NON-COMMERCIAL BUT STILL NON-OFFICIAL SOURCES ARE IMPORTANT AND DESERVE ATTENTION

The NGO channel is relatively insignificant at present and needs to be encouraged

Compared to other financial and economic activities, the amounts being channelled through foreign NGOs are not only insignificant, but also seem to be maintaining a general downward trend. This suggests the need for further efforts to promote the role and activities of these PSD development agents so as to keep pace with other economic and financial factors.

However, bearing in mind that foreign NGOs do not have democratic mandates, the channels through which they reach ultimate beneficiary enterprises should be harmonized with the overall development objectives and strategies of the recipient-country governments. The NGOs should be required to work with and, if necessary, through the latter.

Workers' remittances also need to be facilitated

For many developing countries, receipts from worker remittances are used for financing PSD, and the amounts surpass proceeds from all other foreign sources—official, commercial and otherwise combined. The international market for remittances is segmented and costly, as money transmitter operators charge high fees and use overvalued exchange rates. Commercial banks in both source and recipient countries account for only a small share of the global remittances market. The mode of making remittances should be more organized.

More important, more attention needs to be focused on immigration issues in various international development policy arenas. If host countries have more humane policies towards immigrants from the developing world, this could generate much more external development finance than conventional official sources.

OFFICIAL FINANCING FOR PSD

There are narrow and wider concepts of PSD but the present interest is mainly on the former

In a sense, official financing of PSD, whether channelled directly to business enterprises or indirectly through recipient governments, refers to all forms of foreign official bilateral and multilateral financial support that is intended to benefit the business sector of the recipient country. But a narrow and more focussed concept (adopted here) refers only to the type of support that is directly channelled to—and also directly benefits—the business enterprises, without government guarantee.

Support for PSD has become the 'toast' of official bilateral and multilateral financiers, with many instruments and many channels of interventions

Within the context of this narrow concept, it is not just the volume of official financial flow that matters. First, of central importance are the type and extent of entrepreneurial assistance packaged with it. In the context of multilateral sources, such entrepreneurial support (including the provision of a 'template' for private investors to replicate and the undertaking of pioneering experimental projects) is actually a part of the role of a development bank. Second, the investment-banking role (co-financing, loan syndication, risk and credit guarantees, etc.) is also important because of the catalytic effect it might have. It is expected that such a catalytic effect (foreign source or cross-border) will be high in sectors and/or countries which attract the interests of foreign private investors (including foreign banks) or where they can be relatively easily 'cajoled' into committing funds.

Bilateral donors have various instruments for supporting PSD in developing countries, and most donor aid agencies now have specialized units for PSD-related assistance. On the multilateral front, many multilateral development banks and non-bank institutions provide PSD assistance in one form or the other. Many UN agencies (UNIDO, IFIAD, UNDP, UNESCO, etc.) offer technical support and grants, particularly for small-scale business and microenterprise development. Also, many multilateral development banks, particularly the World Bank Group, provide indirect support through their adjustment lending with the aim of improving the business environment in developing countries. More important, they provide direct financial and non-financial forms of support. Some are established exclusively to provide financial support for PSD, while others whose original mandate was to provide direct support to the public sector, have since diversified into establishing more or less autonomous affiliates charged with the provision of direct support for PSD. Other multilateral development banks, albeit without similar autonomous affiliates in their organizational structures, are providing direct financial and non-financial assistance to enterprises in the countries of their

domain, generally through non-autonomous organizational units or departments. They also have specialized units for microfinance and microenterprises.

But there is the need for coordination in many areas

At present, with respect to PSD, there is little coordination between multilateral agencies, bilateral donors, or even amongst different divisions or windows of the same multilateral agency and there is little evidence of any clear division of labour. There is scant evidence of information-sharing or even of knowledge of each other's portfolios. Although this lack of coordination (and the fact that donors tend to formulate similar programmes) can be considered an advantage because it provides developing countries with a large reservoir of funding, it also militates against their ability to choose between programmes on a strategic basis and generates incoherence. This, in turn, makes the ownership of PSD by developing countries more difficult. Furthermore, there is overlap in terms of destination by sector and country.

Also, attention should be paid on how to catalyse and avoid crowding-out foreign commercial flows

The investment bank-like activities associated with foreign financing of PSD (for example, through co-financing, loan syndication, risk and credit guarantees, etc.) are expected to have a catalytic effect by leveraging foreign commercial capital. Official financing, by carefully selecting destination sectors and countries, is expected to avoid displacing or crowding-out existing foreign finance so as to maximize its overall catalytic effect.

