

**Drowning by numbers**  
**The IMF, the World Bank and North-South Financial Flows.**

**by David Woodward**

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## ACKNOWLEDGEMENTS

Thank you to all those who commented on the report.

Thank you to the C. S. Mott Foundation for their continued support.

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## **PREFACE**

This summer the World Bank surveyed 700 opinion-leaders in industrialised countries to see what they think about international aid and the role of the World Bank. The first question was whether interest in official aid has declined in recent years, then a chance to comment on four possible reasons why this might be the case:

- confidence in aid effectiveness has dropped;
- public sector finance is not necessary because the private sector is doing the job;
- budget cuts mean less money is available for aid;
- debt relief is more important than other forms of assistance.

These questions are vital when considering the future roles of the World Bank and IMF, but frequently NGOs and researchers do not take time to address these trade-offs in depth, and conclude what arguments they will put forward.

The World Bank and IMF were established to mediate international financial flows to poorer countries and to regulate the world economic system to prevent further 1930's-style slumps and trade wars. The context for their operations has changed dramatically since they were established, partly due to their promotion of international economic integration and private sector investment. The view that foreign private investment can resolve the world's serious poverty problems appears almost unchallenged in official circles, with the end of the Cold War, the establishment of the World Trade Organisation and aid being conditioned on all countries adopting the same "right policies".

Yet at the same time this consensus is under assault. The East Asian financial crisis, the Jubilee 2000 campaign, the postponement of negotiations on a Multilateral Agreement on Investment, and the admission by the World Bank that the Washington Consensus model was limited and not relevant for all countries all show that space is opening to put forward alternative analyses. Unless pushed, however, it is likely that many officials will just propose minor modifications rather than rethink their model from first principles.

This report questions some of the basic assumptions underlying models which champion private foreign investment as the key to growth and aims to fill a gap for campaigners and researchers. It is not just relevant to discussions on the Bank and Fund, how much debt relief can be provided, and whether the IMF should have the right to press countries to liberalise their capital accounts, but also on issues such as international trade agreements, investment codes and declining aid budgets.

The arguments here cannot conclude discussion on the areas outlined above, but will, we hope contribute to a more informed debate and appreciation of the pitfalls of the current narrow economic thinking, its irrelevance for many of the world's poorest citizens and its dangers for the world system as a whole.

Chapter One outlines the paradigm shift advocated by the World Bank and the International Monetary Fund, which promotes free-flowing commercial capital flows.

Chapter Two examines the financial cost of these flows and whether they are affordable

to developing countries and a substitute for official finance.

Chapter Three considers the impact commercial flows have on a government's ability to choose between policies and their impact on a country's economic development.

Chapter Four looks at the opportunities for reducing the cost and increasing the volume of World Bank and IMF loans.

Chapter Five weighs up the trade-off between debt relief and aid and proposes alternative sources of funds for debt reduction which could help to reduce this trade-off.

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## **EXECUTIVE SUMMARY**

### **Facilitating Private Sector Flows**

The IMF and World Bank are advocating a new paradigm for capital flows founded on the efficiency of free-flowing private capital. This implies limiting the role of public sector institutions (including the IMF and the World Bank) to helping the market to operate effectively, intervening directly only where it fails to operate.

The IMF and the World Bank have pursued and are further pushing this paradigm shift through:

- structural adjustment programmes (SAPs);
- direct support for the private sector via the International Finance Corporation and Multilateral Investment Guarantee Agency and other guarantees;
- capital account liberalisation (CAL);
- the Heavily Indebted Poor Country Debt Initiative; and
- strategic use of research, conferences, training and high-profile publications.

Aided by these actions, there has been a massive growth in the flows of Foreign Direct Investment (FDI), portfolio equity investment and commercial lending to developing countries in recent years. This trend has coincided with a decline in official flows of grants and loans. According to the logic of their paradigm commercial capital flows should be able to compensate for this decline, yet poverty is pervasive and crises in Mexico, East Asia and Russia show a continuing need for official flows.

### **The Financial, Policy and Development Costs of Commercial Flows**

However, there are a number of serious doubts about over-reliance on these types of investments as mechanisms for North-South financial flows, especially in low-income countries.

- They are extremely expensive in foreign exchange terms, especially for poorer countries. As a result, maintaining a positive net resource transfer requires a continual and increasing flow of new capital, which entails a very rapid build-up of foreign exchange liabilities.
- They are strongly skewed away from poorer countries, whose efforts to compete for the available flows reduce the potential benefits to the host country.
- They are volatile, procyclical and (in the case of equity investment) subject to serious problems of contagion, increasing vulnerability to external shocks.
- They seriously limit a government's economic policy options, and over the longer term, they may seriously weaken the political system by increasing the role of TNCs.

A universal opening to all forms of capital flows for all purposes should be avoided. This suggests a need to retain some degree of control over commercial capital flows. This is incompatible with the proposed extension of the IMF's mandate to include capital account liberalisation. What is needed is a selective approach, to ensure that flows are

limited to those which confer net benefits from a long-term developmental perspective. Simply seeking to sustain the volume of North-South financial flows could be seriously counterproductive if the liabilities created by commercial flows prove unsustainable; or if the wider effects of the flows themselves, or of the processes of opening the economy to them and attracting them, have negative effects on economic or human development.

This suggests that:

- portfolio investment should generally be avoided by low income countries, as being too expensive and too volatile;
- direct investment should be limited as far as possible to the creation of new capacity for the production of exports which will not have an adverse effect on other developing countries (eg., by depressing commodity prices), and other sectors where the benefits of foreign investment to the rest of the economy outweigh the potential costs of the investment (eg., telecommunications); and
- competition for FDI flows which reduces their benefits to host countries (eg., tax breaks, direct or indirect subsidies and preferential treatment) should be avoided.

For middle-income countries, the balance between the costs and benefits of commercial financing tends to be more favourable: the cost is lower; the build-up of the stock of investment is slower; economies are less subject to other external shocks (eg., due to the greater diversification of their export bases); and political systems are generally more robust. Nonetheless, caution is required; and the volatility of portfolio investment is likely to be a particular problem, as demonstrated by the East Asian crisis.

Apart from their limited access to commercial flows, their high cost and volatility will seriously limit the extent to which most low-income countries can rely on this source of finance. Commercial capital flows cannot simply substitute for official sources of finance. Therefore, if financial flows to low-income countries are to be increased significantly in such a way as to enhance rather than damage long-term economic and human development, this will require an increase in net official flows; more grants or loans on concessional terms; and/or a substantially greater degree of debt reduction than is currently envisaged (without an off-setting reduction in new flows).

### **The Volume and Terms of World Bank and IMF Resources**

The scope for lowering the interest rates on IBRD, IDA and ESAF loans is limited. This suggests that a better option for improving the terms of World Bank and IMF resources would be to lengthen the repayment and grace periods.

- Extending the maturity of IBRD loans would help to off-set the effects of the recent increase in interest rates and charges. This would have little or no impact on the Bank's financial position.
- Extending the maturity on IDA loans could only be achieved at the expense of reducing future IDA loans. IDA credits are not generally too expensive for IDA

borrowers, so it is probably only realistic to argue for more concessional terms in specific circumstances where there is a particular need, for example:

- the poorest low-income countries;
- other low-income countries which already have unsustainable debt burdens;
- countries in post-conflict situations, where liquidity can be expected to be weak (or to require new borrowing) for an extended period; or
- projects and programmes where the foreign exchange benefits are indirect or slow to materialise, particularly in the social sectors (eg., health, education, safety net programmes, etc.).

- Extending the maturity of ESAF loans would need to be subsidised from bilateral aid budgets. Since this would immediately affect the availability of resources, and the policy conditions attached to IMF loans make them less attractive than bilateral loans, this would be undesirable. In principle, the IMF could contribute to the ESAF subsidy account from its own resources, including sales of its gold reserves, but this is unlikely and probably less desirable than using the available resources to finance the HIPC Initiative.

The scope for increasing the volume of resources for Bank and Fund lending is also limited. The mechanisms available for doing so represent little more than a switch of control over an essentially fixed amount of aid from bilateral to multilateral donors. Since most bilateral aid is provided on grant terms and IDA and ESAF provide loans, this is unlikely to be justifiable.

The cost of multilateral loans arises partly from their terms of repayment, partly from the transfer of policy control from borrowing governments to the Bank and Fund and partly from frequent weaknesses in the preparation, design and implementation of their programmes and projects. This suggests that there may be more scope for improving the quality than the quantity of multilateral lending. A number of measures could be taken to achieve this.

- IMF and World Bank staff could ensure that governments participate fully in the process of formulating programmes and projects and that civil society is consulted.
- Flexibility could be built into the programme cycle so that programmes coincide with a government's term in office rather than an arbitrary 3-year cycle.
- Improvements could be made to the Bank's internal quality control mechanisms such as the Operations Evaluation Department and the Inspection panel; and an independent evaluation mechanism could be established for the IMF.
- The Bank's incentive structures could be changed so that staff are rewarded for the results of projects rather than the volume of money spent on them.
- A mechanism could be developed whereby the Bank would assume a portion of the burden of repayment for projects which fail due to poor Bank advice or

project design.

### **Financing Debt Reduction and the Trade-off With Official Flows**

On the whole it would be undesirable to transfer more bilateral aid to the World Bank and IMF. Thus there is a trade-off between using Bank and Fund resources for maintaining current levels of lending (or improving the terms and size of IDA and ESAF loans) and providing more debt relief.

A preliminary analysis of the trade-off suggests that it would be preferable to provide debt relief rather than aid. However, the extent of this trade-off will depend critically on how the Bank and Fund contribute to the HIPC Initiative and any further debt reduction. This suggests that resources should first come from those sources which will have the least impact on official financing in the future, particularly to the poorest countries, and used in sequence until the point is reached where the costs to developing/low-income countries of reduced capital flows equal the benefits of debt reduction. The sequence implied by this approach is broadly as follows:

- Bank and Fund loan loss provisions;
- The capital proceeds of sales of IMF gold reserves (with the largest volume of sales politically attainable);
- IBRD reserves released by relaxing the capital-plus-reserves constraint on lending;
- Bilateral contributions;
- IDA reserves and reflows.

While the cost of using bilateral contributions to finance multilateral debt reduction is relatively high, this would not be the case if genuinely additional resources could be generated. One possibility for this would be to secure agreement from those bilateral donors which are not already doing so to meet their international commitment to provide development assistance of 0.7% of GNP for a single year, on a one-off basis, expressly for debt reduction, for example to mark the Millennium. This would generate additional resources of around \$100bn - equivalent to about half of the total debt of all the HIPCS (in present value terms), even before taking account of the debt reduction likely under existing mechanisms.

If current efforts to provide adequate debt-reduction for low-income countries were to fail, other financing mechanisms might be feasible in the long term. These would include, for example, the proceeds of a "Tobin tax" - an internationally-applied tax levied at a very low rate on all international currency transactions. The sheer volume of such transactions means that such a tax would raise very considerable sums (possibly hundreds of billions of dollars per year), which would provide plentiful resources for debt reduction and other priority development needs.

To achieve just and sustainable financial flows will require political mobilisation by

concerned people and governments to press the World Bank and IMF to reconsider their models and operations.

## CHAPTER1

# THE NEW PARADIGM OF INTERNATIONAL FINANCE

The nature of capital flows between developed and developing countries changes considerably over time. In the 1970s, such flows were based largely on syndicated loans from commercial banks. In the 1980s, as this source of financing largely dried up following the Mexican crisis of 1982, official flows became relatively much more important. From the end of the 1980s, there has been a major growth of foreign direct and portfolio investment, which by the mid-1990s represented the majority of net capital flows to developing countries as a whole.

This transformation largely reflects a deliberate paradigm shift by the IMF and the World Bank. They have wrought this shift through several channels.

- Structural adjustment programmes (SAPs): the pro-market conditions attached to SAPs have included the liberalisation of foreign exchange and financial systems, the privatisation of state-owned enterprises, the development of stock exchanges and their opening up to foreign investors, and liberalisation of foreign investment regimes.
- Direct support for the private sector: the operations of the International Finance Corporation (which supports private sector projects in developing countries) and the Multilateral Investment Guarantee Agency (which guarantees foreign investors against certain risks involved in investing in low-income countries) - both part of the World Bank - have grown in recent years.
- Capital account liberalisation (CAL): the IMF is seeking to change its mandate to enable it systematically to pursue CAL in all its member countries.
- The Heavily Indebted Poor Country Debt Initiative - which, by reducing the debt overhang, will help to make the poorest countries more attractive to private capital.
- Strategic use of research, conferences, training and high-profile publications.

## Facilitating Private Sector Flows

In this new paradigm, as in the neoliberal model at the national level, the market takes the predominant role. This means that commercial capital flows<sup>1</sup> (described in Table 1) are, as far as possible, allowed to operate freely, while the role of public sector institutions (including the IMF and the World Bank) is to help the market to operate effectively and to intervene directly only where it fails to operate.

For countries with ready access to commercial flows this implies a relatively limited role for the Bank and Fund. Such countries have recently included the major economies of Latin America and East and South East Asia (at least until the 1997-8 East Asian financial crisis). In these countries, the role of the Bank is likely to be limited to project support for purposes for which commercial finance is unavailable (eg., health, education and environmental protection). In normal times, the IMF has no role beyond its regular

monitoring function. When a crisis arises, however, these roles change, and the IMF and the World Bank are at the centre of financial support packages.

In some other countries, the IMF and World Bank help to encourage commercial flows. IMF programmes provide a "seal of approval", which is intended to act as a signal to private investors that the country is following good economic policies; and the World Bank provides partial guarantees for commercial finance to reduce the risks for investors and loans for projects in the private sector. The aim is primarily to mobilise commercial flows to these countries rather than to provide finance directly.

In many countries, especially low-income countries, there is as yet little sign of commercial flows rising to levels where they can provide adequate support for development. Here, the Fund and Bank can be expected to play a much greater and more direct financial role, somewhat closer to that of the 1980s.

For those countries identified as highly-indebted poor countries (HIPCS), the Bank and Fund are to provide debt reduction, as part of a coordinated package with other creditors, intended to reduce debts to sustainable levels - that is, to levels which can be repaid by governments without them rescheduling or accumulating arrears. For most of these countries, debt reduction is to be phased over a six-year period, with increased adjustment lending in the interim. It is hoped that debt reduction, together with further adjustment, will encourage commercial flows in the future.

Beyond the promotion of financial flows at the national level through adjustment programmes, the IMF is seeking an amendment to its Articles of Agreement to widen its mandate to include capital account liberalisation - that is, the removal of restrictions on financial flows in and out of a country. Economic theory dictates that "free capital movements facilitate a more efficient global allocation of savings, and help channel resources into their most productive uses, thus increasing economic growth and welfare. From the individual country's perspective, the benefits take the form of increases in both the potential pool of investable funds, and the access of domestic residents to foreign capital markets." (Fischer, 1997, p3)

If the IMF's Articles of Agreement are changed, this would introduce a mechanism to seal in the liberalisation of financial flows, in much the same way that liberalisation of current account transactions are promoted at present. It is likely that countries could remove restrictions gradually, but once removed restrictions could not be reimposed except in response to a crisis, and only then with IMF approval<sup>2</sup>.

## **Types of Financial Flows**

Rather than being based on loans from governments and international institutions such as the World Bank and IMF to governments and state-owned enterprises, new international financial flows now mainly comprise various types of investment flows and loans between private sector investors and private companies for commercial purposes. (See Table 1)<sup>3</sup>.

While these flows represent private transactions, some are officially guaranteed. Payments on some export credits and other bank loans are guaranteed against

commercial risks by the government of the recipient country; and some export credits are insured by agencies in the lending country. In the case of non-payment of these debts, the burden of repayment is assumed by the creditor or debtor government<sup>4</sup>. In addition, governments themselves are regaining access to financing from commercial sources. Since syndicated bank loans were mostly discredited by the Latin American debt crisis of the 1980s, developing country governments now raise most private finance via bond issues: bond issues accounted for 83% of net public and publicly-guaranteed borrowing by developing countries from commercial sources in 1996, compared with just 7% in 1980 (World Bank, 1998).

Recent trends in financial flows are shown in Figures 1 and 2. There are three dimensions to the shift in financing<sup>5</sup>:

- a shift from official to commercial sources of finance (A);
- a shift from public to private recipients of financial flows (B); and
- a shift from loans to equity instruments (including direct investment) as mechanisms (C).

### **Concentration**

Commercial flows are heavily skewed towards the better-off and more industrialised developing countries. Equity financing, in particular is much greater for larger middle-income countries, particularly in East and South East Asia and in Latin America, and very limited in the smaller, less developed and mostly low-income countries typical of Sub-Saharan Africa. Public sector bond issues and non-guaranteed loans to the private sector tend to follow a similar pattern.

FDI too demonstrates a broadly similar pattern; while the exclusion of smaller and poorer countries is less absolute, such FDI as does occur in these countries tends to be heavily concentrated within natural resource-based sectors, particularly mineral and fuel production. However, some very small middle-income economies (eg., the smaller Caribbean islands) tend to receive large FDI flows relative to GDP.

In varying degrees for different types of flow, this pattern of concentration arises because of differences in the expected rates of return and in perceived levels of risk, related, for example, to the size and financial security of corporate sectors, the development of financial systems and the size of domestic markets. As commercial flows, and particularly direct and equity investment, become more important, these factors can be expected to be an increasingly important constraint on overall capital flows to poorer and less developed countries. As a result their relative position may be seriously weakened if this tendency is not off-set by larger and better targeted official flows.

