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Globalization: Foreign Investment and Foreign Aid

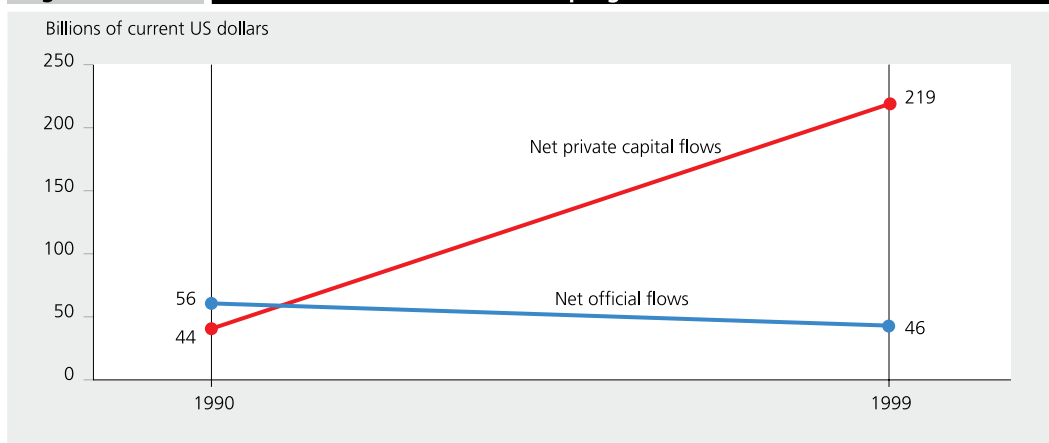


Financial flows to **developing countries** take three main forms—investment from foreign private companies, known as private capital flows, remittances from migrant workers, and aid from foreign governments, often called official development assistance (ODA).

After World War II and until the early 1990s, the main source of external financing 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, peace-keeping efforts, and financing for construction projects. Donor countries were 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 end of the Cold War and upon the start of market-oriented reforms in Eastern Europe and Central Asia, former centrally planned economies also started to receive official assistance, aimed primarily at supporting market reforms. However, the fast growth of private capital flows to developing countries and the declining total amount of ODA have shifted the latter into third place as a source of external financing for developing countries—after foreign direct investment (see Fig. 13.1) and even after remittances from migrant workers (see Chapter 12). Table 13.1 shows the 1999 amounts of net official assistance and

Figure 13.1 Net resource flows to developing countries, 1990 and 1999



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Table 13.1 Net capital flows from high-income OECD countries, 1999
(millions of U.S. dollars)

	Official assistance		Private capital flows					
	Total to developing countries	Total to transition countries	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
Australia	982	3	..	..	..	..	..	..
Austria	527	184	1,334	512	831	512	..	..
Belgium	760	82	4,765	17,604	277	1,825	4,636	15,691
Canada	1,699	165	4,484	-21	4,052	..	460	..
Denmark	1,733	128	410	..	344	..	..	..
Finland	416	74	313	378	145	225	70	167
France	5,637	550	3,524	8,229	5,517	3,953	-1,388	4,058
Germany	5,515	729	13,853	14,007	5,871	4,946	7,075	8,700
Greece	194	11	..	..	..	..	..	..
Ireland	245	..	..	..	..	..	..	..
Italy	1,806	92	9,484	6,137	1,655	-209	8,335	6,831
Japan	15,323	67	-4,297	1,018	5,277	2,624	-3,149	-1,656
Luxembourg	119	3	..	..	..	..	..	..
Netherlands	3,134	22	4,581	2,299	4,103	3,247	-327	..
New Zealand	134	0	16	..	16	..	..	..
Norway	1,370	28	522	556	340	548	..	0
Portugal	276	28	1,953	2,782	1,650	2,779	..	..
Spain	1,363	13	27,655	57	27,710	57	..	..
Sweden	1,630	99	1,192	1,215	665	1,133	..	0
Switzerland	969	70	2,236	6,899	1,834	6,894	..	0
United Kingdom	3,401	326	6,160	-6,446	6,361	-1,734	-98	-4,877
United States	9,145	3,521	32,218	16,221	22,724	15,693	9,319	3
Total	56,378	6,193	110,404	71,446	89,373	42,490	24,934	28,917

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 and grants by nongovernmental institutions.

private capital flows to developing and **transition countries** from the member countries of the **Organization for Economic Co-operation and Development (OECD)** Development Assistance Committee.

