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Foreign Aid and Foreign Investment

Financial flows to **developing countries** take two main forms—aid that comes from foreign governments, often called official development assistance, and investment from foreign private companies, known as private capital flows.

Official Development Assistance

After World War II and until the early 1990s, the main source of external finance for developing countries was official development assistance provided by the governments of high-income countries in the form of food aid, emergency relief, technical assistance, peacekeeping efforts, and financing for construction projects. Donor countries are motivated by the desire to support their political allies and trade partners, to expand the markets for their exports, and to reduce poverty and military conflicts threatening international security. After the breakup of the Soviet Union, former centrally planned economies also started to receive official assistance, aimed primarily at supporting market reforms. Table 14.1 shows the amounts of net official assistance provided to developing and transition countries by the member countries of the **Organisation for Economic Co-operation and Development (OECD)** in 1996.

On average, the donor countries in Table 14.1 spend about one-third of 1 percent of their combined **gross domestic product (GDP)** on official development assistance. Use Table 14.1 and Data Table 1 to calculate which countries spend larger and smaller shares of their GDP on such assistance.

Official assistance to developing and **transition countries** has three main components:

- Grants, which do not have to be repaid.
- Concessional loans, which have to be repaid but at lower interest rates and over longer periods than commercial bank loans.
- Contributions to multilateral institutions promoting development, such as the **United Nations, International Monetary Fund, World Bank,** and regional development banks (Asian Development Bank, African Development Bank, Inter-American Development Bank).

Grants account for 95–100 percent of the official assistance of most donor

Table 14.1 Net capital flows from OECD countries, 1996
(millions of U.S. dollars)

	Official assistance		Private capital flows					
			Total		Foreign direct investment		Portfolio investment	
	Total to developing countries	Total to transition countries	Total to developing countries	Total to transition countries	Total to developing countries	Total to transition countries	Total to developing countries	Total to transition countries
Australia	1,121	10	0	0	0	0	0	0
Austria	557	226	938	355	247	355	0	0
Belgium	913	70	4,528	4,109	461	169	4,194	4,007
Canada	1,795	181	1,859	3	2,024	0	–154	0
Denmark	1,772	120	188	248	199	248	0	0
Finland	408	57	472	146	257	194	162	–64
France	7,451	709	11,115	4,860	4,657	1,192	5,352	3,886
Germany	7,601	1,329	12,336	4,671	3,456	3,648	6,980	171
Ireland	179	1	125	0	0	0	125	0
Italy	2,416	294	289	218	457	153	1,642	706
Japan	9,439	184	27,469	1,928	8,573	1,315	19,981	1,652
Luxembourg	82	2	0	0	0	0	0	0
Netherlands	3,246	13	5,858	–36	6,225	45	–912	–78
New Zealand	122	0	9	0	9	0	0	0
Norway	1,311	50	294	–193	202	–201	0	0
Portugal	218	18	593	–4	482	3	0	0
Spain	1,251	2	2,865	–102	2,865	–102	0	0
Sweden	1,999	178	–17	–107	339	–84	0	0
Switzerland	1,026	97	395	705	1,316	705	–583	0
United Kingdom	3,199	362	18,196	3,952	5,852	390	12,120	3,500
United States	9,377	1,694	42,848	2,652	23,430	2,226	19,472	578
Total	55,485	5,596	130,360	23,406	61,051	10,255	68,963	14,358

Note: Negative figures in the table indicate net outflow of capital to respective OECD countries. Total private capital flows in the table can be greater or smaller than the sum of foreign direct and portfolio investments because they also include smaller flows of capital such as private export credits, grants by nongovernmental institutions, and others.

countries. Most official assistance, however, comes in the form of "tied" aid, which requires recipients to purchase goods and **services** from the donor country or from a specified group of countries. Tying arrangements may prevent a recipient from misappropriating or mismanaging aid receipts, but they may also reduce the value of aid if the arrangements are motivated by a desire to benefit suppliers of certain countries and that may prevent recipients from buying at the lowest price. Official assistance can also be "tied up" by conditionalities—as happens with aid to transition countries. Because these conditionalities are linked to the speed of market reforms, rapidly reforming economies such as the Czech Republic and Poland receive more official assistance (relative to their population and GDP) than those which are less prepared to do so (see Data Table 3).

