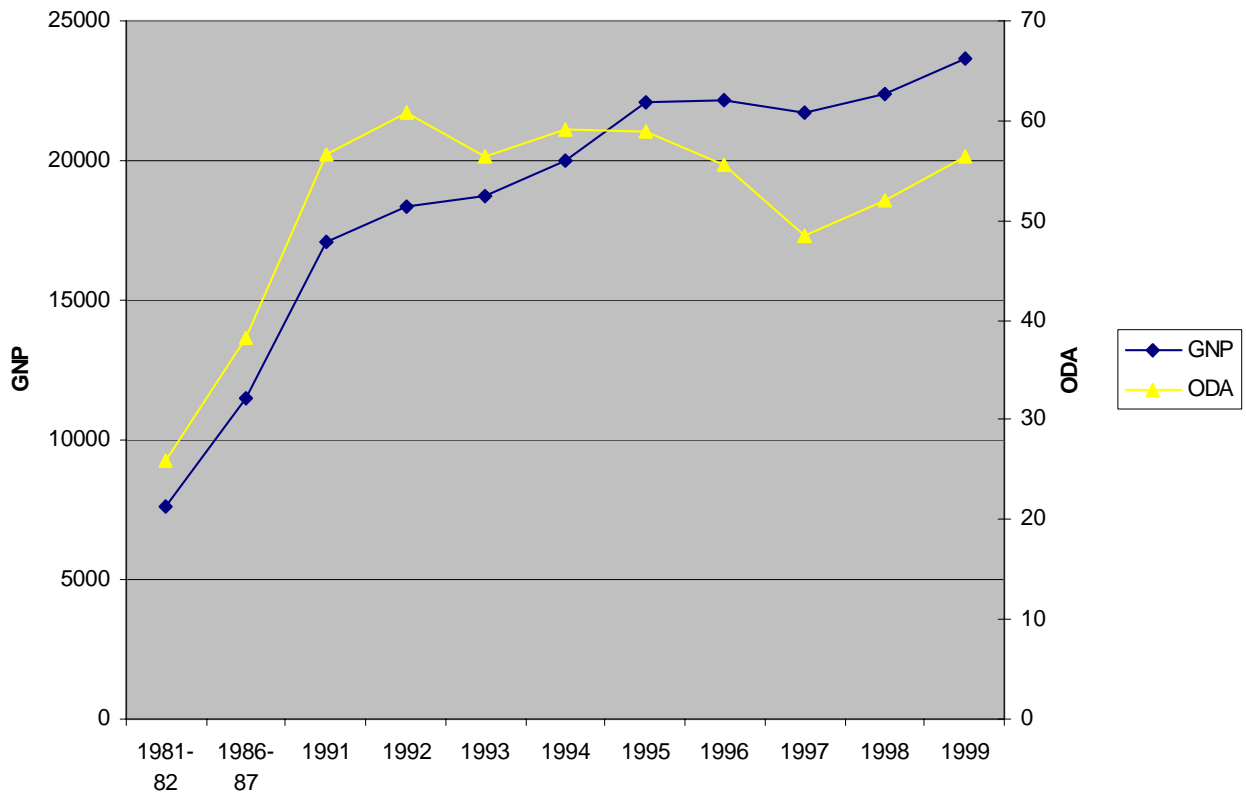
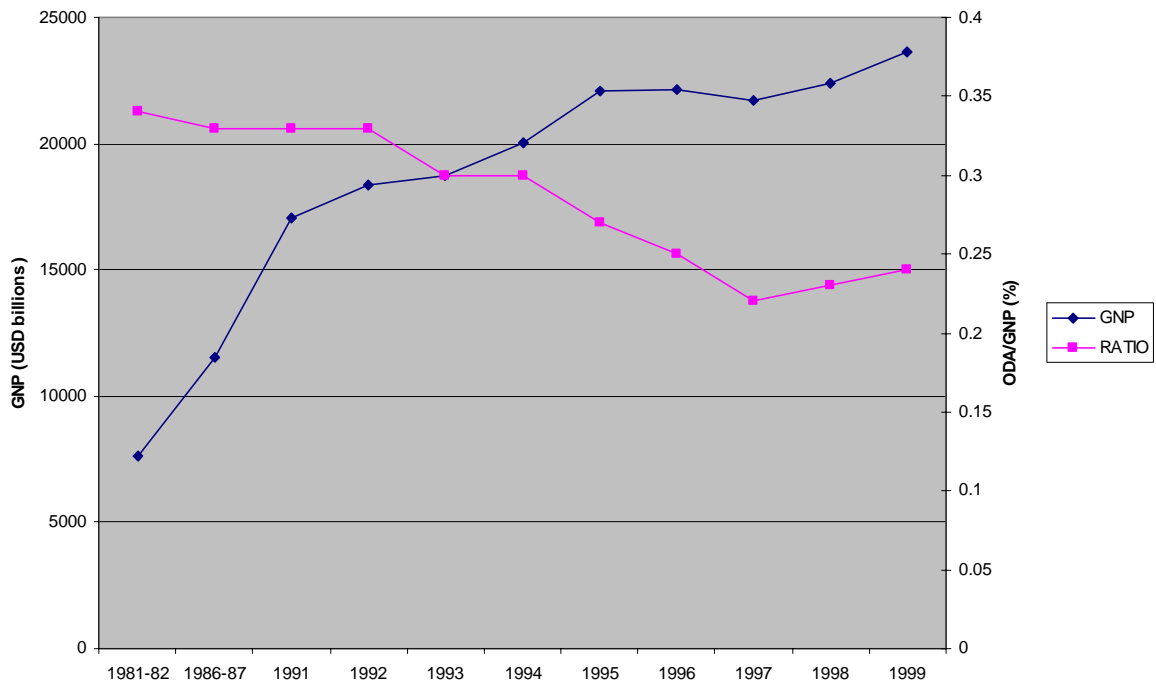