Private Capital Flows

In 1997 the growing **net private capital flows** to developing countries reached their peak at about 7 times the **net official assistance** (see Fig. 13.2).

The structure of private flows also changed notably, shifting from a predominance of bank loans to **foreign direct investment (FDI)** and **portfolio investment** (see Table 13.1). The share of foreign direct investment going to developing countries has increased to 38 percent of global foreign direct investment, driven by rapid growth of transnational corporations and encouraged by **liberalization** of markets and better prospects for **economic growth** in a number of developing countries. However, following the East Asian financial crisis of 1997, net private capital flows to developing countries decreased to the level of the early 1990s (see Fig. 13.2) and the share of FDI to developing countries in global FDI fell to about 20 percent.

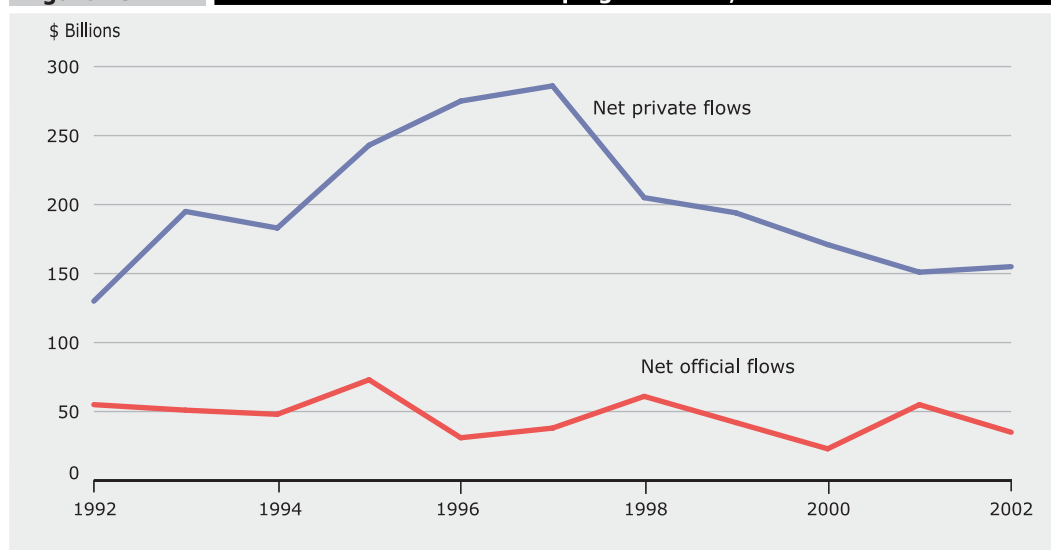
The distribution of FDI among developing countries remains extremely

unequal. In the second half of the 1990s, more than half of FDI went to just 4 countries and over one-third to just 2 big countries—China and Brazil (see Fig. 13.3). At the end of the 1990s the share of the top 10 developing countries receiving the largest amounts of FDI amounted to 78 percent (see Data Table 4). Note that about half of all developing countries receive little or no foreign direct investment. For example, Sub-Saharan Africa as a whole receives about 5 percent of all FDI and most is concentrated in countries rich in petroleum and minerals. The bulk of FDI flows tends to go to middle-income countries, so the exclusion of the poorest countries may have contributed to further widening of global income disparities.