Private Capital Flows

While official assistance to developing countries hardly changed in the 1990s, **net private capital flows** to these countries roughly quadrupled between 1990 and 1994, far surpassing official flows (Figure 14.1). The structure of private flows also changed notably, shifting from a predominance of bank loans to **foreign direct investment** and **portfolio investment** (see Table 14.1). The share of foreign direct investment going to developing countries has risen to more than one-third of global foreign direct investment, driven by rapid growth of multinational corporations and encouraged by liberalization of markets and better prospects for **economic growth** in a number of developing countries.

The developing world is becoming more integrated with global capital markets, but the level of integration varies widely from country to country. In 1990–94 about 90 percent of private capital flows to developing countries were concentrated in just 12 countries (Figure 14.2). For the distribution of foreign direct investment in 1996, see Data Table 3. At least half of all developing countries receive little or no foreign direct investment.

Because poor African countries tend to be the least attractive for foreign investors, the growth opportunities fed by foreign capital flows continue to pass them by. The effective exclusion of such countries from the globalization process may widen international disparities even further.

Figure 14.1 **Net capital flows to developing countries: period averages 1983–95**

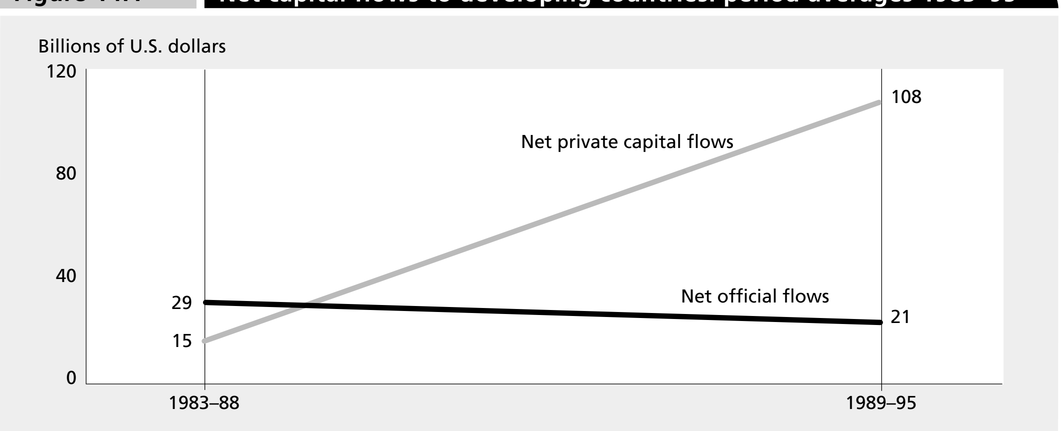
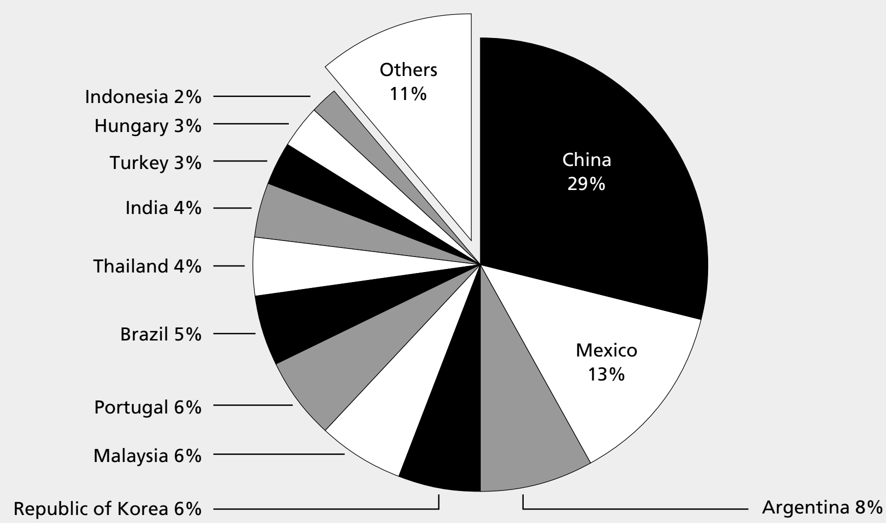