Table 1: COMMERCIAL CAPITAL FLOWS TO THE PRIVATE SECTOR

TYPE OF INVESTMENT	SOURCE OF FUNDS	USE OF FUNDS	DURATION OF INVESTMENT	WHO B...
FOREIGN DIRECT INVESTMENT	Mainly transnational corporations; may be some from individuals.	To buy share (at least 20% of) existing companies or existing productive capacity, or to build new productive capacity.	Until the investment is sold to a local investor; at the discretion of the foreign investor, but generally assumed to be long-term.	Investor (commercial exchange political by MIG)
PORTFOLIO EQUITY INVESTMENT	Mainly institutional investors (eg., pension funds, financial institutions); some individuals.	To buy shares of companies (less than 20% from local owners, or new share issues (eg., for privatisation or expansion).	Until the investment is sold to a local investor; at the discretion of the foreign investor, but generally assumed to be shorter-term than FDI. May be very short term.	Investor market compar
COMMERCIAL BANK LOANS	Commercial banks.	Lent to local companies (and affiliates of transnational corporations), generally to finance investment.	Variable, but generally long-term; typically 4-8 years.	Investor due to i bankrupt guarant country investm
BONDS	Mainly institutional investors; may be some individuals.	To buy bonds issued by local companies, generally to finance investment.	Variable, but typically 5-10 years.	Investor due to i bankrupt
DEPOSITS	Mainly institutional investors; may be some individuals.	Placed on deposit with local commercial banks; on-lent by the recipient to local borrowers.	Variable, between over-night and six months; fixed when the deposit is made.	Investor although guarant devaluat borrowe
EXPORT CREDITS	Commercial banks; some transnational corporations (to finance their own exports).	To pay for imports.	Generally short-term; typically 3-6 months.	Lender due to i bankrupt guarant country in the le
DERIVATIVES	Mainly institutional investors (as a speculative investment) and transnational companies (to "hedge" - protect - against risk, eg., against changes in commodity prices, exchange rates, etc.); may be some individuals.	To buy derivatives issued from local financial institutions which issue them.	Fixed by the terms of the derivative. Variable, but generally short-term.	Investor rate, pri changin was an a hedge comme

## **WHY GOVERNMENTS NEED FINANCE AND THE COST OF COMMERCIAL FLOWS**

### **Uses of Capital Flows and Development Needs**

Historically, North-South capital flows (both aid flows and commercial loans) have helped to fill two financial gaps:

- they finance the current account balance of payments deficit - that is, the gap between imports and exports - by providing an inflow of foreign exchange to the economy as a whole; and
- where money is lent to the public sector, capital flows finance the budget deficit - that is, the gap between the government's spending and its income from taxes, etc., - along with domestic borrowing.

As principal payments fall due on the debts incurred by governments during the surge of commercial lending in the 1990s, the growth of borrowing from private sources (net of repayments) has slowed down considerably, and has not been sufficient to off-set the dramatic decline in official financing since 1993. The overall effect is a decline in finance (net of repayments) to governments. This reduction is much more dramatic if interest payments are considered, as the shift of debt from official to commercial sources has increased its average cost<sup>6</sup>. This represents a major reduction in the external resources available to governments.

For many low-income countries, a particularly important aspect of the financial constraint facing governments is the limited availability of resources to finance recurrent spending (that is, non-investment spending, eg., on salaries, maintenance, drugs and other consumables in the health sector, teaching and learning materials in education, etc.). Most grants and official loans are tied to particular investments, which themselves often increase the need for recurrent spending (for running costs and maintenance), leaving recurrent spending to be financed by tax revenues and borrowing from other (ie., commercial and domestic) sources.

In most low-income countries, especially in Sub-Saharan Africa, government revenues are limited by low incomes and large subsistence and informal sectors (which limit the tax base) and weak administrative capacity (which impairs the ability to collect taxes). An additional problem is that many countries with particularly low revenues rely heavily on taxes on imports and exports, and on corporate taxes, which are typically reduced under IMF and World Bank adjustment programmes (Woodward, 1996, pp55-57).

Access to foreign commercial borrowing for most of these countries is also limited; and the potential for domestic borrowing is restricted in most cases because of low savings rates. Borrowing to finance recurrent spending is in any case a dangerous strategy: unlike investment, recurrent spending does not generate profits which can be used to pay the interest. The dangers of borrowing to finance consumption are clearly demonstrated by the Latin American debt crisis in the 1980s.

A better case can be made for borrowing to finance recurrent spending on health and education, as this is, in effect, an investment in human capital (that is, in the future productivity of the work-force). However, the returns on this investment are indirect and slow to materialise, making commercial and domestic borrowing (which bears high interest rates and is generally relatively short-term) inappropriate. Over the long term, borrowing to finance recurrent spending makes the situation worse, because interest payments on the borrowing will come out of future recurrent budgets.

In middle-income countries, recurrent spending constraints are generally not so tight; and there may be greater scope for governments to borrow locally to make up for the reduction in flows to the public sector from abroad. However, local borrowing is generally much more expensive, because interest rates tend to be much higher than those on foreign commercial borrowing. This strategy can therefore impose very substantial costs on the public finances over the longer term. Perhaps the best-known example of this phenomenon is Brazil, where interest payments on domestic debt amount to some 5% of GDP, putting considerable pressure on non-interest government spending<sup>7</sup>.

The decline in the level of investable resources available to governments may be partly compensated for by the process of privatisation which, by shifting the ownership of industries such as power generation and telecommunications from the public to the private sector, implies that governments now have less need for investment resources.

### **Foreign Exchange Costs of FDI and Equity Investment**

An important feature of FDI and equity investment is their rates of return. Because investors bear the risk that their investments might fail to make a profit, they set higher target levels for profits to compensate them for the greater risks. As a result, rates of return to direct and equity investments are much higher overall than on loans. As well as increasing the rate of return on these investments generally, this also means that the rate of return is highest where the risk is seen as greatest - that is, primarily in the poorest and least developed countries. According to a recent World Bank publication on private capital flows,

"rates of return on FDI have generally been much higher in Sub-Saharan Africa than in other developing regions. During 1990-94, rates of return on FDI in the region averaged 24 to 30 percent, compared to 16 to 18 percent for all developing countries." (World Bank, 1997a, p34)

For equity investment, rates of return may be still higher. Based on World Bank (1995a) data,

"The average rate of return on equity investments in 1976-92 in 15 emerging markets which had attracted foreign equity inflows by 1993 was 29 per cent per annum. In only two cases (Indonesia at -12 per cent and Malaysia at +14 per cent) was the rate of return less than 20 per cent; and in the former case the data covered only three years (1990-92). In three cases (Argentina at 68 per cent, the Philippines at 45 per cent and

Colombia at 43 per cent) it was above 40 per cent." (Woodward, 1996a, p46)

Even 16-18% per year is far above the cost of commercial loans to the private sector, which in turn is greater than that of loans to governments (again because of the higher level of risk). The average interest rate on new loans by private creditors to developing countries as a whole was 7.3% per year in 1996 (World Bank, 1998). For Sub-Saharan Africa, it was 6.1% per year, one-quarter to one-fifth of the rate of return on direct investment.

Private foreign investors generally return at least part of the profits they earn in the host country to their own countries in the form of dividend payments (for equity investments) or profit remittances (for direct investment). In the case of the poorest countries the proportion of FDI profits which is remitted rather than retained and reinvested in the ongoing venture or a new investment project may be large compared with other countries. This may be because:

- the investment climate is riskier so that investors adopt a more short-term view - "The basic rule for black Africa [sic] is: get your money back in 12 to 18 months, or don't do it - who knows what's going to happen next?"<sup>8</sup> or;
- it is perceived that there are fewer investment opportunities - "parent companies want to remit a much higher proportion of their profits from SSA [Sub-Saharan Africa] than from other regions, as they see fewer new manufacturing opportunities."<sup>9</sup>

To repatriate their profits, foreign investors must convert them into their own currencies, which means that the country concerned must be able to provide enough extra foreign currency to allow the conversion to take place. This foreign exchange must come from earnings on additional exports (or savings from reducing imports), or from more financial inflows.

The significance of the high rates of return noted above is generally played down by the proponents of FDI on the grounds that only profits which are made can be remitted. In practice, this does not always appear to be the case: in Botswana, for example, profit remittances on FDI exceeded total declared profits in every year from 1990 to 1994<sup>10</sup>.

More importantly, even where profits are made, they will not necessarily represent an increase in the country's net foreign exchange earnings. In particular, the generation of foreign exchange will be limited for investments which take the form of the purchase of existing productive capacity rather than the creation of new capacity, and where investment is in production for the domestic market (particularly of non-tradeable goods) rather than for export (Woodward, 1997).

The former condition applies in particular to privatisation, and the latter to most investment in services, as well as to many other investments in each case. Privatisation alone accounted for nearly half of all FDI in transition economies in 1991-3, and around one-eighth in developing countries as a whole (Sader, 1995, Table 1). Investment in services (for example, public utilities, fast-food restaurants, etc.) accounts for more than half of the total global stock of FDI; and this proportion has been increasing steadily (UNCTAD, 1997, p71; World Bank, 1998, p21)<sup>11</sup>. Most equity investment also takes the

form of purchases of shares in existing capacity (rather than new issues for the creation of new productive capacity), so that the net foreign exchange effect is almost certain to be negative, because output is not increased.

Where FDI and equity investment fail to generate sufficient extra foreign exchange earnings (or savings) to cover profit remittances, this will worsen the balance of payments. In poorer countries, where the rate of profit is higher, the amount of extra foreign exchange needed will be greater, and a negative overall effect is therefore more likely for any particular investment. In view of the need these countries have for foreign exchange to import essential goods, this is potentially a major drain on the economy.

Over the medium-term, any negative balance of payments effect may be off-set by continued inflows, reinvestment of profits on FDI, and the fact that most of the return on equity investment is in the form of capital gains rather than dividend payments. However, all of these effects serve to increase the value of investment on which future profit remittances will be made, which in turn increases the new flows required to keep the net transfer favourable; and the rate of increase may be very considerable.

In this context, the 24-30% annual rate of return estimated by the World Bank for Sub-Saharan Africa is exceptionally onerous. This is illustrated in figures 3-6. These are based on three scenarios over a 20-year period:

- (A) a one-time inflow of \$100m in year 0, with one-third of profits reinvested in each subsequent year (roughly in line with the average for developing countries);
- (B) a one-time inflow of \$100m in year 0, with new investment in each subsequent year equal to profits (ie., just enough to avoid an outward net transfer); and
- © an inflow sufficient to achieve an inward net transfer of \$100m in every year.

In scenario (A), profit remittances lead to a continuing and increasing outward net transfer of foreign currency, as reinvestment increases the value of the investment. The total outward net transfer in the first 6 years exceeds the initial inflow; and by year 20 as much as is transferred out every 18 months as was originally invested. In scenario (B), by definition, net transfers are zero. However, this is achieved only by rapidly increasing new investment, adding to the capital stock. By year 20, the total value of inward investment is nearly \$7½bn, and the country needs to attract \$1.4bn every year to avoid an outward net transfer, compared with an total inward transfer of \$100m in year 0.

In scenario (C), the new investment needed to off-set profit remittances escalates still more rapidly. By year 20, the total value of inward investment is nearly \$40bn, and inflows of \$7.4bn are required each year to achieve an inward net transfer of just \$100m.

At a rate of return of 0% per year, the picture is considerably worse. In Scenario A, more foreign exchange is transferred out of the economy in 10 months in year 20 than was originally invested. In Scenario B, the stock of investment reaches \$19bn in year

20 (2½-times the figure at 24% per year), and the new inflows needed are tripled to \$4.3bn. In Scenario C, the stock of investment in year 20 is more than doubled to \$82bn, and the new investment needed increases by 150% to \$19bn.

In view of these results, it is not surprising that the stock of inward FDI in Sub-Saharan Africa increased from about 7% of GDP in 1980 to 20% in 1994, while net transfers remained substantially negative throughout this period (UNCTAD, 1997).

**Table 1: Simulated Cost of FDI (Rate of Return 24% PA)**

(\$m)	(a) 33% reinvestment				(b) zero net transfer		© \$100m per year net transfer		
year	capital	profits	remitted	reinvested	capital	profit (all reinvested)	capital	profit	investment
0	100.0				100.0		100.0		
1	108.0	24.0	16.0	8.0	124.0	24.0	224.0	24.0	124.0
2	116.6	25.9	17.3	8.6	153.8	29.8	377.8	53.8	153.8
3	126.0	28.0	18.7	9.3	190.7	36.9	568.4	90.7	190.7
4	136.0	30.2	20.2	10.1	236.4	45.8	804.8	136.4	236.4
5	146.9	32.7	21.8	10.9	293.2	56.7	1098.0	193.2	293.2
6	158.7	35.3	23.5	11.8	363.5	70.4	1461.5	263.5	363.5
7	171.4	38.1	25.4	12.7	450.8	87.2	1912.3	350.8	450.8
8	185.1	41.1	27.4	13.7	559.0	108.2	2471.2	459.0	559.0
9	199.9	44.4	29.6	14.8	693.1	134.1	3164.3	593.1	693.1
10	215.9	48.0	32.0	16.0	859.4	166.3	4023.8	759.4	859.4
11	233.2	51.8	34.5	17.3	1065.7	206.3	5089.5	965.7	1065.7
12	251.8	56.0	37.3	18.7	1321.5	255.8	6411.0	1221.5	1321.5
13	272.0	60.4	40.3	20.1	1638.6	317.2	8049.6	1538.6	1638.6
14	293.7	65.3	43.5	21.8	2031.9	393.3	10081.5	1931.9	2031.9
15	317.2	70.5	47.0	23.5	2519.6	487.7	12601.1	2419.6	2519.6

16	342.6	76.1	50.8	25.4	3124.3	604.7	15725.3	3024.3	3124.3
17	370.0	82.2	54.8	27.4	3874.1	749.8	19599.4	3774.1	3874.1
18	399.6	88.8	59.2	29.6	4803.9	929.8	24403.3	4703.9	4803.9
19	431.6	95.9	63.9	32.0	5956.8	1152.9	30360.1	5856.8	5956.8
20	466.1	103.6	69.1	34.5	7386.4	1429.6	37746.5	7286.4	7386.4

**Table 2: Simulated Cost of FDI (Rate of Return 30% PA)**

(\$m)	(a) 33% reinvestment				(b) zero net transfer		© \$100m per year net transfer		
year	capital	profit	remitted	reinvested	capital	profit (all reinvested)	capital	profit	investment
0	100.0				100.0		100.0		
1	110.0	30.0	20.0	10.0	130.0	30.0	230.0	30.0	130.0
2	121.0	33.0	22.0	11.0	169.0	39.0	399.0	69.0	169.0
3	133.1	36.3	24.2	12.1	219.7	50.7	618.7	119.7	219.7
4	146.4	39.9	26.6	13.3	285.6	65.9	904.3	185.6	285.6
5	161.1	43.9	29.3	14.6	371.3	85.7	1275.6	271.3	371.3
6	177.2	48.3	32.2	16.1	482.7	111.4	1758.3	382.7	482.7
7	194.9	53.1	35.4	17.7	627.5	144.8	2385.8	527.5	627.5
8	214.4	58.5	39.0	19.5	815.7	188.2	3201.5	715.7	815.7
9	235.8	64.3	42.9	21.4	1060.4	244.7	4261.9	960.4	1060.4
10	259.4	70.7	47.2	23.6	1378.6	318.1	5640.5	1278.6	1378.6
11	285.3	77.8	51.9	25.9	1792.2	413.6	7432.7	1692.2	1792.2
12	313.8	85.6	57.1	28.5	2329.8	537.6	9762.5	2229.8	2329.8
13	345.2	94.2	62.8	31.4	3028.8	698.9	12791.3	2928.8	3028.8
14	379.7	103.6	69.0	34.5	3937.4	908.6	16728.6	3837.4	3937.4
15	417.7	113.9	75.9	38.0	5118.6	1181.2	21847.2	5018.6	5118.6

16	459.5	125.3	83.5	41.8	6654.2	1535.6	28501.4	6554.2	6654.2
17	505.4	137.8	91.9	45.9	8650.4	1996.2	37151.8	8550.4	8650.4
18	556.0	151.6	101.1	50.5	11245.5	2595.1	48397.3	11145.5	11245.5
19	611.6	166.8	111.2	55.6	14619.2	3373.7	63016.5	14519.2	14619.2
20	672.7	183.5	122.3	61.2	19005.0	4385.8	82021.5	18905.0	19005.0

[CAN WE DEMONSTRATE THESE FIGURES IN A BETTER WAY - GRAPH FOR EXAMPLE?]

If there were no cost to encouraging more foreign investment then this would not be a problem. However, such a strategy is not costless. As well as the profit remittances on inward investment, there is a risk (especially for equity investments) that capital may ultimately be repatriated or reinvested in another country; and the greater the stock of investment is at this point, the more serious the effects will be. Unless locally-owned capital can grow as quickly as the stock of foreign investment - which is virtually impossible in Scenarios B and C - there will be a progressive transfer of ownership and control of the economy from local people to foreign investors. This could be a political time-bomb.

Borrowing from commercial banks, whether in the form of bank loans or bond issues, is generally much cheaper than equity investment or FDI, but significantly more expensive and shorter-term than borrowing from official sources for all regions (Table 2). For developing countries as a whole, the average interest rate on new commitments from commercial lenders was 7.3% per year in 1996, compared with 4.9% per year for official loans; and average maturities were 8 years, compared with 21 years.

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**Table 2: Average Terms of New Commitments, 1996**

	interest rate (%PA)			maturity (years)			
	commercial	official	difference	commercial	official	difference	
All developing		7.3	4.9	2.4	8.1	21.5	13.4
East Asia/Pacific	7.6	4.7	2.9	9.4	23.5	14.1	
Europe/Central Asia	7.4	5.3	2.1	8.1	15.1	7.0	
Latin America/Carib.		7.3	6.1	1.2	7.2	19.5	12.3
Middle East/N.Africa		5.2	5.0	0.2	8.0	18.6	10.6
South Asia	5.0	4.4	0.6	7.2	25.3	18.1	
Sub-Saharan Africa	6.1	1.5	4.6	12.2	34.1	21.9	
SILICs		5.0	1.5	3.5	9.2	33.8	24.6
SIMICs		8.1	5.6	2.5	6.9	20.0	13.1
MILICs		5.0	4.3	0.7	7.2	25.7	18.5
MIMICs	6.5	5.3	1.2	8.6	19.1	10.5	
other	7.8	5.4	2.4	8.3	17.8	9.5	

all LICs	7.7	3.9	3.8	7.1	27.0	19.9	
all MICs	7.2	5.6	1.6	8.4	17.8	9.4	
SPA countries		5.7	1.2	4.5	7.3	34.9	27.6

**Notes:** data are from World Bank (1998).  
 SILICs = severely-indebted low-income countries;  
 SIMICs = severely-indebted middle-income countries;  
 MILICs = moderately-indebted low-income countries;  
 MIMICs = moderately-indebted middle-income countries;  
 LICs = low-income countries;  
 MICs = middle-income countries;  
 SPA = Special Programme of Assistance.

## Economic Prospects and the Sustainability of Commercial Flows

In principle, it may be sensible for a country to incur debt in order to finance investment projects. The questions are:

- is the existing level of debt (and other external liabilities such as FDI and equity investment) sustainable?
- given the level of these liabilities, how much new capital inflow of which types can be sustained? and
- what sort of investment projects should these inflows finance?

The answers to these questions depend largely on the economic prospects for developing countries. The Bank is generally very enthusiastic about the prospect of increasing commercial capital flows, at least in the case of FDI and equity investment. This is no doubt partly because of its generally favourable predisposition towards the private sector and free markets. However, it also rests at least partly on its characteristically optimistic view of the economic prospects of developing countries and therefore their potential to earn foreign exchange.

The Bank expects developments in the global economy in the coming years to be broadly favourable to the developing countries.