However, available empirical evidence suggests that official financing has not achieved many catalytic nor cross-border effects. Therefore, achieving significant catalytic effects remains a challenge faced by the national and multilateral aid agencies.

In addition, the geographical allocation of finances needs improvement through additional allocations to low-income countries

Commercial capital flows are lopsided in favour of the high- and middle-income developing countries, with virtually nothing going to low-income countries—except those to the latter's mining enclaves. This imbalance is supposed to be at least partly rectified by official PSD financing. However, the bulk of official bilateral and especially multilateral financing for PSD goes to the high- and middle-income developing countries, reinforcing the existing imbalance. It is therefore being suggested here that more allocations be made to low-income countries.

Finally, microfinancing objectives and strategies should be streamlined, and inconsistencies eliminated

There is an inherent tension between profitability (to ensure continuity and growth in the scale of operations) and the social or developmental roles of the aid agencies, particularly the multilateral ones like the IFC. However, this tension seems more magnified when it comes to the financing of microfinance institutions (MFI) for on-lending to microenterprises.

An interesting recent development is the attention now being focussed by donors on microfinance and microenterprises, as donors currently see this channel as a way of accomplishing the goal of poverty reduction in developing countries. Also, donors' involvement in the microfinance movement over the past decade or so is explained mostly by their desire, through financial and technical support, to create and sustain MFIs as social enterprises. These MFIs are supposed to have 'a double bottom line' with both financial/institutional and social objectives. Therefore inherent conflicts exist between the target of financial *sustainability* and the *outreach* of the poor that donors supporting developing-country microfinance institutions often expect of these institutes.

It is being suggested here, however, that donors should be more aware of the tradeoff between the two goals in their microcredit campaigns when microfinance mechanisms are instituted in different local conditions. The tension between the two objectives at the conceptual level is in fact directly translated into incredible pressures on both the microfinance institutions and their clients in the field in many parts of the world. Donors should not try to preach for a standardized across-the-board attainment of full financial sustainability for all microcredit programmes in an unrealistically short period. Instead, they should, in the light of local conditions, pay more attention to projecting a realistic timeframe for attaining different categories of financial sustainability for each of their sponsored MFIs, and for helping to draw up a strategic plan of measures and policies to achieve intermediate targets in sequence. Also, the challenge that economists and the donor community should acknowledge is the need to design a microfinance programme so that the subsidy element would not be used as a mere justification for permanent inefficiency so as to perpetuate aid dependency culture, as is sadly observed in many other official aid programmes.

COMMERCIAL CAPITAL FLOWS ARE NOT ONLY VOLATILE, BUT ARE UNACCEPTABLY GEOGRAPHICALLY LOPSIDED

Two major issues are pertinent to commercial capital flows to the developing countries. First, the flows (especially the portfolio type) are highly volatile or temporally unbalanced in the sense that a period of very high net inflows is often accompanied by a period of excessively low volume of net inflows, if not outflows. Second, and more important, the flows—whether FDI or portfolio—are geographical unbalanced so that the low-income developing countries receive virtually nothing except the little FDI that trickles to their mineral enclaves.

The first issue here is more systemic than developmental and calls for international financial architecture. The second issue, on the other hand, poses a serious developmental challenge which has to be addressed through international concerted efforts. Otherwise, low-income developing countries will continue to be marginalized far into the distant future in terms of the inflow of commercial capital, including FDI. This is because these countries are still characterized by low levels of per capita income, fragmented and underdeveloped financial systems, low levels of integration into the international trading and financial systems, poor infrastructural bases, and a slow pace of response of economic fundamentals to reforms that could appreciably raise the level of investor confidence. Efforts of the international development partners should be geared towards the amelioration of these obstacles and reduction of the investment risks associated with low-income countries. In addition, as pointed out earlier, re-direction of official bilateral and multilateral financing for PSD in favour of low-income countries can rectify this imbalance.

REDUCTION OF FLIGHT CAPITAL AND ITS REVERSAL HAVE ENORMOUS POTENTIAL TO BOOST FINANCING FOR PSD

Existing stock of flight capital is enormous

Capital flight is still a serious issue. Many developing countries have suffered from considerable capital flight over the last few decades. The potential for capital reversal is quite substantial. In 1998, stocks of capital flight held abroad amounted on average to over 40 per cent of GDP for the Sub-Saharan African countries; for the East Asian countries these stocks were 60 per cent of GDP. Thus there may be potentially large resources available for development financing if countries are able to introduce policies to promote the reversal of capital flight. A review of the theoretical and empirical literature on the determinants of capital flight provides insights into the factors that may possibly contribute to this reversal.