Chart 2: DAC GNP vs. ODA/GNP ratio



Source: OECD Development Assistance Committee

There are several possible explanations for this profound shift in donor behaviour during the 1990s. Many donor governments were reducing fiscal deficits, and foreign aid budgets were typically among the first to be cut back and experienced a disproportionate reduction compared to domestic programs. However, the reduction of fiscal deficits was itself taking place in a context of financial instability and currency turmoil, beginning with the European exchange-rate crises of 1992 and the Mexican peso crisis (and the “tequila effect”) of 1994-95. One result of this instability was to make donor governments, anxious to avoid a speculative attack on their currencies, adopt fiscally very conservative policies (notably, the rapid elimination of deficits) in order to convince financial markets of the “soundness” of their policy fundamentals. In other words, an early casualty of global financial instability was funding for official development co-operation, simply because of the perceived need to reduce donor government expenditures and eliminate deficits.

Other explanations relate to shifts in the political context of foreign aid. After the demise of the Soviet Union, a major strategic rationale for aid from the OECD donors fell away. Moreover, donors suffered increasing “aid fatigue” after two or three decades of development co-operation, with disappointing results to show for those efforts among many aid recipients.

While it is not easy to disentangle these explanations, there is increasing evidence to suggest that the problem lies in the nature of previous aid efforts—in other words, foreign aid was part of the problem rather than a solution to the disappointing outcomes of development co-operation (UNCTAD 2000).

A different depiction of the flow of ODA to the poorest countries over the past 30 years helps to illustrate the issue. From the vantage-point of the developing country recipients, *actual receipts* are more important than the disbursements by donors⁶. An examination of the level and trend of grants by one group of low-income countries (the severely indebted, or SILICs; see Annex for various country-groupings) over the past 30 years, juxtaposed with their aggregate GNP, is revealing (Chart 3).

It is particularly interesting to note, first of all, how grant flows have fluctuated over time. Downturns in the level of grants in the mid-1970s and early 1980s were followed, after a year or two, by a resumption in growth. More disturbing, however, is the relationship between grant receipts and aggregate GNP. Downturns in grants *preceded* downturns in aggregate GNP, at least in the early 1980s and in the 1990s. While causality cannot necessarily be inferred, a reasonable hypothesis would be that the reductions in grant flows helped to precipitate the declines, or at the very least did nothing to prevent them.

Chart 3: SILIC GNP and External Grants



Source: World Bank, *Global Development Finance 2001*

However, the pattern of grant receipts in the 1990s exhibits much more volatility than suggested by DAC net disbursements, with substantial fluctuations and an overall decline in the level of grants. The steep decline from 1994 to 1997 preceded the decline in SILIC GNP in 1998, the year of the Asian financial crisis.

Nor is the phenomenon confined to the 1990s. The volatility in aid receipts of 23 least-developed countries (LDCs) over the past three decades has recently been examined by UNCTAD (2000: 179-81). The evidence indicates that foreign aid receipts of the LDCs have exhibited more variation than government revenue and even more than export revenues in a majority of countries examined (Table 1).

**Table 1: Variability in Aid, Government Revenues
and Exports of LDCs, 1970-98**
(coefficient of variation)

	Mean	Median
Foreign Aid	2.74	2.66
Government Revenue	1.18	1.03
Export Revenue	4.00	2.32

Source: UNCTAD 2000: 179 (Table 40)

Moreover, if aid had played a genuinely countercyclical role, fluctuations in receipts would have varied negatively with fluctuations in government or export revenues. In fact, correlation coefficients between variations in aid and variations

in these two other variables were slightly *positive*, if anything reinforcing rather than counteracting the external shocks of the LDCs (UNCTAD 2000: 180-181).