"World trade growth is expected to pick up in tandem with industrial country growth in 1997-98, reaching a longer-term trend of around 6.4 percent....Although there is a near-term risk to private capital flows associated with the expected rise in interest rates in industrial countries over the next twelve to eighteen months, the outlook for continued growth in private flows in the medium and longer term remains favorable on both the supply and the demand side...Prospects for official development assistance flows are not encouraging....[Oil prices] are projected to fall by more than 3 percent a year in real

terms in 1997-2006....Nonfuel commodity prices are forecast to gradually decline in real terms, at perhaps 1-2 percent a year over the coming decade." (World Bank, 1997e, pp 11, 15-16, 18.)

On this basis, the Bank projects fairly strong export growth for all developing regions in 1997-2006.

- 4½-5½% per year for the Middle East and North Africa, Europe and Central Asia and Sub-Saharan Africa;
- 6.7% per year for Latin America and the Caribbean; and
- 9½-10½% for East and South Asia.

Longer-term export growth (for 1992-2020) is somewhat faster for the first group, at 6-7% per year (World Bank, 1997e, Tables 1-5 and 1-8).

As a general rule of thumb, if debt (and other foreign exchange liabilities) are initially sustainable, they can be expected to remain so only if the growth rate of foreign exchange earnings is at least as much as the rate of return on the liabilities. Otherwise, maintaining inward net transfers will mean liabilities growing faster than the economy's ability to bear them, until ultimately they become unsustainable. The only alternative is to allow outward net transfers (probably on a substantial scale and for a long period), which will be a serious drain on the economy.

Table 3 shows the World Bank's long-term projections for export volume growth, and the average interest rate on new commercial loans to different regions in 1996. Several points need to be taken into account in comparing these two sets of figures.

- The export volume figures need to be adjusted for export price changes, which might be in the order of 2½% per year for manufactured exports, 1% per year for non-fuel commodities and -½% for fuel.
- The Bank's projections show both real and nominal US interest rates ½% higher in 1997-2006 than in 1996, suggesting that the figures in the final column should be increased by this amount.
- The figures given are regional averages, and there is likely to be a very wide variation between different countries in both regions, both in terms of interest rates and especially in export volume growth.
- The projections were made before the Asian financial crisis. This makes the starting-point of most East Asian countries much less secure than it appeared at the time. It can also be expected to give rise to an increase in export growth for several countries in East Asia (eg., Thailand, Korea and Malaysia) at the beginning of the period, as they attempt to rectify this situation; but reductions for others both in Asia (eg., China) and elsewhere (notably in Latin America), as their Asian markets decline and their competitive position against the most affected Asian economies is weakened. Export prices are also likely to be weaker - especially for manufactured goods exported from the region, as they increase supply, but also for commodities (especially fuel) as demand is reduced.

Applying the rule of thumb outlined above, and taking account of these factors suggests the following (rather tentative) conclusions for commercial borrowing up to 2006.

- Those countries which have been severely affected by the East Asian crisis must now be regarded as having an unsustainable starting point, suggesting a potentially limited capacity for new commercial borrowing. Some other East Asian economies (notably China) may be better able to afford commercial borrowing, and South Asia as a whole more comfortably so.
- In Latin America, commercial borrowing was barely sustainable before the Asian crisis, and may well be unsustainable since, except in countries with particularly rapid export growth or a large proportion of manufactured exports.
- In Sub-Saharan Africa, the Middle East and North Africa, and Eastern Europe and Central Asia, commercial borrowing was not sustainable overall even before the Asian crisis, and is likely to be even less so now. This applies particularly strongly to countries which have an unsustainable financial situation already, notably most of Sub-Saharan Africa and Russia.

This suggests that only a handful of developing countries can regard commercial borrowing as potentially sustainable over the next decade, based on the World Bank's projections. After 2006, it should be comfortably sustainable for the two regions for which projections are available (the Middle East and North Africa, and Sub-Saharan Africa), barring a large increase in interest rates and an exceptionally serious and sustained fall in oil prices during the period, as export volume growth is projected to accelerate markedly. However, this will depend critically on whether the financial position of the countries in these regions is sustainable at the beginning of the period. In no case are the rates of return on direct and equity investment sustainable by this criterion - although direct investment in export production and import substitution might nonetheless be justified, if it generates enough extra foreign exchange earnings or savings to off-set profit remittances.

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**Table 3: Projected Export Growth and Cost of Commercial Borrowing (%PA)**

	export volume growth (%PA)				interest rate on new commercial loans (%PA, 1996)
	1981-90	1991-96	1997-06	2007-20	
all developing	1.7	8.0	7.2	8.8	7.3

countries					
East Asia	8.2	15.2	9.4	n/a	7.6
South Asia	6.0	11.1	10.7	n/a	5.0
Sub-Saharan Africa	-0.2	1.0	5.5	9.2	6.1
Latin America/ Caribbean	4.2	10.1	6.7	n/a	7.3
Europe/Central Asia	-0.1	3.8	5.0	n/a	7.4
Middle East/ North Africa	-2.2	3.7	4.4	8.6	5.2

**Sources:** Columns 1-4 are based on World Bank (1997e, Tables 1-5 and 1-8). Column 4 is an approximation, based on the assumption that export growth in 1991-2 was equal to the 1991-5 average for all regions. Column 5 is taken from World Bank (1997d).

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However, all of these conclusions depend critically on the reliability of the projections, which may be questionable. Firstly, as discussed in Annex 1, the export growth figures for Sub-Saharan Africa appear inconsistent with the assumptions for commodity prices. This would suggest either that the region's export growth will be slower and/or that commodity prices (and thus the prices of the region's exports) will be lower. In either case, the growth rate of Sub-Saharan Africa's export revenues will be slower, and the sustainable interest rate will be still lower, at least until 2006.

Secondly, there are widespread doubts about the realism and reliability of the Bank's forecasts, which are often seen as being over-optimistic. According to Caufield (1996), for example,

"[The World Bank's] record as a forecaster leaves much to be desired. It failed, for example to anticipate the oil price rises of 1973, 1979 or 1985. The Bank's researchers tend toward overoptimism. Its predictions have frequently exceeded not only reality, but even the estimates of other agencies.... The Bank has...consistently produced overly rosy projections of economic growth.... In 1991, the Bank acknowledged that its predictions of growth were 'too hopeful'. It had, it explained, overestimated how fast world trade would grow, underestimated interest rates, overestimated the flow of capital to developing countries, underestimated how far oil prices would decline, and overestimated global savings." (Caufield, 1996 pp 300-1)

Has the Bank improved its projections since this admission? Some assessment can be made by comparing its projections for the 1990s in the first (1991) edition of *Global Economic Prospects and the Developing Countries* (World Bank, 1991) with actual outcomes for 1991-5, as recorded in the latest (1997) edition (World Bank, 1997e). At first sight, this suggests that export volume growth projections at that time were, if anything, under-estimated. For developing countries as a whole, export growth in 1991-5 was slightly above the "high scenario" projection (8.5% compared with 8.3%). The results for East Asia, South Asia and Latin America were all above the high scenario by substantial margins (between 3% and 7% PA), while that for Europe, the Middle East and North Africa was slightly above the "downside scenario" (the second lowest of the four provided).

However, there are two critically important caveats.

- The conspicuous exception to the pattern of under-estimation is Sub-Saharan Africa, where export growth was in any case the lowest of any region. Actual export growth in 1991-5 was just 0.7% per year, compared with a projection for the 1990s of between 1.3% per year and 4.1% per year (3.0% per year in the baseline scenario).
- While export outcomes were much better than expected, this did not feed through into an equivalent over-performance on economic growth - even though other circumstances (eg., FDI and real interest rates) were also more favourable than predicted<sup>12</sup>.

In fact, developing countries as a whole actually grew more slowly in 1991-5 than the Bank projected even in its worst-case scenario (2.3% PA, compared with 2.9% PA), as did both Sub-Saharan Africa, and Europe, the Middle East and North Africa. Of the regions which exceeded the "high" scenario export growth projection, South Asia's overall growth was in line with the baseline scenario, while Latin America's was in line with the "downside" scenario. While East Asia's growth was again better than the "high" scenario, the margin of over-performance was much less than that for exports (1.7% PA, compared with 7.0% PA); and extending the period to 1998 or beyond would almost certainly eliminate the over-performance altogether.

In other words, while the Bank found their projections for developing countries in the 1980s to have been too positive because of over-optimistic assumptions about global economic conditions, in the 1990s the underlying assumptions were much more cautious and, in the event, seriously under-estimated the reality; but the growth projections were still much too optimistic. This spectacular failure to predict overall economic performance, coupled with the considerable over-optimism of the export projections for Sub-Saharan Africa, raise serious concerns about the Bank's ability to model the linkages from global developments to export performance, or from exports to economic growth.

The Bank's projections of financial developments seem to be particularly unreliable. The 1991 projections predicted average FDI in developing countries as a whole of \$27bn PA; even if there were no further growth from the 1996 level, the actual figure would be

in the order of \$78bn. If the 1990-6 growth rate (28.3% PA) were sustained, it would be \$128bn, five times the projected level. The Bank also failed quite spectacularly to predict the East Asian crisis - "the most severe regional financial disruption since the Latin American debt crisis of 1982 and perhaps since the Creditanstalt default of 1931" (Chote, 1998, p2). As late as September 1997, the Bank dismissed the prospect of a "Mexican-style crisis" in East Asia, observing that "while near-term growth will likely slow [in East Asia], a full-blown Mexican-style crisis appears unlikely because of better economic fundamentals in several respects than in Mexico in 1994" (World Bank, 1997e, p21).

## CHAPTER 3

### THE IMPACT OF COMMERCIAL FLOWS ON ECONOMIC POLICIES AND DEVELOPMENT

As well as the financial costs of international capital, it is important to consider the impacts these flows may have on a country's economic development and the government's ability to implement policies to eradicate poverty. The desire to attract and retain foreign capital flows, and their volatility, can limit a government's ability to change and choose between macroeconomic policies, and the need to compete with other countries for a limited pool of capital can diminish the benefits it can bring.

#### Volatility and Contagion

Commercial capital flows generally tend to be variable and unpredictable, depending heavily on market conditions. Equity investment, in particular, is subject to strong herd instincts on the part of investors, which makes it potentially a very volatile source of capital. This greatly increases the risks of financial crises and makes it much more difficult to plan economic policy effectively.

When a country's economic fundamentals are seen to be good and investment opportunities attract foreign equity investors, this can draw in still more investment. The effect of large scale investment inflows is to push up the values of shares and scarce assets such as real estate. If investors (domestic as well as foreign) expect this process to start, or to continue happening, they will deliberately invest in these assets, so as to profit from the capital gains they anticipate; and their investments, by increasing demand, will help to push prices up still further. This process can become self-perpetuating, so that a "speculative bubble" of unsustainable asset prices is created.

Ultimately, the realisation will set in (possibly because of adverse political or economic developments or just as a result of a change in market sentiment) that the prices of the assets have become unsustainable. At this point, investors will try to sell the assets, so as to avoid incurring losses as the prices fall; and the market will become flooded so that prices collapse. The whole process is largely self-fulfilling: prices go up mainly because investors expect them to, then they collapse because investors change their minds. See Figure ?.

#### DIAGRAM

Such speculative investments are almost entirely unproductive<sup>13</sup>, and bring few if any benefits beyond the private gain to the investor. In fact, the overall economic effects can be seriously negative, as domestic resources are diverted away from productive uses by the much higher rates of return available from speculation. As the East Asian financial crisis has amply demonstrated, the effects of the ultimate collapse of the market can be profoundly negative, in both economic and development terms<sup>14</sup>.

FDI is generally seen as much less volatile than equity investment, because, by its nature, it implies a longer-term relationship between the investor and the host country. Moreover, its proponents argue that profits will be lower when the economy is weak, reducing profit remittances.

Nonetheless, FDI may seriously compound the impact of shocks arising from the external economic environment or adverse domestic developments. This is because FDI flows are strongly procyclical in nature - that is, they are greatest when the economy is performing well, but may fall dramatically when it encounters problems<sup>15</sup>. While they are generally limited in scale, net outflows of FDI can occur and may persist for some time (Woodward, 1996a, p44 and footnote 18).

Moreover, recorded profits by no means always change in the opposite direction to investment flows, and may actually compound the problem. In South Africa, for example, profits on inward FDI ranged between \$500 and \$800m per year in 1984-8, rising dramatically to \$2.3-2.8bn per year in the politically uncertain period of 1989-93, before returning to their earlier level in 1994-5<sup>16</sup>. Coupled with some disinvestment, this gave rise to a cumulative outward net transfer of some \$14bn (more than 10% of annual GNP) over a 5-year period.

The East Asian crisis of 1997-8 and the Mexican crisis of 1994-5 have also demonstrated strong contagion effects between developing country equity markets. The Mexican crisis occurred for entirely predictable and country-specific reasons; but it led to a general loss of confidence in Latin American markets and "emerging markets" more generally, not for any rational reason, but largely because they were seen by creditors as a single category of markets. The same applied to a lesser extent in East Asia. Contagion creates an additional source of volatility: not only may a country be directly hit by adverse developments domestically or in international markets; it may also face a major reduction in capital flows due to problems in another country, merely because investors associate the two markets.

To give themselves some protection against the risks of a capital outflow, countries which receive substantial amounts of equity investment need to keep a high level of foreign exchange reserves, so that they can be sure of meeting the potential costs of capital repatriation, and to counter any speculative attack on the currency. This means that the foreign exchange cannot be used for other purposes, such as purchasing imports, which further reduces the potential benefits of the capital inflows arising from equity investment. For example, for each \$100m that comes into the country, perhaps \$50m might need to be kept in the reserves; and, while the return on the equity investment might be 25-30% PA, the return on reserves is likely to be in the order of 5% PA. Effectively, the country as a whole is borrowing money at a cost of 25-30% per year to invest it at 5% PA.

### **Effects on Vulnerability and Policy Constraints**

The risk of commercial capital flows causing a crisis (or compounding a crisis caused by other factors) greatly reduces the policy options available to governments. As the economy becomes more dependent on inflows of equity investment and FDI, so it becomes more important to keep the capital flowing in; and, as the stock of investment becomes greater, so the potential outflows grow, and it becomes ever more critical to avoid a loss of investor confidence which could precipitate a crisis. This means providing a policy environment that is attractive to foreign investors.

The volatility of commercial capital flows has important implications for economic policies.

“The greatest concern I have about canonizing capital-account convertibility is that it will leave economic policy in the typical “emerging market” hostage to the whims and fancies of two dozen or so thirty-something analysts in London, Frankfurt, and New York. A finance minister whose top priority is to keep foreign investors happy will be one who pays less attention to development goals. We would have to have blind faith in the efficiency and rationality of international capital markets to believe that these two sets of priorities will regularly coincide” (Rodrik, 1998, p11)

At the same time, recipient countries need both to prevent large capital inflows overheating the economy (ie., causing excessive demand growth, which tends to fuel inflation and causes a deterioration of the current account as imports grow faster than exports), and to deal with the economic volatility arising from variations in inflows.

Large and variable capital flows limit the ability of governments to control the money supply and the exchange rate for policy purposes, narrowing the policy options available. The money coming into the economy from export sales and capital inflows has, in effect, to be converted into local currency - that is, the dollars coming in are used to buy local currency. Conversely, local currency has to be used to buy foreign exchange to pay for imports and to finance capital outflows. If more money is coming in than going out, then more local currency is being bought than sold; and this means, either that the price of local currency (that is the exchange rate) rises; or that the Central Bank supplies the extra local currency required by buying the surplus foreign exchange to add to its international reserves, which increases the money supply, and thus inflation.

This creates potential problems. If the exchange rate goes up (appreciates), the production cost of exports increases in foreign exchange terms, so that the country's exports become less competitive in international markets. Similarly, imports become cheaper in local currency terms, and local producers have greater difficulty competing in the home market. If, on the other hand, the money supply is allowed to increase, so as to keep the exchange rate steady, this will fuel inflation, increasing production costs, and again making local producers less competitive. In either case, there is a serious risk that production will be reduced, increasing unemployment.

The government can act to counteract these effects, by "sterilising" the balance of payments surplus. This means that it sells bonds in local currency to the domestic market, so as to take back the money it needs to put into the economy to buy the surplus foreign exchange. However, this too has costs: by issuing bonds (that is, in effect, borrowing money), the Central Bank increases the demand for lending, which increases its price - that is, the interest rate. This deters investment by local producers.

Since the rate of return on the reserves will almost certainly be lower than the cost of domestic borrowing, there will be a negative effect on the public finances.

## WORLD BANK THEORY AND PRACTICE

The World Bank's (1997e) preliminary work on the policy issues arising from private sector capital flows has found that the most effective policies are the avoidance of real rises in the exchange rate and the pursuit of tight fiscal policies (ie., maintaining a small budget deficit or a budget surplus). An increase in the exchange rate is generally prevented by sterilisation, as described above. Tighter fiscal policies are intended in part to moderate the growth of demand by keeping government spending in line with tax revenue.

Pursuing tight fiscal policies during periods of large capital inflows also gives governments the option of loosening them (ie., allowing the budget deficit to increase or surplus to fall), to limit the contraction in demand caused by a sudden outflow of capital, without running unsustainably large deficits. Furthermore, it is argued, they allow the government to establish a reputation for sound budgetary policies, which is intended to increase the market's tolerance for less stringent policies when the circumstances require them.

This raises some interesting issues. Firstly, as noted above, the process of sterilisation increases local interest rates and thus discourages locally-owned investment. Therefore there is a trade-off: an increase in investment financed by foreign commercial flows will be at least partly off-set by a reduction in domestically-financed investment. While capital inflows should still increase total investment, the increase is likely to be less than the amount of capital inflows, and the shortfall will depend critically on how much new productive capacity they create<sup>17</sup>. This also accelerates the shift from local to foreign ownership of productive capacity in the domestic economy.

Secondly, higher interest rates, coupled with a fixed exchange rate, keeps the rate of return available locally above that in the international market. As long as foreign investors expect the fixed exchange rate to be maintained, this will promote still higher capital inflows, requiring still more sterilisation, and pushing interest rates yet higher. Sterilisation may therefore contribute to an ever-accelerating growth of capital inflows, which can be expected to come to an end (rather abruptly) only when the market loses faith in the fixed exchange rate, and anticipates a devaluation (as in East Asia in 1997). This adds still further to the "boom-bust" tendencies of commercial capital flows.

Thirdly, the implication that fiscal policy should be relaxed when financial flows are reversed is in marked contrast with the policy responses to the East Asian crisis imposed by the IMF just months after the World Bank study was issued in April 1997. In general, the fiscal positions of the countries concerned were already strong. Far from making use of the space thus created to adopt more expansionary fiscal policies when the crisis struck, the East Asian countries were pressed to exacerbate the economic decline by making their fiscal policies still more contractionary by increasing their budget surpluses, adding to the financial problems of domestic producers.