Macroeconomic stability is necessary for reversal of flight capital

Policymakers have to recognize the need for macroeconomic stability in order to stem continued capital flight and induce capital flight reversal. Macroeconomic instability may appear in a number of ways: budget deficits rise, current account deficits increase, exchange rates are overvalued, and inflation grows. In all these cases, macroeconomic instability leads (indirectly) to increased taxes and tax-like distortions. This lowers returns, increases risk and uncertainty of domestically-held wealth and compounds the incentives for capital flight. In this context, it is necessary to adopt appropriate exchange rates and positive real interest rates, as well as pay attention to budget deficits in order to increase the prospects for the reversal of capital flight.

But, so is political stability

Policymakers also need to look at the institutional context in which good macroeconomic policies have been carried out. The institutional context itself may give rise to capital flight. Public sector behaviour may have an impact on the risks and uncertainty regarding the policy environment and its outcomes. More specifically, residents—due to a lack of confidence in the domestic political situation and its consequences for the future value of their assets—may decide to hold their assets abroad. Hence, political stability is important in order to stem continued capital flight and induce capital flight reversal.

As also are enhanced private capital flows and more sustainable external debt position

Capital flows may be an important determinant of capital flight, mainly because high inflows could signal future payment problems for the government. If residents perceive that the costs of these repayments are passed on to them by the government, for example through an inflation tax, they may choose to convert their domestic assets into foreign assets. Moreover, the occurrence of capital flight itself stimulates agents to hold money abroad, since the future cost of debt repayment by the government has to be shared by a decreasing number of wealth holders. In this context, policymakers need to pay attention to external debt management. Building up large stocks of external debt may actually reduce resources available for macroeconomic policy when this leads to large capital flight by residents. The empirical evidence is clear on the importance of adverse incentives of large external debts on investment decisions by domestic wealth holders. Knowing this, the international financial community may be advised to consider providing debt relief in a number of individual country cases.

And an appropriate rate of return differentials, too —although this may be a less important factor

Consistent with economic theory and empirical studies, capital flight may occur simply because the returns on assets are higher abroad compared with assets held domestically. In order to deter continuing capital flight and promote capital flight reversal, policymakers should not only maintain positive real interest rates but also ensure a competitive interest rate and capture the covered and uncovered parity conditions. Yet, a review of the empirical evidence would also show that interest rate differentials in general have been a less important determinant of capital flight. Therefore, maintaining a positive interest rate differential may be a necessary but not sufficient condition to secure capital reversals.

CONCLUSION

The destination countries can do much to promote financial flows, but the source countries can do even more

There are many types and sources of external development financing, each with its own unique characteristics. Developing countries need them all as sources of external development finance. Consequently, inflows from all sources, albeit in the right mix, should be encouraged.

Some of the policies for enhancing inflows are at the instance of the developing or recipient countries themselves. These include the promotion of appropriate and enabling macroeconomic, technological, institutional and political environments, and the recipient countries need to make improvements along these lines.

However, much of the increase in inflows can be brought about only through the actions and interventions of the developed or source countries. First, they can use official transfers to leverage improvements in the enabling economic, technological, institutional and political environments of the destination countries. Indirect official transfers via multilateral institutions should have a comparative advantage in accomplishing this. Second, they can use the same official transfers to leverage and ‘crowd-in’ commercial flows to the same destination countries. Third, by increasing the volume of official transfers, they would increase the totality of flows directly.

More questions have been raised than answers provided

What is discussed in this Policy Brief is addressed to researchers, academics, scholars, policymakers, and to the staffs of bilateral and multilateral aid agencies and NGOs, etc. However, it has to be noted that the sustainability of external development financing covers a very wide area. While the scope is briefly covered here, many of the areas are yet to be thoroughly examined by researchers. This is particularly the case with the official financing aspect: for example, researchers have hardly analysed the fact of why some donors are parsimonious while others are generous, or why some are more inclined to tie their bilateral aid than others.

Efforts have been made to address a number of these issues, from examining the basics in some of the background studies to this overview Policy Brief, but the findings are still too tentative and exploratory for any definite policy conclusions to be made. As a result, in a number of cases we refrain from making definite statements. Instead, we have tried to identify the issues needing further investigation and study. However, this is not to say that the Policy Brief is completely void of policy recommendations and conclusions—and some of these may appear provocative, if not radical.