This rather disconcerting conclusion is at odds with that reached by Williamson (2001) and Hufbauer and Dobson (2001)⁷ who claim that official finance has played a stabilizing role in the recent crises in Asia and Latin America. But their claim is heavily weighted by aggregate data and the resource flows to Asia and Latin America, and is based more on the stability of official flows than on their countercyclical role⁸. It may also be true that particular donors have played a countercyclical role by providing more financing to their developing country clients to offset external shocks. The largest multilateral donor, the World Bank, has claimed that both its concessional window (IDA) and its non-concessional lending facility (IBRD) have acted in this manner (World Bank 2000: 64, 73). However, even in this case the declining role played by IDA in the 1990s is evident (UNCTAD, Box 3.3).

Indeed, an even more basic problem with respect to the inadequacy of the global financial system than its volatility is the declining volume of long-term capital flows to the poorest countries. It is evident that the enormous growth in North-South private capital flows that characterized the 1990s all but by-passed this group in favour of the middle-income and larger low-income developing countries⁹. The share of private capital in total net capital inflows to the LDCs was actually greater in 1975-82 (18 percent) than in the 1990s (14 percent); meanwhile, in other developing countries the share of private flows reached 77 percent. Thus, from 1980 to 1998 the volume of net capital flows to other developing countries expanded four-fold, while in the LDCs they barely maintained the same level and actually fell in real terms.

Accordingly, the LDCs have remained largely dependent on official flows to provide them with long-term capital. Unfortunately, after 1994 official flows to the LDCs steadily fell, and by the end of the 1990s were 25 percent below their peaks earlier in the decade and 10 percent below levels in 1988-89. This reflected the fact that DAC donors had reduced the share of ODA allocated to the LDCs from 24 to 19 percent. As a result, donors moved further away from reaching the U.N. target of allocating 0.15 percent of their GNP to aid for the LDCs¹⁰ (Table 2).

Table 2: Declining ODA to LDCs

	\$ million	% of ODA	% of DAC GNP
DAC ODA, 1988-9	11,252	24	0.08
DAC ODA, 1999	10,650	19	0.05

Source: OECD DAC

Debt Relief as a Contribution to Systemic Reform

The current system is inadequate in meeting the needs of the poorest countries not only because of declining and volatile flows of official finance. It also stems from the relationship between their indebtedness and the nature and level of their capital inflows, and the inadequacy of current debt relief measures.

History is instructive. During the 1970s and 1980s, when the foundations were laid for the debt overhang of the poorest countries, there were crucial differences in the terms of financing enjoyed by Asian LDCs as opposed to their African counterparts. In general, the Asian countries were less reliant on loans, more reliant on official financing, and when they received loans, interest rates were lower and grace periods longer. In contrast, the African LDCs received more private loans and official loans (notably official export credits) at commercial terms. It is no accident that many African countries, and very few Asian countries, subsequently experienced severe debt-servicing problems (UNCTAD 2000:70).

Subsequently, as the debt-servicing problems became chronic, the level of foreign aid flows became increasingly tied to the level of debt servicing – the official donors, who were also the main creditors, were putting money in so that the debt could be serviced (Kanbur 2000: 688). As a result, aid was increasingly diverted from development purposes to ensuring that debt was serviced – perhaps as much as a quarter of all bilateral aid, according to Killick (1995) – reducing the development impact of such aid. Worse, it created incentives against reducing the debt, which would have led to a commensurate fall in aid.

By the mid-1990s it became imperative to remedy the shortcomings of this “Aid-Debt Service System,” so in 1996 the [Heavily Indebted Poor Countries](#) (HIPC) initiative was launched and enhanced in 1999 in order to afford faster, broader and deeper debt relief. Considerable weight was placed by the initiative on using resources freed by debt relief to reduce poverty. While a deep reduction of the debt overhang was in order, the HIPC initiative offers much less than its promise, both by way of actual debt relief and, even more, with regard to its contribution to poverty reduction.

First, the initiative is yet to be fully funded. Without full funding the part of the debt most difficult to resolve – that owed to the multilateral creditors (the World Bank, IMF and others) – will fall short. Second, creditors other than those of the Paris Club are required to give comparable treatment, but it is unclear whether or when such treatment will be forthcoming. Third, the extent of *actual* debt relief provided (the difference between what debtors were paying before HIPC and what they will be required to pay under HIPC) is much lower than the extent of nominal relief (equal to the difference between what they were scheduled to pay prior to HIPC and what they will be required to pay under HIPC). In some cases (such as Mali), debtors’ actual payments will rise rather

than fall, indicating that there will be no “debt dividend” to allocate to poverty reduction. In other cases while the debt dividend is positive, in *actual* terms it is very small, amounting to less than 10 percent of current aid flows (Serieux 2001; UNCTAD 2000: 151-9).