In practice, rather than being used an instrument for evening out the economic fluctuations associated with variations in capital flows, the process envisaged seems to be a ratchet effect, whereby fiscal policies are to be tightened in order to attract inflows, tightened further to avoid overheating while capital is flowing into the economy,

and then tightened still further when the capital flows back out. It is far from clear that this is sensible or even coherent.

Fourthly, as well as the fiscal and exchange rate policies discussed above, at least seven countries which received large commercial inflows also imposed or reimposed capital controls in the first half of the 1990s. These "were effective in the short run in reducing the overall magnitude of capital inflows as well as influencing their composition" (World Bank, 1997e, p172); and they appear to have been largely effective in limiting the contagion effect of the Mexican crisis (though not in protecting Mexico itself)<sup>18</sup>. The World Bank is somewhat negative in its conclusions on capital controls:

"The role of restrictions on capital movements...needs to be carefully circumscribed....In the longer term...the desirability of capital controls [is] questionable." (World Bank, 1997e, p217)

However, its grounds for taking this position seem extraordinarily weak, only one argument being presented.

"Regarding desirability, the central problem...is that by restricting the degree of financial integration, controls limit the gains that can be derived from [financial] integration - if for no other reason than they create perceptions of an unfriendly environment." (World Bank, 1997e, p218)

This would seem to cast some doubt on the case for extending the IMF's mandate to promote capital account liberalisation. If the World Bank cannot find any substantive argument against capital account restrictions, is there really a sufficient basis for adopting it as a universal policy prescription for developing countries?

Finally, the Bank sees both sterilisation and capital controls as becoming progressively less effective as financial integration advances, implying that policy options will be narrowed to almost exclusively fiscal instruments. Coupled with the single-mindedness with which fiscal tightening has been pursued at every stage of the process, this seems to reduce the scope for discretion in macroeconomic policy to virtually zero.

### **Capital Account Liberalisation and Financial Crises**

The drawbacks of commercial capital flows discussed above have important implications for the prescription of universal capital account liberalisation by developing countries, and for any attempt by the IMF to enforce it. The significance of capital account liberalisation is not only that it reduces the ability of governments to control the *overall level* of commercial capital flows, but also (and perhaps more importantly) that governments lose the ability to influence their composition and the level and terms of the individual *components*, except through broader economic policies. This may lead to an excessive build-up of liabilities which are more expensive or more volatile than is appropriate for the country concerned; and it is likely to have a significant effect on governments' ability to make economic policy in the future.

Capital account liberalisation entails the removal of controls, not only on capital inflows, but also - and equally importantly - on outflows. The case for this is that potential investors will be seriously discouraged from investing if they face the risk of restrictions on taking their capital out of the country. The removal of such restrictions thus encourages greater inflows. However, greater inflows also imply a faster build-up of liabilities; and, coupled with the removal of restrictions on the repatriation of capital, this entails a larger risk of much greater outflows.

Thus capital account liberalisation implies a much greater volatility of capital flows: more will flow in during good times, and more will flow out during bad times, giving rise to the potential for massive swings in net flows from year to year. This is compounded by the speculative nature of many such flows (eg., equity investments), and the herd-like behaviour of speculative investors. Assuming that investors pull out before the price falls so low that the returns fall to zero or below, the outflow will be greater than the inflow<sup>19</sup>.

In general, developing countries have tended to design economic policies specifically to attract capital inflows - in particular, maintaining fixed exchange rates coupled with relatively high interest rates. Mexico and Thailand have been notable examples. The subsequent financial crises in these countries demonstrate the serious risks inherent in this process, and may discourage others from pursuing this path in the future. Once a country has embarked on such a path, it becomes bound into it by the need to avoid the outflow of the capital which has been attracted. This entails the continuation of the interest rate and exchange rate regimes, possibly long after they have ceased to be viable. Again, Mexico and Thailand are clear examples: in both cases it was clear a long time before the crisis that a major devaluation would be needed sooner or later, but this appears to have been largely ignored by the market. (The Thai crisis suggests that speculators may be learning from experience, accelerating the transition from initial doubts to full-scale crisis.)

Apart from the resulting explosive increase in foreign exchange liabilities, this has potentially important effects for the domestic economy. In particular, the increasingly over-valued exchange rate makes domestic producers of tradeable goods increasingly uncompetitive, in both export and domestic markets; and the resulting loss of profitability, coupled with the high cost of capital due to high interest rates, discourages productive domestic investment. Together with the potentially high rates of return from speculative bubbles, this may divert domestic savings into unproductive speculative investments, inflating the bubble still further. When the bubble bursts - which is inevitable - the economic and social impact can be catastrophic.

Governments have little incentive to avoid the development of speculative bubbles (unless they are confident of still being in office when the bubble bursts), and still less to burst them. Rising property and share values can be expected to increase the popularity of the government among those who own these assets, ie., the richer, more influential sections of the population.

The Mexican and East Asian financial crises are illustrations of the problems which may arise from capital account liberalisation. There has been much dispute in the East Asian

case as to whether the cause of the crisis was the liberalisation of the capital account, or weaknesses in financial and banking systems. However, this is a false dichotomy, as the crisis was caused by the interaction of the two. Capital account liberalisation compounded the initial shortcomings of the financial system, by intensifying the pressures which led to speculative bubbles in stock markets and real estate. It thus made the scale of the potential crisis worse, as well as making it more difficult to manage or control. The crisis might well not have happened if the financial markets and banking systems had not been so weak in the first place; but, given their weakness, capital account liberalisation made the potential crisis inevitable and worse than it might otherwise have been.

The proponents of capital account liberalisation argue that the associated market discipline reduces the domestic causes of such potential crises. However, as the East Asian crisis demonstrates, this is potentially an immensely destructive mechanism. The greatest "economic miracle" of the post-war period has been brought to an end by an economic crisis which, for the countries concerned, is "of the same sort of order as the slump in America during the Great Depression"<sup>20</sup>. The capital inflows associated with capital account liberalisation may have contributed to the initial very rapid growth; but, given the very high domestic savings rates in the region, it is far from clear that the benefits of additional capital inflows significantly outweighed the negative effects of diverting local capital from productive to speculative uses, let alone the devastating effect of the bubble bursting.

As in the Mexican crisis (see above), the relationship between the impact of the East Asian crisis and the openness of capital account regimes, at least among the less developed countries of the region, is telling (Table 4). The slowest projected growth rates for 1997-9 are in Thailand and Indonesia which have gone furthest in liberalising their capital accounts; the fastest is for China, which has throughout maintained the least open regime. Malaysia (which reversed its initial liberalisation more substantially, to regain control of monetary policy) and the Philippines (which opened its capital account more recently than Indonesia and Thailand) fall between the two.

Among the high-income East Asian economies, the picture is less clear. The country with the greatest foreign exchange restrictions (Taiwan) is set to out-perform Hong Kong and Singapore, which have much more open regimes; but the margin is relatively small; part of the shortfall in Hong Kong is also likely to be affected by its reunification with China; and Korea, which also has a relatively restrictive regime, performs worst in this group.

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**Table 4: Openness of Capital Account Regimes, Cumulative Portfolio Flows and Impact of the East Asian Crisis**

<b>capital account regime</b>	<b>average growth 1997-9 (%PA)</b>	<b>GDP shortfall 1999 (%)</b>
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**low/middle-income:**

China	restrictive	7.6	4.2
Malaysia	opening reversed	3.6	10.3
Philippines	opened late	3.6	0.1
Indonesia	opening partly reversed	0.9	15.6
Thailand	opening partly reversed	-0.4	20.4

**high-income:**

Taiwan	restrictive	5.7	7.1
Singapore	open	5.1	8.4
Hong Kong	open	3.6	10.6
Korea	restrictive	1.5	17.8

**Notes:** GDP shortfalls are based on 1970-96 trend growth and 1997-9 projections from *The Economist* (1998). Capital account characterisations are based on this source and World Bank (1996b; 1997e).

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**EFFECTS ON MICROECONOMIC POLICIES****Competition for FDI**

FDI does not simply provide the host country with extra foreign exchange. Many other potential benefits have been identified<sup>21</sup>, including:

- transfer of knowledge and technology;
- improvements in managerial and other professional skills;
- job creation; and
- higher wages.

However, these benefits are likely to be dissipated by the process of competition for investment between countries (Woodward, 1996a, pp 65-68). Investment decisions by TNCs are very largely about *where* to invest rather than *whether* to invest. As FDI becomes relatively more important as a source of financing, there is an increasing incentive for developing countries to offer more favourable conditions to foreign investors as a means of attracting FDI away from alternative locations. Such policies may include:

- tax concessions and tax holidays, which reduce the revenues earned by the government;
- easing restrictions on profit remittances and capital repatriation, which may result in less profit being reinvested in the host country and make capital flows more

- volatile;
- relaxing restrictions on ownership, which could lead to a concentration of market power and limit the linkages with the rest of the economy;
- easing restrictions on the use of expatriate workers in senior and technical positions, and strengthening patent protection for imported technology, which can limit the potential for the transfer of knowledge; and
- removal of labour bargaining rights, which may lessen potential improvements in pay and conditions.

These policies may well increase FDI in the country which implements them, but to the extent that efforts to attract FDI are competitive, it will reduce investments elsewhere.

Smaller low-income countries are generally least able to provide the underlying conditions which are most conducive to FDI inflows, such as:

- a stable macroeconomic environment;
- rapid and sustained economic growth, leading to increasing consumer demand;
- effective legal systems;
- high educational levels; and
- good infrastructural services.

The main advantage which low-income countries have in attracting FDI is low wage levels, but low wages are no longer seen as a major factor in attracting FDI, and are generally insufficient to off-set these disadvantages - hence most low-income countries' relatively weak performance in attracting FDI flows. If they are to attract FDI flows against competition from middle-income countries with better underlying conditions, they will need to offer sufficient incentives, but by doing so, they risk competing away many of the potential benefits.

## **Political Implications**

As well as the direct constraints they impose on economic policies, direct and equity investment have potentially important political dimensions. As noted above, with very high rates of return on FDI, avoiding net foreign exchange outflows entails a very rapid increase in the stock of foreign investments. This in turn implies a commensurate increase in the role of TNCs in the economy. TNCs can thus be expected to acquire a major and increasing role in the political process, to defend their commercial interests. Moreover, their resources and corporate experience in political lobbying will generally be considerably greater than that of domestic interest groups, particularly those representing non-commercial interests, or even political parties; and their objectives will often be shared with other influential external agencies, such as the developed country governments and the IMF and the World Bank.

Coupled with the tight resource constraints, and often weak administrative capacity, of many governments, particularly in low-income countries, there is a real risk that TNCs will thus exercise a disproportionate influence in the policy-making process, skewing policies further towards their interests and, within the constraints imposed by their need to maintain political stability, away from the interests of the population at large. This suggests at best a weakening of the democratic process, and in some circumstances

may actually reinforce anti-democratic pressures<sup>22</sup>.

### **Conclusion: Are Capital Account Liberalisation and Commercial Flows Appropriate for Developing Countries?**

Official flows (particularly aid budgets) are declining, and infrastructure, health and education systems are being privatised. This suggests that sustaining North-South capital flows will become increasingly dependent on commercial financing. While this has indeed increased considerably over the past decade, a major part of the increase has been in the form of direct and equity investments; and there are a number of serious doubts about over-reliance on these types of investments as mechanisms for North-South financial flows, especially in low-income countries.

- They are extremely expensive in foreign exchange terms, relative to other forms of capital flows, especially for poorer countries.
- As a result maintaining a positive net resource transfer requires a continual and increasing supply of new capital flow, which entails a very rapid build-up of foreign exchange liabilities.
- They are strongly skewed away from poorer countries, whose efforts to compete for the available flows reduce the potential benefits to the host country.
- They are volatile, procyclical and (in the case of equity investment) subject to serious problems of contagion, increasing vulnerability to external shocks.
- They seriously limit a government's choice of economic policy, and over the longer term, they may seriously weaken the political system by increasing the role of TNCs.

This is not to suggest a blanket exclusion of commercial capital flows to low-income countries, but rather the need to avoid a universal opening to all forms of capital flows for all purposes. What is needed is a selective approach, to ensure that flows are limited to those which confer net benefits from a long-term developmental perspective. Simply seeking to sustain the volume of North-South financial flows could be seriously counterproductive if the liabilities created by commercial flows prove unsustainable, or if the wider effects of the flows themselves, or of the processes of opening the economy to them and attracting them, have negative effects on economic or human development.

This suggests

- that portfolio investment should generally be avoided by low income countries, as being too expensive and too volatile;
- that direct investment should be limited as far as possible to the creation of new capacity for the production of exports which will not have an adverse effect on other developing countries (eg., by depressing commodity prices), and other

sectors where the benefits of foreign investment to the rest of the economy outweigh the potential costs of the investment (eg., telecommunications); and

- that competition for FDI flows which reduces their benefits to host countries (eg., tax breaks, direct or indirect subsidies and preferential treatment) should be avoided.

In general, commercial bank lending and bond issues are likely to be preferable to direct and portfolio investment; but their much higher (and, in the former case, less predictable<sup>23</sup>) cost than official flows will seriously limit the extent of borrowing which is realistic for most low-income countries, quite apart from their limited access to such loans at present. While greater debt reduction could increase the scope for commercial borrowing, this would require substantially more progress than seems likely in the foreseeable future; and any significant shift towards greater commercial finance could easily bring a renewed debt crisis within a relatively short period.

If financial flows to low-income countries are to be increased significantly in such a way as to enhance rather than damage long-term economic and human development, this will require an increase in net official flows in grants or on concessional terms. This in turn requires an increase in aid budgets; a major reallocation of bilateral aid resources from middle-income to low-income countries; and/or a substantially greater degree of debt reduction than is currently envisaged (without an off-setting reduction in new flows).

For middle-income countries, the balance between the costs and benefits of commercial financing tends to be more favourable: the cost is lower; the build-up of the stock of investment is slower; economies are less subject to other external shocks (eg., due to the greater diversification of their export bases); and political systems are generally more robust. Nonetheless, caution is required; and the volatility of portfolio investment is likely to be a particular problem, as demonstrated by the East Asian crisis. Competition for FDI flows may again tend to limit their benefits, as well as attracting flows away from low-income countries which are less able to compete.

This suggests a need to retain some degree of control over commercial capital flows; and this is incompatible with the proposed extension of the IMF's mandate to include capital account liberalisation.

“Where knowledge is limited, the rule for policy makers should be: first do no harm. Enshrining capital-account convertibility in the IMF's articles of agreement is an idea whose time has not yet come. We have no evidence that it will solve any of our problems, and some reason to think that it may make them worse.” (Rodrik, 1998, p3).

It also suggests a need to coordinate policies towards FDI, and (for most low-income countries, at least) to regulate FDI itself. This is at odds both with the blanket liberalisation of FDI regimes and financial systems under adjustment programmes and with the proposed extension of the IMF's mandate. It also implies a radical change in the strongly investor-oriented view inherent in current international regulations and negotiations concerning FDI (eg., the Uruguay Round agreements on trade in services

and trade-related investment measures, and the proposed Multilateral Agreement on Investment).

## CHAPTER 4:

# The Volume and Terms of World Bank and IMF Resources

While there has been massive growth in commercial capital flows to developing countries in recent years, they remain concentrated in just a few countries - mainly those with large markets, good infrastructure and skilled labour. The World Bank and IMF are examining ways in which they can help other developing countries to attract more commercial flows, through the policy reforms attached to their adjustment loans, and through new instruments such as IDA guarantees to reduce risks to investors.

However, the poorest developing countries are likely to remain unattractive to commercial financing and unable to afford it, and will therefore be critically dependent on official financing for many years to come. Even those developing countries which can attract commercial flows still need finance from official sources. Commercial capital is expensive; it is only likely to finance projects with a high rate of return relative to risk; and the benefits tend to be skewed towards urban areas and better-off households. This means that governments concerned with reducing poverty or ensuring a fair distribution of resources will themselves need to finance less commercial projects, such as rural water and power distribution, schools and health services; and this is likely to require official financing.

Increasingly, official capital flows are being channelled through multilateral institutions, the most important of which are the World Bank and the IMF<sup>24</sup>. In contrast with commercial flows, official finance is:

- intended to support economic and social development in order to eradicate poverty; and
- not motivated by profit but made available on subsidised terms, and therefore, in principle, affordable to countries for which commercial finance is too costly.<sup>25</sup>

The questions are then:

- are official capital flows sufficiently concessional for the poorest countries?
- are the repayment terms of official flows to both low and middle income countries appropriate given that they are likely to be invested in projects whose financial returns may well be small, indirect and slow to materialise? and
- will enough official financing be available to meet development needs?

The Bank<sup>26</sup> and Fund<sup>27</sup> do not have an unlimited supply of resources (particularly concessional resources); and they therefore argue that the interest rates and repayment periods on their loans are constrained by the need for a continuing supply of resources to lend to other clients. This is a reasonable concern. However, if the Bank and Fund's programmes and projects perform as intended, then the need for new financing should diminish over time, as developing countries become less dependent on official financing and better able to access and afford finance from commercial sources. Thus the Bank the Fund should be able to reduce their lending volume over the long term.

## Current Terms

The degree of concessionality of a loan can be measured in terms of the "present value" of the payments due on it. In effect, this is the amount of money the borrower would need to have in a bank account, earning interest at the market rate, when the loan is made, so that all the payments due on the loan could be made from the account, and the final payment would reduce the balance of the account exactly to zero. This means that the present value of a loan lent at exactly the market rate of interest is exactly equal to the amount lent.

The degree of concessionality of BWI lending varies considerably between sources.

- International Bank for Reconstruction and Development (IBRD) loans are non-concessional, bearing interest at approximately market rates, so that the present value is approximately equal to the amount of the loan.
- International Development Association (IDA) credits bear interest at a fixed rate of  $\frac{3}{4}\%$  per year, and are repayable over 40 years (including a grace period of 5 years, during which only interest is paid), so that a \$100m loan gives rise to a debt of about \$40m in present value terms (assuming a market interest rate of 6% per year).
- IMF loans from the Enhanced Structural Adjustment Facility (ESAF) also bear interest at  $\frac{1}{2}\%$  per year, but have a shorter maturity of ten years (including five years' grace), so that a \$100m loan gives rise to a debt of about \$63m in present value terms.

This makes ESAF loans substantially more expensive, and IDA credits more concessional, than the average of new commitments from official lenders for low-income countries: the average terms of new loans from all official sources to the severely-indebted low-income countries in 1996 (including IBRD/IDA, but excluding the IMF) were 34 years total maturity at an interest rate of  $1\frac{1}{2}\%$  (World Bank, 1997f). This implies a present value in the order of \$50m per \$100m borrowed.

Despite the relatively low cost of ESAF and IDA loans, some of the poorest developing countries owe a major part of their overall debt to the Bank and Fund<sup>28</sup>. Payments made by governments on their debts are consuming a growing proportion of their revenues, leaving less revenue to fund essential investments and recurrent spending (World Bank, 1996c).