Figure 14.2 **Distribution of private capital flows to developing country recipients, 1991–94**



The developing countries that attract the most private capital flows do so thanks to their favorable investment climate (business environment), which includes such elements as a stable political regime, good prospects for economic growth, easy convertibility of the national currency, and liberal government regulation. Higher foreign investment in these countries helps them break the vicious circle of poverty (see Chapter 6) without adding to their foreign debt. In addition, foreign direct investment usually brings with it advanced technologies, managerial and marketing skills, and easier access to export markets. The added competition between foreign and domestic companies also makes national markets more competitive and national economies more efficient.

The increased international mobility of capital has its risks, however. If private investors (foreign and domestic alike) suddenly lose confidence in a country's stability and growth prospects, they can move their capital out of the country much faster. In that respect portfolio investment is much more dangerous than foreign direct investment, because portfolio investors—who own only a small stock of shares in a company and have little or no influence on its management—are much more likely to try to get rid of these shares at the first sign or suspicion of falling profits. The East Asian financial crisis that started in 1997 is seen by some experts as an example of the negative implications of excessive capital mobility.

Private capital flows to the transition countries of Europe and Central Asia are often deterred by uncertainties about property rights, inflation, taxes, price controls, export and import regulations, and other aspects of the business environment. As a result private capital flows to these countries remain relatively small, accounting for only about 13 percent of the flows to developing countries in 1990–95. Moreover, the distribution of these flows has been highly uneven. Countries seen as more advanced in market reforms—the Czech and Slovak Republics, Hungary, and Poland—attracted almost three-quarters of foreign investment in this group of countries (see Data Table 3). The distribution of foreign direct investment among selected transition countries is also shown in Table 14.2.

While some countries have managed to rely on foreign investment to alleviate the difficulties of the transition period, Russia—along with some other former Soviet Union countries—has suffered from significant, mostly illegal capital outflows. If the illegal outflows of the 1990s were reflected in statistics, the numbers for net capital flows to these countries would turn negative. According to some estimates, more than $110 billion in capital flowed out of Russia in 1993–97. The ongoing capital flight from Russia is the biggest obstacle to its economic development. This situation underscores the importance of creating a favorable investment climate, which is critical not only for attracting foreign investors but, even more important, for preventing and reversing domestic capital flight.

Table 14.2 Foreign direct investment in selected transition countries, 1991–96
(millions of U.S. dollars)

Country	*Cumulative flows*
Armenia	36
Belarus	54
Kyrgyz Republic	146
Uzbekistan	190
Albania	248
Bulgaria	588
Latvia	614
Slovenia	650
Slovak Republic	687
Estonia	859
Ukraine	1,163
Romania	1,379
Kazakhstan	2,997
Poland	4,862
Russia	6,205
Czech Republic	6,368
Hungary	12,767
China	121,704

The structure of foreign investment, particularly the proportion of direct to portfolio investment, also has a big effect on a country's development. Russia has received much more foreign portfolio investment than direct investment (Table 14.3). As a result foreign private capital has not had the expected positive influence on production technology and enterprise management, but has aggravated Russia's dependence on foreign creditors. In 1998 Russia's foreign debt, including the $80

Table 14.3 Net foreign investment in Russia, 1994–98
(millions of U.S. dollars)

Type	*1994*	*1995*	*1996*	*1997*	*1998*
Foreign direct investment	538	1,658	1,708	3,640	1,156
Portfolio investment	36	–2,408	8,757	45,433	7,779

Source: Central Bank of Russia.

billion inherited from the Soviet Union, totaled $140 billion.

Among the countries investing in Russia in 1997, the leaders were the United States, the United Kingdom, Germany, Switzerland, and the Netherlands, which together provided more than three-quarters of foreign investment. Most attractive to foreign investors were the finance and fuel industries (48 percent of foreign investment) and trade and restaurant services (20 percent). Much less was invested in machine building, metallurgy, wood processing and paper, chemicals and petrochemicals, and communications (16 percent). Thus foreign investment did not contribute to the much-needed structural shift of Russian industry toward manufacturing, especially technologically advanced and knowledge-intensive industries.