In sum, while HIPC provides a good start to the long-overdue need for debt relief, the current initiative will provide little, at best, in the way of resource additionality and at most a very modest contribution toward the major challenge of poverty reduction in the LDCs. So much for the immediate prospect. In the longer term, there is the more fundamental question of whether these countries will remain below the threshold over which their debt once again becomes “unsustainable”¹¹. The answer to this question will turn on two critical variables: the terms on which future capital is obtained, in particular the degree of concessionality; and secondly, on the growth performance of the debtor countries. The lower the degree of concessionality (or the lower the proportion of grant financing) and the lower the growth rate, the higher the probability of another debt-servicing problem requiring further relief measures.

Toward Systemic Solutions

The trends examined above may now be summarized.

- Since 1970, the poorest countries have been heavily dependent on official capital flows, a fact that did not change in the 1990s even as rapidly-growing private capital made up the bulk of flows to other developing countries.
- Far from constituting a stable and dependable source, official capital flows have been volatile, more so in the 1990s. Moreover this volatility has not offset shocks suffered by the poorest countries and in fact has been somewhat procyclical.
- Because of substantial cutbacks in aid, official flows to the poorest countries have declined significantly in the 1990s, far outweighing a slight increase in private flows, resulting in a substantial fall in aggregate flows.
- The HIPC debt-relief initiative has constituted the only systemic initiative aimed at the poorest countries. However, that initiative will provide only limited resource additionality and there is as yet no longer-term strategy to prevent a redevelopment of chronic debt overhang among these same countries.

The plight of the poorest countries has tended to be overshadowed by the dramatic financial crises emanating from the emerging markets of the 1990s, primarily because those crises have posed a clear and present threat to the stability of the global financial system. In contrast, far from threatening the

stability of the global system, a case can be made that the global system has utterly failed the poorest countries and threatens *their* solvency.

The question is what, if anything, can be done to remedy these shortcomings.

First, a prefatory remark: The issue of more stable and reliable external funding relationships cannot be separated from the issue of successful and sustainable development strategies for the poorest countries. External funding arrangements may be at the right level, delivered at the right time and under acceptable terms, but all for naught, if the recipient's development goes off the rails. However, it is not possible here to address what is surely the most intractable question haunting development specialists for the past 50 years, namely, that of identifying the necessary and sufficient ingredients for sustainable development in the poorest countries.

Rather, it must suffice to say that adequate external financing on appropriate terms must be complemented with a package of domestic (e.g. resource mobilization) and other external (e.g. trade) policies that work together to strengthen each country's growth. Moreover, the optimum mix of domestic and external policies will vary between countries. There are no blueprints for success; each country can learn from the experiences of others but ultimately must find its own way, on the basis of its unique resource endowment, opportunities and challenges. Perhaps it also bears saying that, unless per capita GNP growth rates in the poorest countries rise to and remain at levels of around 8 percent (from negligible or negative levels in many cases), the prospects for reducing poverty by one-half over the next 15 years are extremely dim (UNCTAD 2000: 16).

(a) Increasing the Volume of Flows

A good place to start is with the inadequacy of ODA flows to the poorest countries, compounded by their steady drop over the past decade. If the international development targets for the year 2015 are to be reached, there seems little alternative but to increase ODA substantially. For example, UNCTAD (2000: xii) has estimated that required flows for most African and Asian least-developed countries need to be between 50 and 150 percent higher than current levels.

Despite the fact that the fiscal deficits of the early 1990s gave way by the end of the decade, in many donor countries, to increasing fiscal surpluses, there are few signs¹² that aid budgets will resume their growth, let alone regain their former levels. While exhortations to donors to increase their aid budgets should nonetheless continue, it may be unrealistic in the medium term to expect rising aid levels to respond adequately. Instead, a more pragmatic strategy would be to call for a combination of gradually rising aid levels and a reallocation from

middle-income to the poorest countries. A doubling of DAC ODA to the least-developed countries could, for example, be achieved by reallocating three-quarters of current ODA, or \$10 billion, from the lower middle-income countries (LMICs) and most of the aid from the upper middle-income countries (UMICs) and high-income countries (HICs), an additional \$2 billion, to the least-developed countries (LDCs), leaving untouched the current allocation to other low-income countries (LICs) (Table 3).