The Bank and Fund have historically refused on principle to cancel debts owed to them. Instead, in many cases they have provided new loans to repay older loans falling due - a practice known as "defensive lending". However, this has not prevented the build up of debt; and the Fund and Bank have recently introduced the Heavily Indebted Poor Country Debt Initiative (HIPC Initiative) to allow multilateral debt cancellation for qualifying countries (see below). However, the question remains whether IMF and Bank resources could be provided on more favourable terms, to prevent the build up of debt becoming unsustainable in the future.

## Effects of Greater Concessionalality

Clearly, it would be preferable from the point of view of borrowers if loans from the Fund and Bank were more concessional. This can be achieved in two ways: by reducing the interest rate; or by extending the repayment period of a loan.

Lowering interest rates is unlikely to be feasible for IBRD loans, because they are financed by the Bank's borrowing on international financial markets. If the interest rate were reduced, the returns to the Bank would be insufficient to cover the cost of borrowing, and it would make a loss (or at least make a smaller net income). This in turn would reduce the resources available for alternative uses<sup>29</sup> (eg debt reduction for low-income countries and support to post-conflict reconstruction programmes - see table 5), which are generally of higher priority than reducing the cost of borrowing to middle-income countries.

Indeed, the Bank has recently decided to raise the costs of IBRD loans, so as to maintain its real income. It was announced on 31 July 1998 that the interest rates charged to IBRD borrowers will be increased by 0.7%<sup>30</sup>. In addition a one-time charge of 1% will be made when each loan is made effective<sup>31</sup>.

Nonetheless, IBRD loans remain cheaper than financing from commercial lenders, who generally charge substantially more than market rates to provide profit margins and to compensate for the risks of non-payment. This suggests that IBRD borrowers could benefit from extending the maturity of IBRD loans, helping to off-set the effects of the higher interest rates and charges.

Extending the maturity of IBRD loans would have little or no impact on the Bank's financial position - it would merely mean that the Bank would need to borrow on longer maturities, or borrow more to bridge the gap from when repayments were originally due until they were actually made. However, since repayments would be made over a longer period, the IBRD's loan volume would be higher at any given point in time. If the capital-plus-reserves constraint were binding this could limit IBRD's capacity to make new loans(see below).

**Table 5: Uses of IBRD Net Income, FY 1995-7**

	<b>FY 1995</b>	<b>FY 1996</b>	<b>FY 1997</b>
Net income	\$1,354m	\$1,187m	\$1,285m
IDA	\$300m	\$250m	\$600m
IDA Debt Reduction Facility	0	\$100m	0
Trust Fund for Gaza/West Bank	0	\$90m	\$90m
Emergency Assistance for Rwanda	\$20m	0	0
Trust Fund for Bosnia/Hercegovina	0	\$150m	0

HIPC Debt Initiative Trust Fund	0	0	\$500m
<b>Total</b>	<b>\$320m</b>	<b>\$590m</b>	<b>\$1,190m</b>
Residual	\$1,034m	\$597m	\$95

**Sources:** World Bank (1996, p170); World Bank (1997d, p188).

Similarly, the very low interest rates currently charged on ESAF and IDA loans ( $\frac{1}{2}\%$  PA in both cases) severely limits the scope for increasing concessionality by lowering them further<sup>32</sup>. Moreover, these rates only cover the Bank and Fund's administrative costs of arranging the loans.

A potentially more fruitful option would be to lengthen the grace and repayment periods:

- extending the grace period of IDA credits from five years to ten years, and allowing interest payments to be capitalised (ie added on to the loan rather than paid) during this period would reduce the present value of a \$100m loan from \$40m to \$32m;
- extending the total repayment period from 40 to 50 years as well would reduce the present value further to \$27m;
- doubling the repayment period of ESAF loans (to 20 years, including 10 years' grace period) would reduce the present value of a \$100m loan from \$66m to \$46m.

However, increasing concessionality would not be costless. Debt-service payments on IDA credits (IDA reflows) are used to finance new IDA credits, implying that fewer resources would be available from this source to re-lend in the future. Also, some IDA credits are used to refinance non-concessional IBRD debts held by low-income countries - a significant element of the debt strategy for some highly-indebted poor countries. However, since only new credits would be subject to the new terms, the effect on IDA reflows would materialise relatively slowly, which should allow the refinancing of IBRD loans to continue until they had been fully repaid.

While the sacrifice of future lending for increased concessionality might well be worthwhile overall, it is difficult to argue that IDA credits are generally (let alone universally) too expensive. It is therefore probably more realistic to argue for more concessional terms in specific circumstances where there is a particular case for greater concessionality, because of a country's solvency situation, its liquidity situation during the extended grace period, or the nature of the project to be supported (see Box 1).

Such circumstances might include, for example:

- credits to the poorest low-income countries;
- credits to other low-income countries which already have unsustainable debt burdens;
- support to countries in post-conflict situations, where liquidity can be expected to be weak for an extended period; or
- support for projects and programmes where the foreign exchange benefits are

indirect or slow to materialise, particularly in the social sectors (eg health,

#### BOX 1: Liquidity and Solvency

There is an important distinction between two different types of financial problem which may be faced by developing countries: liquidity problems and solvency problems.

A liquidity problem arises when a country does not have enough foreign exchange to meet the debt-service payments and other obligations due at a particular point in time, although it would ultimately be able to meet all its obligations if they were delayed long enough. This generally arises when creditors are unwilling to lend, for example because of a loss of confidence, even though the country would be able to service the loans. If a country has a liquidity problem, its main need is for more foreign exchange going into the economy, to meet its immediate obligations. There may be a limit to the terms of the new loans it can afford; but this is a secondary consideration.

A solvency problem arises when a country would never be able to meet all its obligations, however long they were delayed. Even if creditors are willing to defer the country's obligations, or lend more money to finance them, the obligation in the future would increase. Insolvency problems can only be tackled by cancelling existing obligations (eg through debt cancellation), or by improving their terms either directly (eg by lowering interest rates or by deferring obligations at interest rates well below the market rate) or indirectly (eg by providing grants or highly concessional loans to meet the obligations).

education, safety net programmes, etc).

The precedent for extending the terms of ESAF loans has been established by the HIPC Initiative (see below). However, the additional cost of providing greater concessionality on ESAF loans more generally would need to be met from the interest subsidy accounts<sup>33</sup>. This implies that any increase in concessionality would require either more donations to these accounts or a reduction in the volume of lending (so that the same amount of subsidy could be spread more thickly).

Any increase in the subsidy account would almost certainly come from bilateral aid budgets, and thus reduce bilateral flows to low-income countries. In principle, the IMF could contribute from its own resources, including sales of its gold reserves, but this is unlikely and probably less desirable than using the available resources to finance the HIPC Initiative (see below).

The cost of doubling the maturity of ESAF loans would be \$20m per \$100m of loans affected (the difference between the present value before and after the change). This suggests two options: either this cost could be met by diverting \$20m of bilateral aid into the ESAF subsidy account or the total subsidy could be reduced back to its original level by reducing the level of ESAF loans by about 40%.

Either of these options would have a significant effect on the liquidity position of low-

income countries. In the former case, this would probably occur at the beginning of the process, as bilateral aid flows were reduced so that the money could be paid into the ESAF subsidy accounts. In the latter case, it would be spread over the period for which the ESAF remained in operation, which would be substantially longer. In either case, the effect would be a substantial short-term cost to low-income countries, to be off-set by savings in debt-service payments later. It is far from clear that the benefits would necessarily justify the costs. Moreover, policy conditions attached to IMF loans make them less attractive than bilateral loans or grants.

## **Larger Loans?**

### **INCREASING ESAF LENDING**

A recent independent evaluation of the ESAF (Botchwey et al, 1998), recommended an increase in ESAF loans to countries which have reached the "post-stabilisation" phase of adjustment (although they proposed achieving this by making ESAF lending more selective rather than by increasing the total volume of ESAF lending, as discussed in the next section).

At present, the IMF assumes that a country no longer needs ESAF resources once it has achieved stabilisation, because private sector and other aid resources become available to it. In practice, however, IMF resources have not been replaced by commercial capital flows. Commercial lenders and foreign investors tend to rely on the IMF's "seal of approval" on a country's economic policies as a basis for their investment decisions; and governments often cannot afford the spending on infrastructure, health services, education, etc which is necessary to "crowd in" private investment.

By providing more loans in the post-stabilisation phase, in support of an "investment-oriented" (as opposed to a "stabilisation-oriented") programme, the review argues, the IMF could help to encourage commercial capital flows, both by supporting necessary spending and by sending a clear signal that the country has good investment potential. Thus a country would graduate from a crisis (or stabilisation) phase into a second phase of increasing investment before graduating from IMF concessional financing completely.

ESAF lending could be increased by the provision of additional resources from bilateral donors. These would include contributions to the capital available for ESAF lending (in the form of loans at commercial interest rates), equivalent to the increase in lending; and donations to the subsidy accounts, amounting to about one-third of the increase. The latter would come from aid budgets, reducing available bilateral aid. Since these donations would again be made at the beginning of the process, while the increase in lending would be spread over a longer period, it is likely that there would be a negative effect on the liquidity of low-income countries in the short term, to be off-set by an improvement later<sup>34</sup>.

Besides such financial considerations, there is also a danger that continued IMF involvement in these countries through the provision of more ESAF money may not provide the correct signals to commercial lenders and investors. While adjustment programmes have benefitted investors by reducing regulation and bureaucracy, and

liberalising trade and foreign exchange markets etc., the lack of success of previous ESAF programmes may in fact have deterred investors.

“It is argued that adjustment may have hastened disinvestment. This could be due to the overriding short-term effects of devaluation on profits in foreign currency. Investors are concerned that this deterrent to manufacturing is so great there may be no medium to long term prospects left...However, SAPS [structural adjustment programmes] have neglected structural and social issues such as infrastructure or labour skills, and regional integration. In addition stochastic shocks can sometimes throw the reform effort into chaos. Investor confidence is undermined by bad advice from BWIs [Bretton Woods Institutions] that results in bad programme design, and by hasty implementation” (Bhinda and Martin, 1997, p18)

This is consistent with the widespread evidence of declining investment during adjustment programmes. (See, for example, World Bank, 1988; World Bank, 1990; Mosley et al, 1991; Woodward, 1992.)

Continued IMF involvement in the post-stabilisation phase would also legitimise continued involvement by the IMF in aspects of developing countries' economic policies where it has little expertise and a questionable track record. Apart from questions of competence, this also raises important issues relating to national sovereignty and democracy.

#### INCREASING IDA LENDING

An increase in IDA lending would need to be financed either by greater bilateral contributions or through a larger transfer from the IBRD's net income. Bilateral contributions would come directly from aid budgets thus reducing bilateral aid. Since most bilateral aid is provided on grant terms, while IDA credits need to be repaid, this would be likely to represent a deterioration in the terms of new financing - although this would be off-set eventually by increased IDA lending in the future, since debt-service payment on IDA credits are recycled into new IDA lending.

In order to be worthwhile, the use to which IDA resources are put would need to be better than alternative bilateral uses by a margin sufficient to off-set this deterioration. While this might well be the case for some donors (eg the US, Japan and Italy, whose aid programmes are distorted towards more prosperous developing countries, are largely tied to their own exports, are lent on relatively expensive terms, and/or support projects of relatively low quality or low developmental priority) it is less likely for others (eg the Scandinavian countries, the Netherlands and the UK) who provide better targeted, less tied and higher quality aid on more favourable financial terms. Moreover, if the Bank continues to encourage more private sector provision of infrastructure, such as power generation, this implies that government investments will largely be focused on sectors that are unlikely to generate substantial financial returns, particularly in the short to medium term, e.g. health and education. This suggests that this type of investment might be better supported by grants from bilateral donors rather than IDA loans.

Thus the case for increasing IDA resources is finely balanced, and would require a more detailed assessment, based on the relative quality of IDA and bilateral aid programmes (including the conditions attached to them) and the distribution of contributions between donor countries, as well as the purely financial effects. This argument applies equally in reverse to a reduction in IDA lending, in that the benefits of the bilateral aid resources released by reducing IDA contributions could outweigh the costs of lower IDA lending.

Alternatively, the Bank could channel more of its IBRD net income into IDA. However, this would involve a trade-off between resources for IDA and resources for other non-self-sustaining programmes (see Table 5) and/or IBRD lending (see below).

The Bank's other arms also earn generate profits, most notably the International Finance Corporation (IFC), which lends to and invests in private sector projects. The link between the Bank's objective of reducing poverty and many of the projects supported by the IFC appears at best tenuous. This suggests a strong case for establishing a mechanism for transferring a proportion of the IFC's net income (which is currently recycled into future IFC operations) to IDA and other priority initiatives.

It is conceptually possible that the World Bank could use its reputation as an honest broker to catalyse private investments in priority projects with large social benefits, such as water distribution systems, in poor countries. However, its private sector arms and IBRD guarantee programmes have to date shown little poverty focus or clear targeting (Wilks, 1997).

#### INCREASING IBRD LENDING

Prior to the East Asian crisis, the case for increasing IBRD lending would have appeared to be quite weak. However, the costs of relying on commercial finance and the crisis that can ensue when these flows are rapidly reversed, suggest that some countries will, from time to time, require substantial IBRD resources to off-set economic crises<sup>35</sup> and their social consequences; and that some countries that appeared to have graduated from the IBRD will need to borrow again.

In principle, IBRD lending can be increased without substantially reducing other official flows to developing countries, as it is financed by borrowing on the market rather than by contributions from bilateral aid budgets<sup>36</sup>. However, IBRD is required to limit its lending and guarantees to the value of its capital and reserves. The capital-plus-reserves constraint is not currently binding, coming into effect at \$198.7bn, compared with outstanding loans of \$106bn in mid-1997 (World Bank, 1997d, p206). However, the capacity for future lending is much more limited than these figures would appear to imply, as outstanding loan commitments (including the parts of loans which have been approved but not yet disbursed) were \$157.4bn in mid-1997 (World Bank, 1998d, p186). Moreover, subsequent lending (particularly the Bank's participation in "bail-out" packages for South East Asian countries) will have brought the total of outstanding loans much closer to the limit: IBRD disbursements this year and next are forecast to be \$16bn higher than the Bank expected last year<sup>37</sup>.

Previously expected disbursements (net of principal repayments) may have been in the order of \$1-2bn per year, suggesting an increase in outstanding and disbursed debts to around \$140-142bn. Adding in undisbursed commitments might bring the total to \$190-195bn, only slightly below the statutory lending limit (although the constraint would be eased by further principal repayments before outstanding commitments were disbursed). Nonetheless, this does suggest that the Bank would need to start taking greater account of the statutory lending limit in considering its lending.

This means that any increase in lending would require:

- an increase in the Bank's capital;
- a faster accumulation of reserves, by increasing the Bank's net income or retaining a greater proportion of it; *or*
- a relaxation of the capital-plus-reserves rule.

The scope for the first of these options is probably limited, because it is unlikely to be accepted by member countries, who would have to provide the additional capital (although the cost to them would be relatively small)<sup>38</sup>.

The recent changes in the IBRD's interest rates and loan charges will add to its net income but this is primarily to compensate for a decline over the coming years as relatively profitable fixed interest rate loans are paid off, and floating rate loans form a progressively larger part of the Bank's portfolio<sup>39</sup>. World Bank President Wolfensohn announced at the 1998 Spring Meetings that the Bank's income was set to halve between fiscal year 1996 [when it was \$1.2bn] and fiscal year 2005. By fiscal year 1999 income would be too low to inflation-proof its \$25bn capital base<sup>40</sup>.

The increase in charges will broadly off-set the projected decline in income but is unlikely to increase it significantly from its present level<sup>41</sup>. Building-up reserves would therefore require further increases in charges which are unlikely to be politically acceptable in the near future.

Since neither accumulating more reserves nor increasing the capital base appears feasible, the options narrow to a relaxation of the capital-plus-reserves rule. This would allow the Bank: 1) to increase its lending with the same level of reserves; or 2) to reduce its reserves while maintaining the current level of lending. Given that its lending may soon be constrained and that other middle income countries such as Russia and Brazil may need to borrow in the near future if the contagion from the East Asian crisis continues, some increase in lending may be needed. However, this will limit the resources released from the reserves to fund other programmes such as the HIPC Initiative (see below). There is therefore a trade-off between increasing IBRD resources to help middle income countries through potential crises and increasing resources for the HIPC Initiative to help the poorest countries climb out of their chronic debt-trap.

Any relaxation of the capital-plus-reserves rule would be strongly resisted by the Bank's Management (who have generally been successful in influencing the members on such issues), on the grounds that any significant reduction in its reserves would jeopardise its AAA credit rating; and that this would increase the cost of its borrowing on international financial markets. Any such increase in costs would have to be passed on

to IBRD borrowers in the form of higher interest rates. While this argument is disputable<sup>42</sup>, the recent decision to increase charges to IBRD borrowers strengthens the Management's position, as members will be reluctant to risk increasing the costs of loans further.

## **SELECTIVITY**

An alternative to increasing the overall volume of Bank and Fund lending is to lend more money to fewer countries. The Bank has shifted towards this approach, motivated by Dollar and Burnside's (1997) finding that aid resources are only effective in a "sound" policy environment<sup>43</sup>; and, as noted earlier, the recent independent review of the ESAF has recommended a similar shift on the Fund side, proposing that increased ESAF lending to "post-stabilisation" countries should be financed by restricting ESAF loans to countries that demonstrate a commitment to a "good policy environment".

This approach raises a number of inter-related issues. Firstly, World Bank and IMF lending are of central importance to the overall financing available to developing countries, both directly and (especially in the Fund's case) as a catalyst for other sources of official and commercial financing. This means that those countries excluded under the selectivity approach would face severe financial and, in turn, social consequences<sup>44</sup>. This threat could give the Bank and Fund greater power to dictate economic policies to developing country governments.

Secondly, there is a risk that exclusion under the selectivity approach would affect the poorest developing countries disproportionately, since their very poverty and lack of resources limit their ability to pursue "sound" policies (eg by contributing to conflict, weakening administrative capacity, etc).

Thirdly, the Bank and the Fund may be very inflexible in their interpretation of what constitute "sound" policies. Historically, the Bank has shown a marked tendency to prefer promoting the free-market policies it believes in, rather than investigating their actual economic effectiveness or the merits of alternative policies on an objective basis<sup>45</sup>, or observing the preferences of national governments, however strong their democratic credentials. The former is again particularly important for low-income countries, where the evidence of the appropriateness and effectiveness of the Bank's preferred policies is weakest. If the Bank is to adopt the selectivity approach, it will be important that objectivity, flexibility and the values and interests of national populations should prevail over ideology. Otherwise, it would simply be another method of imposing conditionality. (For a discussion of the failure of conditionality and alternative proposals see Bretton Woods Project, 1998, forthcoming).