PUBLICATIONS

The UNU-WIDER project on the 'Sustainability of External Development Finance' has resulted in several publications, including WIDER Discussion Papers, an edited manuscript and special issues of three academic journals.

External Finance for Private Sector Development: Appraisals and Issues

edited by Matthew Odedokun, published by Palgrave Macmillan (isbn 1-4039-2091-5)

Chapter 1 Foreign Financing of Developing Countries' Private Sectors: Analysis and Description of Structure and Trends
Matthew Odedokun

Chapter 2 Comparative Appraisal of Multilateral and Bilateral Approaches to Financing Private Sector Development
Peter Gibbon and *Lau Schulpen*

Chapter 3 Bilateral Official and Non-governmental Organizations' Support for Private Sector Development
Ayodele Jimoh

Chapter 4 Multilateral Development Banks and Private Sector Financing: The Case of IFC
George Mavrotas

Chapter 5 Donors' Support for Microcredti as Social Enterprise: A Critical Reappraisal
Machiko Nissanke

Chapter 6 Flow of Foreign Direct Investment in Developing Countries: A Two-Part Econometric Modelling Approach
Oluyele Akinkugbe

Chapter 7 Flight Capital and its Reversal for Development Financing
Niels Hermes, Robert Lensink, and *Victor Murinde*

Chapter 8 The 'Pull' and 'Push' Factors in North-South Private Capital Flows: Conceptual Issues and Empirical Estimates
Matthew Odedokun

Journal of Economic Development, volume 28, number 1, June 2003

Four Selected Articles from the UNU/WIDER Research Project on "Sustainability of External Development Finance". Guest Editor: Matthew Odedokun (issn 0254-8372)

An Examination of the Long-run Trends and Recent Developments in Foreign Aid
Howard White and Simon Feeny

Analysis of Deviations and Delays in Aid Disbursements
Matthew Odedokun

Modelling Aid Allocation: Issues, Approaches and Results
Mark McGillivray

Strategic Interaction, Aid Effectiveness
and the Formation of Aid Policies in Donor Nations
S. Mansoob Murshed

The World Economy, volume 27, number 2, February 2004

UNU/WIDER Special Issue on Development Financing, edited by Matthew Odedokun (issn 0378-5920)

Introduction – Sustainability of Development Financing:
Multilateral Issues and Perspectives
Matthew Odedokun

Reforming the International Financial System for Effective Aid Delivery
Sylvanus I. Ikhide

Conditionality and Aid Effectiveness Re-evaluated
Oliver Morrissey

Donor Funding of Multilateral Aid Agencies:
Determining Factors and Revealed Burden Sharing
Tony Addison, Mark McGillivray and Matthew Odedokun

Innovative Sources of Development Finance:
Global Cooperation in the Twenty-first Century
Raghbendra Jha

Financing the Provision of Global Public Goods
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Multilateral and Bilateral Loans versus Grants: Issues and Evidence
Matthew Odedokun

Bankruptcy Proceedings for Sovereign State Insolvency
Jonathan P. Thomas

Arab-related Bilateral and Multilateral Sources of Development Finance:
Issues, Trends and the Way Forward
Eric Neumayer

International Review of Economics and Finance, volume 13, forthcoming 2004
(issn 1059-0560)

Trends in the Volume and Allocation of Official Flows from Donor Countries
Howard White

Bilateral Donors' Aid Allocation Decisions. A Three-dimensional Panel Analysis
Jean-Claude Berthélemy and Ariane Tichit

Descriptive and Prescriptive Analyses of Aid Allocation:
Approaches, Issues and Consequences
Mark McGillivray

Aid Effort and its Determinants
Jeffery I. Round and Matthew Odedokun

Strategic Interaction and Donor Policy Determination
S. Mansoob Murshed

Additionality of Debt Relief and Debt Forgiveness,
and Implications for Future Volumes of Official Assistance
Léonce Ndikumana

Bankruptcy Proceedings for Sovereign State Insolvency
and their Effect on Capital Flows
Jonathan P. Thomas

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PB1 Forests in Global Warning, by Patrick Humphreys and Matti Palo, January 1998 (available only in PDF from www.wider.unu.edu)

PB2 Social and Economic Policies to Prevent Complex Humanitarian Emergencies: Lessons from Experience, by Jeni Klugman, March 1999

PB3 Access to Land and Land Policy Reforms, by Alain de Janvry and Elisabeth Sadoulet, April 2001

PB4 Inequality, Growth and Poverty in the Era of Liberalization and Globalization, by Giovanni Andrea Cornia and Julius Court, November 2001

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