**Table 3: Net ODA Receipts, By Income Group
(US\$ million)**

	1995	1996	1997	1998	1999
LDCs	16 532	13 482	12 573	12 075	11 058
Other LICs	15 324	14 711	11 818	13 168	13 356
LMICs	12 946	12 737	10 995	11 491	13 413
UMICs	2 180	1 725	1 565	1 850	1 622
HICs	1 080	792	684	801	735
Unallocated	11 138	10 689	10 661	10 826	11 385

Source: OECD DAC 2000

Such a reallocation would be more equitable in the sense of giving highest priority for scarce aid resources to the poorest countries¹³. However, to the extent overall aid volume rises, it would be less necessary to reallocate as much from the LMICs, and would also permit aid reallocations to and growth for low-income countries other than the least-developed. The World Bank has estimated, for example, that even if donor countries attained an ODA:GNP ratio of 0.35 percent, just one-half of the U.N. target, there would be \$20 billion in additional aid (World Bank 2001), which could increase flows to the poorest countries more than 150 percent.

(b) Stability of funding: pool-based ODA

Because of the increasingly unstable international environment in which the poorest countries find themselves, subject to both economic and natural shocks, it is critical, at a minimum, to ensure that official flows (likely to be the main source of external capital) be as stable as possible and avoid the fluctuations of the 1990s. It would be even better if official flows had a built-in countercyclical capacity so that flows could be increased more automatically as and when shocks impact the countries concerned.

This goal can only be attained if aid delivery and implementation mechanisms are radically transformed to ensure that aid is available when needed and is used to further the development strategies of the recipients rather than be motivated by the political and commercial interests of donors. If

transformed in this manner, it would enhance “ownership” of the development strategy by the country – a factor typically missing in the aid relationship, eroding the effectiveness of much aid-financed activity (Helleiner 2000).

How could such a difficult goal be achieved? One idea attracting a growing number of adherents is the “common pool” approach (Kanbur et al 1999). Under this approach, the recipient country would develop its own strategy, programs and projects primarily in consultation with its own people but also in dialogue with donors. It would then present its plan to donors who would put unrestricted financing into a common pool, which, along with the government’s own resources, would finance the development plan. A multi-year commitment would build in latitude to draw greater amounts from the pool when economic shocks and/or natural calamities strike – in other words, it would build in a compensatory (or countercyclical) financing capacity¹⁴.

Moreover, a common-pool approach converges with evolving ideas and institutional arrangements in the sphere of development co-operation, namely the comprehensive development framework (CDF) and the poverty reduction strategy paper (PRSP). These initiatives, which are complementary, have been spearheaded by the Bretton Woods organizations, the CDF being a creature of the World Bank, and the PRSP emerging as part of the enhanced HIPC initiative launched in 1999 after the Cologne G-8 Summit. A related idea is that of the sector-wide approach (SWAP).

Indeed, one could argue that a common-pool approach would make the CDF, PRSP and SWAP function more in accordance with their fundamental purposes. One of the fundamental purposes of the CDF, for example, is to provide a consistent and coherent framework of co-ordination within which, for each aid recipient, all donors, multilateral and bilateral, would come together to provide all the necessary resources for projects, programs, budgetary support, and so on. And the PRSP is motivated by the objective of ensuring ownership by the recipients. Drafting a poverty reduction strategy through an inclusive, participatory process is aimed at increasing local ownership by putting the government, along with civil society and the business community, in the “driver’s seat”¹⁵.

A common-pool approach would not only be entirely consistent with the spirit of local ownership and participation of the PRSP and the co-ordination objectives of the CDF; it would also make them both work more effectively. By increasing the degree of fungibility among the several donors’ contributions, it would make implementation of the development strategy easier. Procurement would not be restricted to the participating donors¹⁶, and coherence and consistency in strategy implementation would be enhanced¹⁷. For its part, the SWAP is more explicitly congruent with a common-pool approach since it is aimed at bringing donors and recipients around a shared set of strategic aims within a given sector.

Donor commitments to a common pool would necessarily involve providing budget support, since the resources would also be used to provide for budgetary shortfalls and not just for project financing. While budgetary support used to be anathema to donors, there is a growing recognition the donors that such support plays a vital role in development co-operation. But in order to build donor confidence in the usefulness of budgetary support, the budgetary and fiscal management systems of recipients need to be enhanced or even reconstructed (UNCTAD 2000: 202).

More to the point being made here, a common-pool approach should also allow increased flexibility within the CDF, PRSP and SWAP, and permit greater counter-cyclical drawings from the common pool. In other words, in the face of external shocks, recipients would be enabled to compensate by drawing more heavily than anticipated in the original plan. Of course, this latitude should be built into the PRSP and acknowledged by the donors in advance.

Given the inertia underlying the existing aid regime (which has after all persisted for several decades), and the ambitiousness of the CDF, PRSP, and SWAP, let alone a common-pool approach, it may be many years before the current system can be transformed. Nonetheless, there are reasons to believe that the current system is evolving (and indeed must evolve) in this direction.