Finally, both the Bank and the Fund may well find in practice that their ability to be selective in their lending is in practice constrained by the need to carry on providing loans to heavily indebted countries (both low- and middle-income), to enable them to continue servicing the debts they are already owed - that is, by the need for defensive lending (Caufield, 1996, pp 320-22). Historically, the Bank in particular has generally sought to keep making net transfers to its borrowing member countries (that is, to provide more in new loans than is due in debt-service), so as to maintain the incentive

for borrowers to continue servicing their debts. If the selective approach were adopted, some countries would face the prospect of continuing outward net transfers to the Bank over a prolonged period, and would therefore have little incentive to go on servicing their existing Bank debts; and the Bank might well face a growing arrears problem as a result. This in turn would require part of IBRD net income to be allocated to loan loss provisions, reducing either the reserves (and thus the level of future lending) or else the resources available for other uses of net income (as outlined above).

In short, there may be a case for greater selectivity in Fund and Bank lending but there must be serious doubts about the criteria which they currently envisage. A broad debate should take place before this move is finalised, as others may feel that other factors, such as a government's commitment to poverty reduction and the existence of a poverty reduction strategy or democratic governance structures are more appropriate than the macroeconomic ones.

### **Conclusion: Cost, Quantity or Quality?**

This Chapter has focused on the questions of cost and quantity - the possibility of increasing the concessionality of IMF and World Bank lending or increasing the amount available. If it were thought desirable to make IMF and World Bank lending more concessional, the most practicable (and politically realistic) way of doing this would be to extend their maturities rather than to reduce the rates of interest charged. However, this could come at a substantial price in terms of the availability of resources, particularly in the case of ESAF, for which this option should probably not be pursued. It might, nonetheless, be beneficial to extend IDA maturities on a selective basis; and extended maturities on IBRD loans could be useful as a way of compensating borrowers for the recent (or any future) increase in interest rates and charges.

While mechanisms are, in principle, available to increase the resources for lending by the IFIs, in most cases these would represent little more than a switch of control over an essentially fixed amount of aid from bilateral to multilateral donors. Unless it can be demonstrated that this would lead to an improvement in the overall quality of aid, this is unlikely to be justifiable. While a reorientation of the economic policies supported by the Fund and Bank would make this more likely, a sufficient shift in this direction seems unlikely in the foreseeable future. This option should therefore not be pursued unless and until such a reorientation takes place.

The cost of multilateral loans arises less from their terms of repayment than from the transfer of policy control from borrowing governments to the Bank and Fund whose conditions have proliferated into more areas of government policy, with no obvious increase in the success of their programmes. The frequent weaknesses in the preparation, design and implementation of their programmes and projects suggests that there may be more scope for improving the quality than the quantity of multilateral lending. A number of measures could be taken to achieve this.

- IMF and World Bank staff could ensure that governments participate fully in the process of formulating programmes and projects and that civil society is consulted, so as to improve their design and ensure that governments are more

committed to them. The Bank has recently established a working group to examine how to build the principles of ownership and participation into the process of designing and implementing country programmes. It is now consulting with other donors, governments and civil society about a new approach it is developing<sup>46</sup> (World Bank, 1998b).

- Flexibility could be built into the programme cycle so that programmes coincide with a government's term in office rather than an arbitrary 3-year cycle. The Bank is currently considering this option (World Bank 1998c).
- The remit and powers of the Bank's internal quality control mechanisms, such as the Operations Evaluation Department and Inspection Panel, could be broadened, for example by extending the Inspection Panel to include projects supported by the IFC and MIGA (Center for International and Environmental Law, 1997; Bank Information Center, 1997); and an independent evaluation mechanism called be established for the IMF (Wood and Welch, 1998).
- The Bank's incentive structures could be changed so that staff are rewarded for the results of projects rather than the volume of money spent on them (Rich, 1994; Tjonneland, E. N., et al, 1998).
- A mechanism could be developed whereby the Bank would assume a portion of the burden of repayment for projects which fail due to poor Bank advice or project design (Caulfield, 1996).

## CHAPTER 5: **Debt Relief Versus Aid?**

### **The Benefits of Debt Reduction**

There is little doubt that reducing public debts would help heavily-indebted low-income countries (Martin, 1997, Box 1). However, if debt reduction consumes resources that would otherwise have been made available as aid then there is a trade-off. In considering this trade-off, it is necessary to assess:

- the potential benefits of debt reduction to recipients;
- the costs of debt reduction to creditors;
- the extent to which these costs will impinge on aid; and
- the costs of any resulting reduction in aid on the recipient countries.

A distinction must also be made between debt reduction which simply reduces the level of scheduled debt repayments to the level which the country would otherwise have paid (that is, it merely prevents the build up of arrears by cancelling debt which would not have been paid anyway) and debt reduction which reduces debt repayments beyond this level and therefore frees up government resources for other uses.

Debt has essentially two types of effect on the economy.

- a. Servicing debts takes resources away from alternative uses, particularly in terms of imports, government spending and investment.
- b. Anticipation of the economic effects of debt (slower market growth, higher taxation, uncertainty in policy making, etc) discourage private investment.

Reducing debts to the level which would otherwise be repaid will only reduce the debt overhang effect (b), since actual debt-service payments are not reduced. Further debt reduction beyond this level will have both types of effect.

Debt reduction can also have a beneficial effect from the point of view of new aid flows by reducing or eliminating the need for defensive lending. If, for example, IDA resources are being used in effect to service existing debts (as they are in many cases), then reducing the debts should release at least part of this money for other, more productive, uses - for example to relieve pressure on recurrent spending for health, education and administration, or investment in infrastructure. This could add significantly both to economic growth and to human development.

### **The Costs of Debt Reduction**

The costs of debt reduction to creditors can be considered from two perspectives:

- (a) the economic cost, corresponding with the loss of income to the creditor; and
- (b) the accounting cost, corresponding with the amount which the creditor needs to find to make its accounts balance.

From this perspective, debt reduction can be divided into three notional parts.

- Reducing debts to the value of payments which would otherwise have been made has no economic cost, in the sense that there is no reduction in the payments which are received by the creditor over the long term. This element of debt reduction is no more than a recognition of losses which have already been incurred, and the accounting cost should, in principle, be met from loan loss provisions. Since these do not form part of the base for new lending, capital flows should not be affected.
- In practice, however, loan loss provisions may be inadequate to cover the reduction of debts to the level at which they would otherwise have been paid. While there is still no economic cost, the accounting cost will need to be borne sooner than would otherwise have been the case; and this will need to be met from some source other than provisions. This is likely to have some effect on new lending in the short term, in effect bringing forward an effect which would otherwise have occurred later (and possibly more gradually).
- Any reduction in debt *beyond* the payable level will have both an accounting and an economic cost. This will need to be found from other sources, and is likely to have an effect on new financing which would not otherwise have occurred even in the long term.

In the context of IMF and World Bank debts, however, there is an added complication, in that any reduction implies a reallocation of costs (economic and accounting) to the Fund and Bank from bilateral creditors. The Bank and Fund have historically maintained the value of their debts by refusing to reduce them, leaving all the potential losses to be borne by commercial and bilateral creditors (who have tacitly allowed this). In the absence of multilateral debt reduction under the Heavily Indebted Poor Country Debt Initiative (HIPC Initiative), the costs of non-payment would therefore have been borne mainly by the bilateral creditors<sup>47</sup>. This is therefore the base-line against which the effects of the HIPC Initiative should be judged.

### **Bad Debt Provisions**

In practice, it seems unlikely that a significant part of debt reduction by the Fund and Bank under the HIPC Initiative will be financed from provisions. IDA does not have any loan loss provisions:

"no provision for credit losses has been established because it is not practicable to determine such an amount in view of the nature and maturity structure of the credit portfolio. Should actual losses occur, they would be charged against IDA's Sources of Development Resources." (World Bank, 1996, p212)<sup>48</sup>

The IMF and IBRD do have provisions; but the approach taken to provisioning is based, not on the solvency of a country and its long-term repayment capacity, but rather on its repayment record, and particularly whether its up-to-date with its debt-service

payments. In effect, it has been implicitly assumed that the Bank and Fund's preferred creditor status will protect them from a general inadequacy of debt-servicing capacity in a borrowing country, by enabling them to push the costs onto other creditors. This assumption does not appear to have changed, despite the prospect of multilateral debt cancellation under the HIPC Initiative<sup>49</sup>.

However, virtually all of the countries with arrears covered by the Fund's provisions of SDR1.8bn (\$2.5bn) in April 1997 are categorised as HIPCS (Liberia, Somalia, Sudan and the Democratic Republic of Congo), the sole exception being the Federal Republic of Yugoslavia, which accounted for only 3% of the total. In principle, this should mean that some \$2.4bn of provisions<sup>50</sup> could be used to provide debt reduction to these countries (assuming that by doing so they cleared their arrears and attained a sustainable debt position).

However, this is complicated by the unusual nature of the Fund's provisions (Special Contingency Accounts 1 and 2). These have been financed by increasing interest rates charged to borrowers and cutting the rates paid to lenders to the Fund, with the proviso that they will be refunded when the arrears of the countries whose debts are covered by them are cleared. This means that the provisions could only be used to the extent that the contributors, developed and developing countries, agreed to waive their rights to the refunds.

While the World Bank's latest Annual Report (World Bank, 1997d, p207) states that "IBRD has taken the situation of [the HIPCS] into account in its review of the adequacy of the Accumulated Provision for Loan losses", it does not appear that provisions have actually been made for these countries' debts. Bad debt provisions amounted to \$3.21bn in mid-1997, marginally less than the \$3.25bn of debts owed by countries in non-accrual status (those with arrears of more than three months - ie DR Congo, Iraq, Liberia, Sudan, Syria and FR Yugoslavia - plus Bosnia), including overdue interest and charges. HIPCS account for only 10-15% of these debts, suggesting that some \$350-450m of provisions could be used for the HIPC Initiative. Again, however, this would be contingent on the countries concerned (DRC, Liberia and Sudan) qualifying for debt reduction.

This suggests that the resources available to finance debt reduction from the existing bad debt provisions of the IMF and the IDA are likely to be inadequate, even under the HIPC Initiative as it stands, so that it will need to be financed from alternative sources. The extent of the impact on aid and the level and cost of capital flows will be critically dependent on which sources are used.

## **World Bank Sources of Financing for Debt Reduction**

### **ARRANGEMENTS UNDER THE HIPC INITIATIVE**

The World Bank has separate mechanisms for dealing with the debts owed to IBRD and IDA under the HIPC Initiative:

- IBRD debts will not be reduced, but will continue to be refinanced by IDA credits on a year-by-year basis under the "Fifth Dimension" programme;

- IDA credits due for cancellation under the HIPC Initiative will be purchased from IDA by the HIPC Debt Initiative Trust Fund for an amount equivalent to the present value of the debt-service payments due on them. The (accounting) cost to IDA of the cancellation is thus limited to the difference between the face value of the credits and their present value; and the economic cost is zero (since IDA will receive the value of the payments due from the Trust Fund). The Trust Fund is to be financed, primarily at least, by transfers from IBRD net income. The Executive Board approved a transfer of \$500m into the Trust Fund in FY 1997.

In principle, this will actually increase the amount available for IDA disbursements, or at least bring them forward: instead of receiving, say, \$100m of payments (in present value terms) over a period of up to 40 years, which can only be used to finance new credits when they are received, IDA will have \$100m available for immediate disbursement. However, there will be a cost to the IBRD's net income, reducing the resources available for other purposes (see table 5) and/or the level of IBRD lending (see below).

As well as the ultimate debt cancellation, IDA resources will be provided on grant terms to HIPCS between the decision point and the completion point. This implies some loss of future lending (because of the loss of IDA reflows) but this will be relatively limited and spread over the repayment period of the credits concerned (ie over the next 35-40 years).

However, while resources in the Bank's Trust Fund should be sufficient to allow the level of IDA debt reduction currently envisaged under the HIPC Initiative - and possibly some additional reduction due to over-optimistic projections for the HIPCS - it would be unlikely to provide the resources for any expansion of the HIPC Initiative, or for any reduction in the post-HIPC level of debt. Any significant movement in this direction, such as that called for by many NGOs<sup>51</sup>, would therefore require more resources, probably from alternative sources.

#### SOURCES OF ADDITIONAL RESOURCES

The scope for increasing the use of the IBRD's reserves to finance debt reduction is probably limited. As noted earlier, the IBRD's reserves already represent a constraint on its new lending; and interest rates and charges to borrowers have recently been increased to off-set an expected fall in income. More of the reserves could be used to finance the HIPC Initiative only at the expense of reducing IBRD lending and/or the other uses of the IBRD net income (including IDA).

There may nonetheless be a case for a modest contribution from this source, though primarily from a political perspective. This would have the advantage of spreading the financial burden more widely and thinly (in that it would extend the net to IBRD borrowers, though at a very small cost to any individual country); and this could be useful as a lever against reluctant developed country governments. ("If Mexico/the Philippines/Poland is contributing, why shouldn't the US/Japan/Germany?", etc.) Against this, the IBRD borrowers can be expected to resist any move in this direction,

and the Asian (and Russian) crises would make at least the more sceptical developed country governments reluctant to press the point.

A second possible source of additional financing is IDA's accumulated surplus, which amounted to \$2.0bn in mid-1997. However, since this is part of IDA's general resources, its use to finance debt reduction would directly reduce its lending. It would therefore be preferable to find an alternative financing mechanism. The same applies to future IDA reflows, which would also have the disadvantage of delaying the availability of resources for debt reduction.

## **The IMF's Sources of Financing for Debt Reduction**

### **ARRANGEMENTS UNDER THE HIPC INITIATIVE**

The IMF's contribution to debt reduction under the HIPC Initiative will come from special ESAF grants, which will be paid into escrow accounts<sup>52</sup> for use in later years to pay debt-service due to the Fund. These may be supplemented by ESAF loans, on longer maturities than at present (20 years, including 10 years grace) to smooth out the debt-service profile where payments due are bunched. These grants and loans will be made from the ESAF-HIPC Trust Fund, but the sources of financing for this fund remain unclear.

The Fund approved in principle a transfer of up to SDR180m from the Reserve Account (ie from its accumulated income) to support this Trust Fund in financial year 1997. However, this transfer will be made only if contributions from other sources prove inadequate (Decision No. 11434-(10/97) ESAF, of 4 February 1997; IMF, 1997, p197); and, when the ESAF-HIPC Trust Fund is eventually liquidated, repaying this transfer will be the first call on the remaining resources (IMF, 1997, p200).

There is also the possibility that 5m ounces of the Fund's 100m ounces of gold reserves could also be sold and invested, the income (though not the capital) being credited to the Trust Fund. However, a decision on this has been deferred as not yet being necessary (IMF, 1997, p121). This delay reflects a reluctance on the part of the Fund's Management to override the opponents of the proposal (especially Germany), even though the latter do not have enough votes at the IMF Board to prevent the sale.

It appears that the IMF is hoping to finance the Trust as far as possible from bilateral contributions. As of April 1997, one donation of SDR2.3m (\$3.2m) had been received from Finland, and a deposit of SDR14.6m (\$20.4m) from an unnamed source. In the latter case, however, the resources available to support debt reduction will be limited to the profit on its investment above the 2% interest rate to be paid over the five year duration of the deposit, which might represent another \$3-4m. Further contributions are likely to have been received subsequently.

### **IMF GOLD SALES**

The use of the IMF's gold reserves to finance debt reduction is quite feasible and practicable, and would have no effect on new lending in the foreseeable future. The only cost is the opportunity cost of not being able to sell the reserves for an alternative

use in the future; and although it is unlikely that any future use of these reserves would be as beneficial as debt reduction for the HIPC now. The opportunity cost is further reduced by the poor prospects for the world price of gold<sup>53</sup>.

The main obstacle to IMF gold sales is political rather than economic. German opposition is the main reason for the delay. It also represents a serious obstacle to any improvement on the present very limited proposal (to allocate only the investment income on sales of 5m ounces of gold to the ESAF-HIPC Trust). This would provide a capital sum of around \$1.2bn, providing income to the Trust Fund of perhaps \$60m per year. While this could provide some \$300-400m over six years, the delay in the decision to sell the gold will reduce this amount, by about \$5m per month, although this will be affected by any change in the gold price. The delay has reduced the amount potentially available for debt reduction by nearly 40% (\$225m) over the last sixteen months<sup>54</sup>.

The relatively limited opportunity cost of gold sales as a source of funding for debt reduction suggests that this should be a high priority. The resources to be generated by the current proposal for gold sales will almost certainly be needed to finance the Fund's contribution to HIPC, so the question is largely one of when rather than whether the 5m ounces should be sold. Moreover, the investment income on the proceeds of gold sales is likely to be both greater than any rise in the gold price and a great deal more certain.

There would also be a strong case for a much more ambitious proposal - for example the sale of half of the Fund's 100m ounce gold reserves, and the use of the capital rather than merely investment income to finance debt reduction<sup>55</sup>. The use of investment income rather than capital represents an important constraint on the acceleration of the HIPC process; and the total resources available limit the overall extent of debt reduction. These are important constraints on the effectiveness of the HIPC Initiative in terms of reducing the debt to a genuinely sustainable level from the perspective of economic and human development.

While there would be strong opposition to this proposal it would nonetheless be worth pursuing. Merely securing acceptance of the principle that the capital proceeds of gold could be used for debt reduction rather than investment income could raise an additional \$800-900m for debt reduction, even if only 5m ounces were sold.

#### ALTERNATIVE SOURCES

The scope for using ESAF funds to finance debt reduction would be relatively limited even if the ESAF itself were abolished. In effect, the funds available would be limited to the amount available for interest rate subsidies, rather than the amount available for loans<sup>56</sup>. However, the loans themselves would also be lost, at least to the low-income countries (who could not afford them without the subsidy)<sup>57</sup>.

In principle, there would thus be a direct trade-off between debt reduction and the subsidies available (in present value terms) on future ESAF loans. The direct financial benefit would thus be limited to bringing forward the receipt of the subsidy; and there would also be a loss of new financing considerably greater than the amount of debt

reduction. While there should be some additional benefit from reducing the debt overhang (and there could be a further indirect benefit from the reduction of conditionality, if this is seen as harmful), the abolition of ESAF would need to be justified on its own merits, rather than as a means of financing debt reduction.

In principle, it would be possible to use an additional part of the Fund's general reserves to fund the HIPC Initiative, to be repaid by the additional interest on the recent loan to Korea (and any similar loans made in the near future). This use of the excess interest appears to be envisaged as a possibility by UK Chancellor Gordon Brown in his evidence to the House of Commons International Development Committee (1998, p76). However, the exceptional circumstances of Korea (as the richest country likely to require IMF financial support in the foreseeable future) suggest that further loans of this nature are unlikely within the time-scale of the HIPC Initiative.

### **The Trade-Off**

In assessing the debt-reduction/aid trade-off, it should be noted that the effects of debt reduction and of aid are somewhat different, and will depend on the nature of the aid which is lost. The use of aid is to a great extent within the control of the donors, and much of it will be ear-marked to specific investment projects. The cost of losing this aid will depend to a considerable extent on the nature of the investment concerned, as well as on its financial terms.

By contrast, debt reduction (beyond the level at which debt would otherwise have been paid) releases resources which can be allocated to any purpose (subject to whatever conditionality may be applied). Even if each \$1 of debt reduction is off-set by a \$1 reduction in aid, this may be beneficial if resources for recurrent spending are a major constraint, or if the aid lost would have supported a relatively low-priority project.

The timing of benefits is an important consideration to take into account. The effect of a reduction in aid applies essentially to the year in which the aid would have been received (although the future income on the investment which it would have financed is lost). In the case of debt-reduction, the effect is a continuing stream of benefits: other things being equal, the debt will be lower (and the debt overhang reduced) in every future year. Similarly, if the debt is reduced below the payable level, the saving on debt servicing will also continue for an extended period.

The strength of the trade-off between aid and debt-reduction in terms of their effects on investment and growth is very difficult to assess, and the results are critically dependent on the specification used. Based on the (rather simplistic) approaches taken in Woodward (1996b), for example:

- the relationship of new investment to the stock of debt and net inflows of official finance suggests that \$1 of aid is equivalent in its effect to \$20-25 of (nominal) debt reduction; but
- the relationship of the growth rate of investment to changes in the debt stock and in net inflows of official financing suggests that \$1 of aid is equivalent to about \$3

of (nominal) debt reduction<sup>58</sup>.

However, three important factors should be noted in considering these results. Firstly, while the above figures are based on changes in the nominal (face) value of debt, the cost of debt reduction is equivalent to the change in its present value (as defined earlier). Accordingly, a \$1 reduction in nominal debt costs substantially less than \$1 - perhaps in the order of \$0.75<sup>59</sup>. Secondly, as noted above, the effect of \$1 of aid is limited to the year in which it is received, and should therefore be fully captured in the above estimates, while debt reduction generates a continuing stream of benefits, of which the above estimates include only a single year. The real trade-off which we need to consider is therefore between the one-year effect of aid, and the present value of the whole stream of benefits from debt reduction.

Taking account of these factors, and assuming that the stream of benefits from debt reduction continues indefinitely, the effect of \$1 of debt reduction is roughly equal to that of \$1 of additional aid based on the first relationship, and about 7-8 times as much based on the second. This would appear to suggest that, even if there were a one-to-one trade-off between debt reduction for the HIPCS and aid for low-income countries, the net effect would at worst be neutral and could be strongly positive.

As discussed previously, it would be relatively easy to ensure that the trade-off with aid was less than one-for-one - and at least possible to eliminate it entirely. This would make the effect unambiguously positive. Prioritising the sources which only have an impact on aid flows well into the future (eg IDA reflows) would also tend to increase the net benefits. Even with a one-to-one trade-off with immediate aid disbursements, the effect could be made more positive by diverting aid flows which have a below-average development impact, eg., those on less favourable financial terms, tied to exports from the donor country, or for low-quality or low-priority projects.

Clearly, this conclusion must be treated as tentative, because of the very basic analytical methods used. However, there is some reason to expect that the net benefits may be under-stated: the estimates above exclude investment in human capital (health and education) and a range of other factors which may contribute substantially to growth (eg., maintenance of infrastructure, administrative capacity, political stability, etc.); and these are likely to benefit more from debt-reduction than from aid, as they are primarily related to recurrent spending rather than to investment.

## **Conclusion**

In summary, there are a range of options for financing debt reduction. These should be ordered in terms of their effects on financial flows to developing (and particularly low-income) countries, and used in sequence until the point is reached where the costs to developing/low-income countries of reduced capital flows equal the benefits of debt reduction. Where exactly this point occurs requires further investigation.

The sequence implied by this approach is broadly as follows.

- Loan loss provisions. While IDA has no such provisions, some \$1-2bn of IMF

and IBRD provisions could be released to support the HIPC Initiative, provided DR Congo, Liberia, Somalia and Sudan qualified for debt reduction, and some IMF members waived their rights to refunds of their contributions to Special Contingency Accounts 1 and 2.

- The capital proceeds of sales of the IMF's gold reserves (with the largest volume of sales politically attainable). Even the 5m ounces whose sale is currently proposed could raise \$1¼bn if used in this way; and in principle sales of ten times this amount should be feasible. This would provide around \$12bn at the current world price. This could be used to cover other multilateral debts, prioritising those in the weakest financial position (notably the AfDB), as well as those owed to the IMF.
- IBRD reserves released by relaxing the capital-plus-reserves constraint on lending. Allowing the Bank to lend 10% more than its capital and reserves could allow the Bank both to increase its lending by \$15bn and to use \$5bn of reserves to finance additional debt reduction<sup>60</sup>.

Taken together, these sources could provide around \$18-19bn for the reduction of multilateral debts, at a minimal cost in terms of new finance; provided the political constraints could be overcome. The net effect of debt reduction financed in this way would be clearly positive. There may also be some other funds within the IFIs which would also fall into this category.

Using the following funding sources would imply a roughly one-for-one trade-off between aid and debt reduction. These could still provide net benefits, if \$1 of debt-reduction is more beneficial than \$1 of new financing from the source concerned (given its uses, terms, etc); but these will be more limited than the previous sources. These sources should be prioritised to the potential net benefits of the capital flows affected.

- Bilateral contributions to multilateral debt reduction. These would be likely to come directly from aid budgets; but where aid budgets are poorly allocated, and the cost is borne by low priority uses (eg hidden trade subsidies and politically motivated support for countries with limited need for aid), there would be substantial benefits.
- IDA reserves and reflows. These contribute directly to new IDA credits, which would therefore be reduced if these sources were used to finance debt reduction. In view of the highly concessional nature of these resources, this should probably be avoided. As with the ESAF, any argument for a reduction or reorientation of IDA credits would need to be justified on its own merits.

While the cost of using bilateral contributions to finance multilateral debt reduction is relatively high, this would not be the case if genuinely additional resources could be generated. One possibility for this would be to secure agreement from those bilateral donors which are not already doing so to meet their international commitment to provide development assistance of 0.7% of GNP for a single year, on a one-off basis, expressly for debt reduction, for example to mark the Millennium. This would generate additional

resources of around \$100bn (Woodward, 1998) - equivalent to about half of the total debt of all the HIPCS (in present value terms), even before taking account of the debt reduction likely under existing mechanisms.

If current efforts to provide adequate debt-reduction for low-income countries were to fail, other financing mechanisms might be feasible in the long term. These would include, for example, the proceeds of a "Tobin tax" - an internationally-applied tax levied at a very low rate (generally assumed to be a fraction of 1%) on all international currency transactions. The sheer volume of such transactions means that such a tax would raise very considerable sums (possibly hundreds of billions of dollars per year), which would provide plentiful resources for debt reduction and other priority development needs<sup>61</sup>.

However, the practical and legal problems of establishing such a tax, together with the considerable political resistance to its introduction, mean that this is only a possibility in the long term. To rely on this as a means of financing debt-reduction would mean seriously delaying the process, to the detriment of countries whose need for debt reduction is urgent.

## Conclusion

The IMF and the World Bank have been instrumental in the development of a new paradigm of North-South financial flows, dominated by commercial capital. However, some of these financial flows have played a central role in the East Asian and Russian financial crises. The international community has to address problems arising from the new paradigm while the problems arising from more traditional financial flows - the chronic debt problems of the poorest countries - persist.

Undaunted, the Bank is moving still further in this direction, through the development of guarantees for commercial capital flows; and the Fund is seeking to consolidate and accelerate the process, by extending its mandate to encompass the liberalisation of capital account transactions. At the same time, both institutions are increasingly preoccupied with massive rescue packages in response to the East Asian and Russian crises. However, while they have made some belated efforts to deal with the continuing debt problems of low-income countries, through the HIPC Initiative, this has received neither the attention nor the resources that it needs.

This raises a number of serious issues, which this paper has sought to address. Clearly, given the scale and scope of this paper, the answers are fairly tentative. Nonetheless, the discussion does suggest a number of areas of serious concern, which raise equally serious questions about the roles of the Fund and the Bank in relation to North-South financial flows.

There must be real doubts about the appropriateness of the new paradigm even in the better-off and more robust developing economies, let alone in the poorest and least-developed. The financial cost of commercial capital flows is high, and is generally higher in poorer than in richer countries. The benefits of portfolio equity investment, in particular, appear limited, and the costs and risks attached to it are considerable. Even in the case of direct investment, the benefits may be considerably less than is widely assumed, and may well be insufficient to compensate for the high rates of return demanded by investors, especially in low-income countries. The East Asian crisis shows all too clearly the risks inherent in the new paradigm of unfettered movement of large commercial financial flows.

This raises serious doubts about the proposal to extend the IMF's mandate to cover the liberalisation of capital account transactions. The case for such a change seems to be based almost entirely on theory and supposition, for which there is little if any evidence. Recent experience, particularly of the Mexican and East Asian crises, seems to point ever more strongly in the opposite direction; and even the World Bank's support for this proposition seems at best half-hearted. This would seem to argue strongly for the proposal at least to be deferred until the potential effects can be rigorously investigated in the light of recent developments.

The promotion of commercial capital flows to low-income countries seems particularly questionable. However, if aid budgets continue to decline, the continued exclusion of these countries from commercial flows would seem to imply an ever-decreasing level of capital inflows. Increasing IMF (ESAF) and World Bank (IDA) lending would not help: this would represent little more than a shift in control over a more or less fixed level of

aid.

Greater debt reduction for the poorest and most heavily indebted countries could be much more helpful. This would not only reduce the outflows of debt-service from these countries, but also help to increase investment by removing the "debt overhang" effect. Moreover, this need not have a substantial effect on aid flows, if the financing were appropriately designed.

In all these areas, what is needed is a paradigm shift *within* the Fund and the Bank. At present, their actions are driven by their world view and the interests of their largest shareholders - the major developed country governments. They have promoted commercial capital flows, based on an instinctive belief that markets work and the encouragement of their major shareholders, whose multinational companies, institutional investors and banks profit from such flows. They have launched massive "rescue packages" for Mexico, Russia and the East Asian countries, because the same commercial interests would stand to lose billions of dollars (and the developed countries would risk contagion) without them. By contrast, their efforts on the debts of the poorest countries have been belated and limited, partly because of an underlying belief in the sanctity of contracts, and partly because some major developed country governments are reluctant or indifferent, while the beneficiaries are among the poorest countries - and the smallest shareholders.

## APPENDIX

World GDP growth for 1992-2020 is projected at 2.9% PA. This might suggest annual growth in the demand for non-oil primary commodities of perhaps 1½% PA (since in most cases demand grows more slowly than income). If output of these commodities exceeds this rate, prices will fall in real terms, as supply increases faster than demand. As noted above, such a reduction is envisaged, amounting to 1-2% PA. Since the price elasticity of demand for most primary commodities is also relatively low (that is, the price falls faster than supply increases), this might be compatible with output growing by, say ½-1% PA faster than demand growth - that is, at about 2-2½% PA. While the faster decline in real oil prices, coupled with greater income and price elasticity of supply, would allow a faster growth rate for oil exports, this might still be limited to about 6% PA.

This means that much of the projected growth in the region's exports will have to come from increased exports of manufactured goods. A rough estimate suggests that these might need to increase by 9-10% PA in 1997-2006, and by 14-16% PA in 2007-20. These rates of growth would be exceptional for most countries: for 2007-2020, such a growth rate is in line with the exceptional performance of East Asia in 1991-6, and much faster than recorded or projected for any other region between 1980 and 2020. In 1981-94, only Thailand and Hong Kong achieved export growth of 14% or more (World Bank, 1997e, Table 5). It seems implausibly optimistic to assume such strong growth in manufactured exports from Sub-Saharan Africa.

This interpretation of the projections also implies an increase in the share of manufactured goods in the region's total exports from around 20% at present (concentrated in a handful of countries, most notably South Africa, Mauritius and Zimbabwe) to 70-75% by 2020<sup>62</sup>. Again, this seems highly improbable.

It is nonetheless possible, in principle, that the projections could be internally consistent. Firstly, the commodity price projections appear to refer to 1997-2006, while the export volume figures refer to 1992-2020. It is therefore possible that the export growth (and the associated reduction in commodity prices) is expected to occur mainly in 2007-20, so that most of the volume growth is included in the projections, but most of the resulting fall in prices is excluded. However, this would imply a much greater decline in export prices than that envisaged above, and a marked acceleration in this deterioration after 2006. Even without this assumption, the projections suggest a serious decline in the terms of trade (that is, the price of exports relative to imports), of around 18% by 2020, even assuming that manufactured export prices keep pace with import prices.

This interpretation is clearly possible; and the increase in the export growth rate between 1997-2006 and 2007-20 would appear to be consistent with this general pattern. However, this would represent a far from positive outlook. By reducing the real growth rate of export revenues well below the volume growth projection, it significantly reduces the proportion of countries for which commercial borrowing would be sustainable from 2007 even if they had attained a sustainable starting position.

Secondly, it is possible that a faster fall in the prices of commodities exported by Sub-Saharan Africa (associated with faster output growth) is off-set by slower falls or actual

increases for other commodities. This would imply a faster decline in Africa's export prices, and a slower growth of its export revenues, throughout the period, making commercial borrowing more clearly unsustainable up to 2006 and less likely to be sustainable thereafter.

Thirdly, it is possible that a rapid increase in the production of commodity exports by Sub-Saharan African producers could be off-set by a reduction in production elsewhere. However, this seems unlikely. It is by no means obvious that the price declines projected would be sufficient to induce a substantial reduction in output by other producers: overall non-fuel commodity prices are projected to be higher in 2006 than in 1991-2 (World Bank, 1997e, Figure 1-10, p18); and those for metals and minerals above their 1993 trough.

Moreover, historical experience suggests that most producers have tended to be reluctant to wind down production in primary (or other) sectors even when their goods are produced at greater cost than those supplied by producers in other countries and they are able to produce alternative products more competitively. Often governments will provide large subsidies or impose protectionist measures to maintain the sectors concerned. Agriculture in the EU and the US are conspicuous examples. Some countries have even responded to falling world prices or intensified competition by developing new productive capacity using alternative technologies (eg cocoa in Malaysia, cut flowers in the Netherlands, rice in the United States).

This appears to be the view taken in the Bank's projections, at least for agriculture (which accounts for around three-quarters of SSA's non-oil commodity exports. Taken together, World Bank (1997e) Tables 1-8 and 1-9 imply an increase in the market shares in primary agricultural exports between 1992 and 2020 for the OECD countries (from 57.6% to 57.8%), the newly-industrialised economies (from 2.0% to 4.8%) and the "Big Five" (China, India, Brazil, Indonesia and the transition economies, from 13.7% to 18.5%). This reduces the share available for other developing countries from 26.7% to 18.9%. While this includes various other regions, the prospects for an absolute increase in Sub-Saharan Africa's share within this dramatically decreasing envelope seem limited.

If Sub-Saharan Africa's market share is to decline over this period, this means that a given growth rate of world exports of commodities will be associated with a significantly slower rate for Sub-Saharan Africa. To illustrate, if the growth of world supply is 2-2½% PA, as assumed above, and SSA's share of the world market falls at the rate suggested by the "rest of the world" figures cited above (that is, by about a quarter between 1996 and 2020), the region's agricultural exports would grow at no more than ¾-1¼% PA. If this were the case, manufactured exports would need to grow still faster than is suggested above, and the proportion of manufactured goods in total exports would reach an even more implausible level.

## END NOTES

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## GLOSSARY<sup>63</sup>

**Appreciation:** an increase in the value of the local currency in terms of foreign currencies.

**Arrears:** payments (on debts or for receipt of goods and services) which should have been made, but have not.

**Balance of payments:** a country's receipts and expenditure in international trade and financial transactions.

**Balance of payments support:** foreign exchange, generally in the form of loans from official creditors intended to allow the recipient to run a larger current account deficit than would otherwise be possible.

**Bilateral creditor/donor:** government which provides loans/grants to another government.

**Bond:** a form of debt which is transferable between creditors. The issuer (debtor) agrees to repay the bond at a specified date usually at a fixed rate of interest. They are generally repaid in a single installment.

**Budget support:** finance from official creditors/donors to support government spending in particular sectors, such as education or health.

**Capital account:** the part of the balance of payments which details capital flows other than grants in and out of the country. All the items in the capital account give rise to foreign exchange liabilities and future foreign exchange outflows from the recipient country, in the form of interest to lenders and profit repayments to investors.

**Capital flow:** foreign exchange in the form of grants, loans or investment.

**Capital investment:** investment in machinery, equipment, a factory, inputs etc., used in the productive process.

**Commerical creditors:** creditors in the private sector.

**Commercial interest rate:** an interest rate corresponding to that charged on commercial transactions.

**Commerical risk:** the risk that a loan to a private sector company will not be serviced in full because of a deterioration in the borrower's financial position.

**Commodities:** unprocessed agricultural produce and minerals.

**Concessional loan:** loan on which the interest rate is below the commercial rate.

**Contagion:** the phenomenon whereby developments in one country's economy lead to similar developments in another country's economy.

**Current account:** part of the balance of payments which details the difference between receipts for exports of goods and services and expenditure on imports of goods and services, plus grants from official creditors and workers' remittances.

**Debt overhang:** the excess of a country's external debt over its long-term capacity to pay, which acts as a discouragement to adjustment and investment.

**Depreciation:** a reduction in the value of the local currency in terms of foreign currencies.  
**Disbursement:** the payment to a borrower of all or part of the sum to be borrowed.

**Domestic borrowing:** money borrowed by government or private company/individual from residents in the same country. The loan is made in the local currency.

**Foreign borrowing:** money borrowed by government or private company/individual from a foreign source. The loans is made in a foreign currency.

**Foreign Direct Investment (FDI):** investment made by an company or individual resident in one country in productive capacity in another country.

**Grace period:** under a loan or rescheduling agreement, the period during which no principal payments are made.

**Herd instinct:** the tendency for investors to follow each other when making the decision whether or not to invest or disinvest in/from a country or sector.

**International capital market:** the international market for financial capital in the form of loans, deposits, financial investments, etc. the term relates essentially to commercial transactions.

**Multilateral creditor:** international agency providing loans.

**Net transfer:** the overall transfer of financial resources between a country and its investors/creditors.

**Portfolio equity investment:** investment in shares (also known as equity investment).

**Present value:** this is the amount of money the borrower would need to have in a bank account, earning interest at the market rate, when the loan is made, so that all the payments due on the loan could be made when they fall due from the account, and the final payment would reduce the balance of the account exactly to zero.