(c) Preventing relapses into unsustainable indebtedness

To avoid a build-up of debt to unsustainable levels in the future, it would help in the present to ensure that current debt is reduced to truly sustainable levels. However, according to critics the thresholds of sustainability established under HIPC II are questionable, given the possibility of lower growth, lower export earnings and higher import costs than those projected under the initiative, which may have been based on excessively optimistic forecasts. In other words, there is need for deeper, faster and broader debt reductions than those currently provided, just to reduce current debt to genuinely sustainable levels. When the possibility of new borrowing for future development projects is taken into account, a new round of debt-servicing difficulties could rapidly re-emerge (General Accounting Office 2000; UNCTAD 2000; Serieux 2001).

So the first requirement may in fact be to review the adequacy of HIPC II and to consider the possibility of a HIPC III in selected cases where the debt overhang was not reduced to manageable levels. And the second would be the prevention of further borrowing where outstanding debt is approaching sustainability thresholds.

However, to prevent further borrowing would be also, in many cases, to prevent further much-needed investment. The issue is really one of ensuring that incremental financing is on terms that are fundamentally consistent with each

country's debt-carrying capacity. It is surely in the interest of the poorest countries to attract as much additional investment, of the growth-inducing, poverty-reducing variety, consistent with domestically owned, coherent strategies, as can be absorbed efficiently. In this regard, the poorest countries are in a fundamentally different position from the emerging market countries, many of which already enjoy high rates of domestic savings (and hence have less need for foreign capital). Therefore such countries can deflect foreign capital for prudential reasons, especially in the form of short-term debt, which is acknowledged to be more volatile.

The challenge for the poorest countries, in other words, is to attract external capital in the desired magnitudes and with low or manageable debt-servicing requirements. The best form of such external flows is ODA, preferably on grant terms. However, if the reallocation from lower middle-income countries to the poorest does not take place on the scale suggested here, and/or if overall ODA levels continue to stagnate at around current levels, other options must be considered.

In particular, private foreign direct investment (FDI) is held to combine several characteristics that are very desirable to capital-importing developing countries. In contrast to bank and bond lending, which carry fixed debt-servicing requirements, income remissions on FDI usually depend on the prior generation of profits. Moreover, FDI typically comes with a bundle of other benefits, including technology, the potential for skilled employment and management opportunities, and access to foreign markets.

Additionally, FDI flows to developing countries witnessed sustained growth throughout the 1990s, even through the turmoil of the Asian financial crisis, when all other private flows fell substantially¹⁸. However, although FDI is considered much more stable and less volatile than other private flows, there is evidence from the Asian financial crisis that foreign owners of FDI are adept at liquidating their assets and resorting to capital flight (see Helleiner 1999).

Moreover, most of the poorest countries cannot regard FDI as a major source of external capital over the medium term. The fact is that FDI for the past decade has been highly concentrated in a dozen developing countries, with the People's Republic of China, Brazil, Mexico, Argentina and a few other mostly middle- or high-income countries typically capturing the lion's share. Excluding the People's Republic of China, FDI flows to low-income countries in 1997-99 amounted to 1.0 percent of GDP, compared to 2.7 percent for middle-income countries (World Bank 2000: 42, Table 2.2). It is true that FDI flows have grown rapidly even to the low-income countries of Sub-Saharan Africa, and are no longer mostly limited to oil- and mineral-producers; nonetheless, it would be unreasonable to assume that FDI growth to the poorest countries could make up for the lack of growth in ODA (World Bank 2000; UNCTAD 2000).

Finally, despite its many advantages FDI will always be driven by the needs and demands of the transnational corporations undertaking the investment. These demands may be different from local development priorities¹⁹. The latter might typically be dominated by the need to build or enhance infrastructure, either physical (rural roads; ports) or social (health, education); while the former is typically dominated by resource extraction or processing and manufacturing. To be sure, there is considerable complementarity between these; a principal reason for low FDI flows to the poorest countries is inadequate infrastructure. The point is, however, that most FDI is not likely to provide investment for rural health clinics, teacher education, or agricultural research and extension services.

What is required are mechanisms or procedures whereby viable investments, conforming to domestic development priorities, and identified through the PRSP or a national development plan, are funded on terms compatible with the recipient country's debt carrying capacity. Countries approaching their debt-sustainability threshold should not have to eschew viable investment opportunities simply because grant or concessional financing is unavailable.

The best-case scenario would be one in which each country's development plan or PRSP is fully funded through medium-term commitments by its donor constituency through the common pool. However, if grant and concessional financing is inadequate, and the only choice is borrowing at commercial terms (either from official sources, e.g. export credits, or private sources) a second-best option would be to use the grant and concessional resources of the common pool to cover debt-servicing, or at the very least to reduce debt-servicing requirements to well below sustainability levels.

A Brief Conclusion

Recent discussions of global financial reforms have not acknowledged the vulnerability of the poorest countries to the volatility of international markets. Such discussions must start to contemplate systemic change that would, at a minimum, avoid relapses into unsustainable debt burdens, and more ambitiously, help strengthen longer-term development strategies aimed at substantially reducing poverty over the next two decades.

In this paper, three sets of solutions have been advanced:

- More ODA for the poorest countries, either through higher overall volumes (even returning the average donor ODA/GNP effort to the 0.35 percent level of the 1980s would be enormously helpful), and/or through reallocation from middle- and high-income developing countries;
- A common-pool approach to development co-operation, for a number of reasons, including greater flexibility to deal with external shocks; and

- Much more forward-looking mechanisms and procedures to ensure that the poorest countries do not relapse, within a few years, into unsustainable indebtedness.

It has been suggested that changes in these directions to the current system is unavoidable, and in some instances has already begun. But a considerable amount of additional work is required if such ideas are to be brought to fruition. Not only will work be required just to refine the technical details, but perhaps more importantly, to persuade donor publics and policy-makers that such changes to the international system are urgent and overdue.

These changes will necessarily take time, and they will require genuine commitment on the part of donors as well as recipients. Indeed, if these much more ambitious approaches to development co-operation are to succeed, it is important to agree on ways of ensuring that donors also keep to their commitments. "Aid performance monitoring" is as yet in its infancy, but there has already been a promising donor initiative in the case of Tanzania. The issue of monitoring donor performance needs to be put high on the list of priorities for discussion at the upcoming conference on Financing for Development, and in the follow-up to the conference on the least-developed (UNLDC III) (See Helleiner 2000b and UNCTAD 2000: 197).

Annex: Country Groups

Afghanistan (L, S)	the Gambia (L, H)
Angola (L, S, H)	Ghana (H)
Bangladesh (L)	Guinea (L, S, H)
Benin (L, H)	Guinea-Bissau (L, S, H)
Bhutan (L)	Guyana (H)
Bolivia (H)	Haiti (L)
Burkina Faso (L, S, H)	Honduras (H)
Burundi (L, S, H)	Kenya (H)
Cambodia (L)	Kiribati (L)
Cameroon (S, H)	Lao People's Democratic Republic (L, S, H)
Cape Verde (L)	Lesotho (L)
Central African Republic (L, S, H)	Liberia (L, S, H)
Chad (L, H)	Madagascar (L, S, H)
Comoros (L, S)	Malawi (L, S, H)
Congo (H)	Maldives (L)
Côte d'Ivoire (H)	Mali (L, S, H)
Democratic Republic of the Congo (L, S, H)	Mauritania (L, S, H)
Djibouti (L)	Mozambique (L, S, H)
Equatorial Guinea (L)	Myanmar (L, S, H)
Eritrea (L)	Nepal (L)
Ethiopia (L, S, H)	Nicaragua (S, H)

Niger (L, S, H)
Nigeria (S)
Rwanda (L, S, H)
Samoa (L)
Sao Tome and Principe (L, S, H)
Senegal (H)
Sierra Leone (L, S, H)
Solomon Islands (L)
Somalia (L, S, H)

Sudan (L, S, H)
Tanzania (L, S, H)
Togo (L, H)
Tuvalu (L)
Uganda (L, S, H)
Vanuatu (L)
Viet Nam (S, H)
Yemen (L, H)
Zambia (L, S, H)

L = 48 least-developed countries
S = 34 severely-indebted low-income countries
H = 41 heavily-indebted poor countries

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¹ It must be acknowledged that the balance sheets of some regional multilateral creditors, such as the African Development Bank and the Central American Bank for Economic Integration, have been seriously undermined. However, even if these agencies were totally incapacitated, they would not represent a "systemic threat" similar to that posed by contagion from the Mexican, Asian and Russian financial crises.

² These include the following targets by the year 2015: halving the number of people living in absolute poverty, achievement of universal primary education in all countries, reduction by two-thirds the rate of infant mortality and by three-quarters the rate of maternal mortality, universal access to reproductive health services. They also include the following targets for the year 2005: demonstrated progress toward gender equality by eliminating gender disparity in primary and secondary education, and the implementation of national strategies for sustainable development to ensure the reversal of current trends in the loss of environmental resources at the global and national levels by 2015.