**Price elasticity of demand/supply:** the extent to which demand for/supply of a good or service changes in response to a change in its price.

**Private sector:** activities undertaken by individuals or commercial businesses.

**Profit remittances:** transfers to foreign investors of part or all of the profits on their investments.

**Public sector:** activities undertaken by the government.

**Rate of return:** the average annual income on an investment as a percentage of the amount invested.

**Recurrent spending:** the continuing operational costs of an investment, as opposed to its initial capital cost.

**Reserves:** a government's holdings of foreign exchange, usually held by the Central Bank.

**Return:** income earned from an investment.

**Syndicated bank loans:** a commercial bank loan in which a number of banks participate.

**Terms of trade:** the ratio between the average price of exports and the average price of imports, expressed as an index. The terms of trade show how much a country can buy abroad for each unit of exports it sells.

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1 . The following (World Bank) convention is followed in debt terminology in this paper: loans from and debts owed to the private sector are referred to as commercial, and loans from and debts owed to governments (or guaranteed by government agencies in the creditor country) as official; loans to and debts owed by private sector companies are referred to as private (private non-guaranteed if they are not covered by guarantees provided by the government of the borrowing country), and loans to and debts owed by the public sector as public.

2 . The arrangements in the IMF's Articles for the removal of controls on current account transactions essentially represent a ratchet mechanism: while exchange restrictions which exist when a country joins the Fund remain (largely) protected, the introduction of new restrictions (including the reintroduction of restrictions which have been removed) is heavily proscribed. Article VIII Section 2(a) of the Fund's Articles of Agreement states that "no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions". This is modified by Article XIV Section 2 to allow a member to "maintain and adapt to changing circumstances the restrictions...that were in effect on the date on which it became a member", but this in turn is subject to a requirement that "members shall withdraw restrictions maintained under this Section as soon as they are satisfied that they will be able, in the absence of such restrictions, to settle their balance of payments in a manner which will not unduly encumber their access to the general resources of the Fund". While this places the decision firmly on the member government, the Fund has some scope for over-riding their decisions: "The Fund may, if it deems such action necessary in exceptional circumstances, make representations to any member that conditions are favourable for the withdrawal of any particular restriction, or for the general abandonment of restrictions" (Article XIV Section 3). If the member retains the restriction, a process may be initiated culminating in the member's effective expulsion from the Fund, under Article XXVI.

3 . For a description of some of the major types of investors see Ganzi and Seymour (1998) and Singh (1998).

4 . Loans which are guaranteed are treated in statistical sources as if they were borrowed or lent by the guarantor - that is, as debts of the public sector if they are guaranteed by the government of the recipient country, and as debts to governments (official debts) if they are guaranteed by an export credit guarantee agency.

5 . The first two trends are likely to be substantially understated because private non-guaranteed loans are almost certainly under-estimated in 1990 and 1996 (as witness the under-reporting of such loans to East Asian countries revealed by the current financial crisis); and derivatives and inter-bank deposits are not included in the data.

6 . Gross commercial borrowing by governments increased from \$51.7bn in 1991 to \$69.8bn in 1993, and to \$99.2bn in 1996. However, while commercial principal repayments fell slightly between 1991 and 1993, they increased from \$46.3bn to \$65.6bn between 1993 and 1996, so that net lending rose only from \$23.5bn to \$33.6bn. Over the same period, grants and net official lending fell from \$53.5bn to \$34.7bn, so that overall external financing for governments fell from \$77.0bn to \$68.2bn, while interest payments increased from \$44.8bn to \$63.9bn. This implies a reduction in net transfers (grants and loans minus principal and interest payments) from \$32.2bn to just \$4.1bn in three years.

7 . Domestic debts are also potentially problematic in a number of low-income countries, particularly in view of their much weaker tax bases in many cases: if domestic interest payments are 5% of GDP, and government revenue is 30% of GDP, as in Brazil, one-sixth of the money the government raises will go in interest; but if government revenues are only 15% of GDP, as in

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Tanzania, the proportion rises to one-third. Apart from Tanzania, other low-income countries with large domestic debts include Ghana, Kenya, Malawi, Tanzania and Zimbabwe.

8 . Bhinda and Martin, 1997, p8.

9 . Bhinda and Martin, 1997, p15.

10 . This might be explained by TNCs selling some of their assets to local investors, thereby realising the capital gains accumulated over previous years, and repatriating the proceeds.

11 . There is, of course, a substantial overlap between privatisation and FDI in services: "some 40 percent of the revenues generated by privatization programs during the 1990s have been directed to services, and this share has increased rapidly in recent years" (World Bank, 1998, p22).

12 . According to the sensitivity analysis of the projections (World Bank, 1991, Box Table 4.3, p50), faster export growth coupled with much higher FDI (\$65bn per year in 1991-5, compared with a projection of \$27bn per year for the 1990s as a whole) should have added 2½% per year to the overall growth rate for developing countries. In addition, real US interest rates were 2% less than projected, which should have added a further 0.4% PA, although a shortfall of perhaps 1% in OECD growth would be expected to reduce developing countries' growth by 0.7% PA. This combination of circumstances implies a growth rate significantly above the "high" scenario, not only for developing countries as a whole (by 2-2½% PA), but also for every individual region.

13 . There may be some production, for example where investment in real estate entails the construction of new buildings rather than the purchase of existing ones. However, most of the capital gain is likely to be in the value of the land rather than of the building; and much of the construction which takes place during a speculative boom may well be surplus to long-term requirements.

14 . This occurred in Latin America in 1994-5, and in East Asia in 1997. Equity flows to Latin America fell from \$27.2bn in 1993 to \$7.2bn in 1995, while flows to East Asia fell from \$14.4bn in 1996 to an estimated \$1.5bn in 1997. Moreover, these aggregate figures understate the severity of the reversal for the most seriously affected countries. Equity flows to Mexico fell from \$14.3bn to just \$0.5bn in 1993-5, a reduction equivalent to 6% of 1995 GNP; and those to Argentina fell from \$5.5bn to \$0.2bn. Since the loss of confidence in East Asia did not become a full-scale crisis until the middle of the year, it seems likely that there was a substantial net outflow in the second half of the year in at least some countries.

15 . This is most clearly demonstrated by the experience of Latin America in the 1980s. After the debt crisis of 1982, Latin America faced a particularly acute need for foreign exchange (and for investment), as foreign lending dried up and adjustment weakened economic activity. This problem was compounded by a major reduction in FDI, which remained well below its 1980-82 level throughout the rest of the 1980s. Only once the foreign exchange constraint was relieved by renewed access to foreign lending in the early 1990s (so that FDI was less needed as a source of foreign exchange) was there a substantial recovery in direct investment inflows.

16 . The reason for this is far from clear, but may involve some degree of creative accounting.

17 . Equity investment and FDI through the purchase of existing assets will only create new capacity to the extent that the original owner invests the proceeds of the sale productively in the local economy.

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18 . Five of the six countries categorised as less affected by the Mexican crisis were among those which imposed or reimposed capital controls, while the sixth (Korea) already had a relatively restrictive capital account regime. Apart from Mexico itself, only Brazil was among the seven countries classified as more affected by the crisis despite tightening capital controls.

19 . An essentially similar process could occur without capital account liberalisation or inflows of foreign capital; and it would still have damaging economic effects. However, there are two critical differences. Firstly, a domestically-financed speculative bubble is limited by the domestic resources available for investment, whereas with capital account liberalisation the resources available to inflate the bubble are virtually unlimited, both accelerating and compounding the process. Secondly, while a domestically-financed bubble will have an impact on the financial system, with capital account liberalisation there is also a serious effect on the balance of payments, which greatly complicates the policy response.

20 . "Asia's New Jobless", *The Economist*, 25 April 1998, p20.

21 . However, not all these benefits actually arise in all cases. For example, the transfer of technology is often limited where foreign investment is in assembly plants, particularly in "enclave" areas with limited linkages to the rest of the economy; improvements in managerial and technical skills may be limited by the use of ex-patriate staff in senior positions; and the effects of job creation may be off-set by the displacement of locally-owned firms from the market in the case of non-tradeable goods and services.

22 . The role of TNCs (particularly US-based fruit companies) in Central America, especially from the 1920s until the 1940s, illustrate the potential problems. (See Barry et al, 1982; or, for a more measured assessment, Bulmer-Thomas, 1987, pp285-7).

23 . Interest rates on commercial loans generally vary in line with market rates, whereas most official lending is at a fixed interest rate.

24 . While other multilateral institutions such as the Asian and Inter-American Development Banks and the European Union are growing in importance, the Bank and Fund are still dominant in terms of their influence on policy and research agendas.

25 . The International Finance Corporation is slightly different in that it provides resources to the private sector for projects which are expected to earn a profit so that they will be self-sustaining once official support is withdrawn.

26 . The Bank has four arms which provide finance for different purposes: the International Bank for Reconstruction and Development (IBRD) provides non-concessional loans and guarantees; International Development Association (IDA) provides concessional loans to low-income countries, partly financed by income earned on IBRD loans; the International Finance Corporation (IFC) provides loans to local or foreign private sector companies in developing countries; and the Multilateral Insurance Guarantee Agency (MIGA) provides guarantees to foreign private sector companies investing in developing companies.

27 . The IMF has various funding facilities but this report is only concerned with the Enhanced Structural Adjustment Facility (ESAF) which provides concessional finance to low-income countries.

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28 . The IMF and World Bank have "preferred creditor status", which means that borrowers must pay them before they pay other creditors. This protects the Fund and the Bank as creditors from the effects of their borrowers' debt problems. While most countries have continued to repay the Bank and Fund, this has often been at the expense of increasing arrears to other creditors.

29 . The net income the IBRD earns on its loans to middle income countries is used to fund IDA and other programmes which do not generate sufficient returns themselves to be fully self-sustaining.

30 . Previously, the notional interest rate was 0.5% above the Bank's cost of borrowing, but 0.25% of this was waived, so that the extra charge was effectively 0.25%. In future, the interest rate will be 0.75% above the Bank's cost of borrowing, of which only 0.05% will be waived (at least in the current financial year and probably in subsequent years), implying an effective extra charge of 0.7%.

31 . "World Bank's Board Approves New Loan Charge Policy", World Bank press release, 31 July 1998.

32 . In the case of ESAF loans, the present value of a \$100m loan would be reduced from \$66m to \$63m by reducing the interest rate to zero; for IDA credits, the reduction would be somewhat greater, from \$40m to \$31m.

33 . The ESAF has 3 accounts: the loan Account; the Subsidy Account; and the Reserve Account. Funds paid into the Loan Account are only lent to the IMF, and must be repaid at roughly market interest rates. The resources in the Subsidy account are provided by donors as grants (often from their aid budgets), and the Fund uses them to subsidise the rate of interest on the loans it makes from the Loan Account. Reflows on past ESAF loans are deposited in the Reserve Account and used to ensure that donors to the Loan Account can be repaid if a country defaults on its ESAF loan.

34 . This negative effect would be increased if contributions to the capital of ESAF were also made from aid budgets, so that bilateral aid flows were reduced by the amount of the increase in ESAF loans. If the contributions to the ESAF were returned to aid budgets when ESAF loans were repaid, the liquidity effect would ultimately be reversed by the extra bilateral aid resources this would provide.

35 . However, bailing out commercial lenders and investors is not an appropriate use of IBRD resources, and it has not been demonstrated that bail-out packages are effective.

36 . There might be some negative effect if lending to the Bank were seen as a substitute for direct lending to developing countries - for example, if investors bought the additional World Bank bonds instead of developing country bonds which they buy at present. However, the two have very different profiles of risk and return: World Bank bonds are generally seen as being safe investments, with relatively low rates of return, while developing country bond issues offer higher rates of return at higher levels of risk. The extent of substitution between the two is therefore likely to be limited.

37 . Robert Chote, "World Bank's Loans to Prop up Asia Leave Little for the Poor", *Financial Times*, 28th April 1998.

38 . It would, in principle, be possible for the Bank to increase its capital base by issuing more shares to its members. Since only a small part of the capital is paid-in (\$11.05bn of \$182.4bn in

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mid-1997) the immediate financial cost to the members would be relatively limited; and, while the remainder ("uncalled capital") would be a contingent liability, which could be called on in the future, the actual payments would almost certainly be very limited.

39 . In the past, the Bank made loans at fixed interest rates. As market rates fell, so did the cost of the Bank's own borrowing; but the interest rates on these loans was not reduced, so that they generated higher profits. Partly because this increased the costs to borrowers, the Bank switched to its present formula of charging a fixed spread above its cost of borrowing. As the old fixed rate debts are paid off, so this source of extra profit is drying up, reducing the Bank's net income.

40 . Robert Chote, *op. cit.*

41 . The reduction in the interest waiver should generate about an extra \$200m in the 1997/8 financial year (growing slightly over subsequent years if it is maintained); the 1% charge on loan effectiveness about another \$150m per year; and the increase in the margin charged on new loans above the Bank's cost of borrowing will generate further additional net income, progressively increasing over time. However, the increase in income arising from these last two changes will be much slower to materialise, as they apply only to loans on which the initial invitation to negotiate is issued after 31st July 1998. The negotiation process can be expected to take perhaps two years on average, with a further delay of between six months and a year before loans become effective (when the 1% fee is charged). Disbursements are spread over a period of years - often a very long period in the case of project loans - and the extra interest will be received only on the money which has been disbursed on each loan. The delay will be increased by the projected reduction in faster-disbursing adjustment lending. Provided the lower interest waiver is retained, this suggests that IBRD net income may be increased by about \$200m in each of the next two financial years, reaching perhaps \$350m above its current level in four years (due to the new front-end fees), and will increase more slowly thereafter (due to the higher interest rate margin).

42 . Other observers argue that the Bank's AAA rating and low borrowing costs are based, not so much on its financial position as on the fact that it is effectively under-written by the major developed country governments. The African Development Bank, for example, is able to borrow on similar terms despite a much weaker financial position (and indeed more equivocal support from leading developed country governments).

43 . A policy environment seen as promoting growth, particularly open trade regimes, fiscal discipline, and avoidance of high inflation.

44 . These countries would still be eligible for project finance and technical assistance but not programme support.

45 . See, for example, Tjonneland, E. N., et al (1998) and Woodward, D. (1992, Volume I Annex I).

46 . This proposal puts developing country governments, and their people, at the centre of the development process by requiring governments, in consultation with civil society, to develop national development strategies as the first stage in the process. Donors would then provide resources in support of this programme. While this approach is potentially very useful, it lacks detail and it is as yet unclear whether it can work in practice. Moreover, it is based on a selective approach, which could simply imply a disguised form of conditionality. See Bretton Woods Project, 1998, forthcoming.

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47 . The commercial debts of the HIPC countries are reduced through the IDA Debt Reduction Facility, which provides grants for low-income countries to "buy back" their debts to commercial banks at their market price, which is far below their face value. This is not materially affected by the HIPC Initiative.

48 . This is a significant change from the equivalent passage in the 1996 Annual Report, where potential losses are described as being charged against IDA's accumulated surplus (World Bank, 1996, p212). Sources of development resources include member countries' subscriptions, and contributions and transfers from IBRD, as well as IDA's cumulative surplus.

49 . No reference was made to the HIPC Initiative in the context of the Special Contingency Accounts in the 1997 Annual Report (IMF, 1997).

50 . This represents a proportion of provisions equivalent to the share of HIPC countries in the total commitments of countries with arrears greater than six months

51 . These include, for example, the Jubilee 2000 Coalition (1998); Oxfam International (1998); Christian Aid (1998); and the Catholic Fund for Overseas Development (Northover et al, 1998).

52 . An ESCROW account is an account within the control of a third party, into which money can be paid by one party to a contract without being received by the other party until a certain date, or until certain conditions have been met. The reason for using the ESCROW account approach is a practical one: on paper, the cost of cancelling or paying off a concessional loan immediately is its face value; using the ESCROW approach, this can be reduced to the present value of the debt.

53 . From an economic perspective, the opportunity cost of gold sales to the developing countries is the present value of the net proceeds of sales at a future date, at the projected world market price at that time. If this were in 2010, using a discount rate of 6% per year, this would amount to about \$160 per ounce, or about two-thirds of the potential net proceeds at present. Deferring the sale to 2010 would thus effectively impose a cost of \$75 per ounce, or \$7½bn on the Fund's total reserves of 100m ounces. Any further delay, or a faster decline in the international price (which is already one-fifth below the projection on which the above estimate is based) would increase the cost of delay, and reduce the opportunity cost of using the reserves, still further.

54 . The gold price at end-April 1997 was \$340 per ounce, so the sale of 5m ounces would have raised \$1.7bn (\$1.45bn net of the mandatory SDR35 per ounce). Allowing for a 5% per year rate of return over seven years, this would have provided investment income totalling nearly \$600m. By August 1998, the price had fallen to \$285 per ounce, reducing the proceeds to \$1.42bn (\$1.17bn net) as well as shortening the period of investment by sixteen months. This would imply total investment income of only \$375m.

55 . Sales of 50m ounces of gold would provide net proceeds of around \$12bn at current world prices. By comparison, the total present value of debt owed to the Fund by the 20 HIPC countries classified as unsustainable or possibly stressed at end-1994 amounted to less than \$5bn (based on IMF/World Bank, 1996, Table 9a), and actual debt reduction by the IMF under the HIPC Initiative would be a fraction of this amount. This suggests that IMF gold sales would be sufficient to finance a considerably greater degree of IMF debt reduction than is currently envisaged, for a much wider range of countries, and could still leave a substantial surplus to finance reduction by other multilateral agencies, such as the African Development Bank.

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56 . See endnote 33.

57 . The funds could, however, be redirected as unsubsidised loans to middle-income countries, eg as part of the current East Asian (or similar future) rescue packages.

58 . These figures are based on ordinary least squares regression, using the ratio of debt to exports and the ratio of net official financing to GDP in the first case, and the changes in these ratios in the second. The figures of \$20-25 and \$3 are based on the median exports/GNP ratio for HIPCS of 32.5% (estimated from World Bank, 1997, Table A1.4).

59 . Based on the median present value/nominal debt ratio for HIPCS of 73.5% (estimated from World Bank, 1997, Table A1.4).

60 . This would also require a reduction in the reserves target of 13-15% of lending. However, this target is not mandatory, and a lower reserves coverage would be unlikely to increase the Bank's borrowing costs.

61 . See, for example, Cornford (1996) Halifax Initiative (1996), UNCTAD (1996),

62 . This is roughly in line with the figures for East Asia in 1996, or for the developed countries in 1980 (World Bank, 1998b, Table 4.4), and higher than for any other developing region in 1992 (World Bank, 1994, Annex Table 15).

63 . Definitions are taken from Woodward 1992.