³ OECD DAC, *Shaping the 21st Century*

⁴ The criteria underlying the current list of LDCs are:

- **a low income**, as measured by the gross domestic product (GDP) per capita;
- **weak human resources**, as measured by a composite index (Augmented Physical Quality of Life Index) based on indicators of life expectancy at birth, per capita calorie intake, combined primary and secondary school enrolment, and adult literacy;
- **a low level of economic diversification**, as measured by a composite index (Economic Diversification Index) based on the share of manufacturing in GDP, the share of the labour force in industry, annual per capita commercial energy consumption, and UNCTAD's merchandise export concentration index.

Of the 49 countries classified as LDCs, 33 are in sub-Saharan Africa, 15 are in Asia and the Pacific, and one in the Americas. The Annex lists the LDCs, along with the countries eligible for HIPC.

⁵ OECD DAC press release of April 23, 2001. Available at <http://www.oecd.org/media/release/nw01-37a.htm>

⁶ The difference stems from differing statistical conventions by the OECD DAC (which uses the ODA net disbursement measure) and the World Bank (which uses the grant receipts measure). ODA net disbursements by donors include disbursements to multilateral institutions; these do not necessarily match those institutions' disbursements to developing countries in any year. Moreover, the World Bank excludes technical co-operation grants, which are included by the DAC. (World Bank (2000): 73, footnote 1.)

⁷ It is also at odds with Collier (1999) who claims that aid to sub-Saharan Africa has been less volatile than, and negatively covariant with, government revenue. However, there are some problems with Collier's statistical analysis. Other analysts, however, (Gemmell and McGillivray [1998]) find that over a broader range of countries aid has been volatile and somewhat countercyclical. See UNCTAD 2000: 204, fn. 9.

⁸ In the face of highly volatile private flows, it would not be sufficient for official flows simply to remain stable in order to play an effectively countercyclical role. Instead, official flows would need to rapidly increase in the face of private capital flight, something that the IMF and multilateral banks have attempted to do in the face of the recent crises. But given the order of magnitude of private flows, it is becoming impossible for official creditors with far less financial capacity to play this role.

⁹ Although absolutely small in size, private flows to some of the poorest countries (e.g. in sub-Saharan Africa) have been larger relative to GNP than similar flows to Latin America and Asia. Moreover these have exhibited pronounced volatility and procyclicality (Kasekende et al, 1997).

¹⁰ Only five donors, Norway, Denmark, the Netherlands, Sweden and Luxembourg actually achieved the target in 1998, with the first four of these having surpassed 0.20 percent since 1990 (UNCTAD 2000:61).

¹¹ One of the most contentious issues in the design of the HIPC initiative is how the debt “sustainability” thresholds were chosen. Many critics of HIPC argue that the thresholds are still too high (in other words debt servicing levels will continue to impair domestic investment and development efforts), even after they were reduced in the 1999 “enhancement” of HIPC. If correct, such criticism implies that much further debt reduction is still in order.

¹² Other than in the U.K. which announced a significant increase in 2000 in the context of a major policy review.

¹³ This may overstate the reallocation away from the LMICs, UMICs and HICs to the extent that their shares of the “unallocated” portion of Table 3 remain untouched.

¹⁴ The first compensatory financing facility was devised by the International Monetary Fund. However, the CFF, which began as a low-conditionality facility, gradually became harder to access and carried stricter conditionality. In any case the CFF (which later became the Compensatory and Contingency Financing Facility) could never be a grant facility (given the revolving fund nature of the IMF’s resources), whereas the common pool approach is generally understood to be a grant pool.

¹⁵ In contrast, the traditional (and current) aid relationship is characterized by strong conditionality under which resources provided by each donor are tied both as to sources of procurement and uses of the funds. But the resulting lack of ownership by aid recipients is now widely agreed to be one of the principal reasons for the failure of much aid, either at the project level or (even where individual donor-funded projects appear to be achieving their individual objectives) at the country level (because of the lack of integration or consistency among a plethora of donor-funded interventions).

¹⁶ A pragmatic compromise would involve restricting procurement to participating donors and developing countries, following the principles of the multilateral development banks. This would have the effect of tying procurement to particular donors where the donor pool consists of only a few countries, but be less restrictive where the common pool involves a large and diverse group of donors.

¹⁷ In a sense, under a common-pool approach, the CDF and PRSP would converge, since a key rationale of the CDF is to allocate different sectoral responsibilities among different donors, who would then be responsible for procurement, policy conditionality, etc. A common-pool approach would effectively terminate the unique and differentiated contributions of the donors, who would buy into a single package put forward by the recipient in the PRSP.

¹⁸ FDI to developing countries fell slightly in 2000 for the first time since 1990 (World Bank 2001).

¹⁹ The same may be said of most investments funded through official export credits, since the purpose of export credit programs is to capture business for the countries supplying plant and equipment, not necessarily to respond to the investment priorities of the recipient.