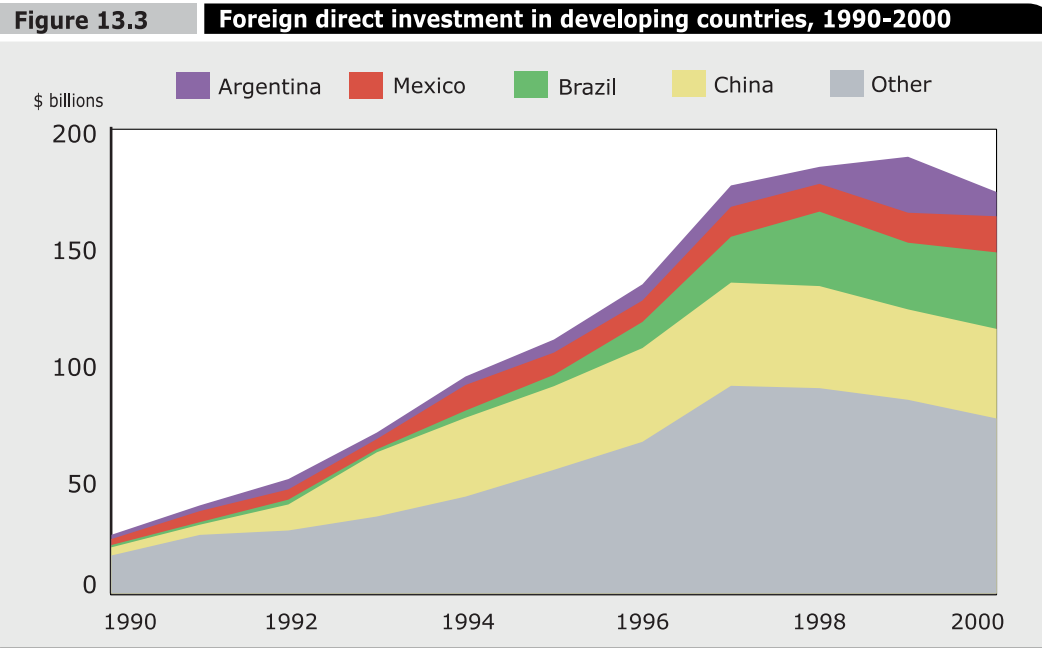
The developing countries that attract the most private capital flows do so thanks

Can increased private capital flows to developing countries make up for reduced official assistance?

Figure 13.2 Net financial flows to developing countries, 1992-2002



Should developing and transition countries strive to attract more foreign investment?



to their favorable investment climate, which includes such elements as a stable political regime, good prospects for economic growth, liberal and predictable government regulation, and easy convertibility of the national currency. 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 may bring with it advanced technologies, managerial and marketing skills, and easier access to export markets. The added competition between foreign and domestic companies may also make national economies more efficient. On the other hand, foreign investors can be less sensitive to social and economic needs of receiving countries. It is the

responsibility of national governments to protect their citizens from the possible negative consequences of foreign direct investments and to use these investments in the interests of national economic development. Unfortunately, in some cases competition among developing countries for attracting FDI prevents them from fully meeting this responsibility.

Furthermore, the increased international mobility of capital is associated with considerable economic risks. 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 percentage 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 of 1997 is seen by some experts as an example of the negative implications of excessive capital mobility.

Another example of excessive capital mobility can be found in Russia, where liberalization of capital markets was carried out in the midst of the transition crisis with high inflation, characteristic uncertainties about property rights and government regulations, and a generally negative investment climate. As a result, while some transition countries have managed to rely on foreign investment to alleviate the difficulties of their transition to market economies, Russia (as well as some other former Soviet Union countries) has suffered from significant capital outflows, legal and illegal. According to some estimates, about \$20 billion in capital flowed out of Russia annually throughout most of the 1990s, making “capital flight” the biggest obstacle to Russia’s economic development.¹ 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.

Official Development Assistance

For most low-income countries, unable to attract private investors, official development assistance (ODA) remains the most important source of foreign financial flows. However, the share of ODA in their economies is not as high as many people in developed countries tend to think—less than 3 percent of low-income countries’ GDP and only 0.5 percent of GDP in middle-income countries. Most high-income donor countries decreased the share of their **gross domestic product (GDP)** spent for ODA from the average of 0.5 percent in the early 1960s to 0.3 percent in 1990 and 0.2 percent at the turn of the century. Many of the 22 members of the OECD Development Assistance Committee have pledged to provide 0.7 percent of their GDP for aid to developing countries, but only 4 of them—Denmark, the Netherlands, Norway, and Sweden—have met this target.

Even in absolute numbers, ODA expressed in **real** terms dropped by about 20 percent over the 1990s (see Fig. 13.2). In 2002 it increased to \$58 billion, but remained more than 10

Should your country spend more on development assistance?

¹If the illegal outflows of the 1990s were reflected in statistics (for example, see Table 13.1), the numbers for net capital flows to Russia and some other countries with unfavorable investment climate would turn negative.

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times smaller than the sum of defense expenditure by high-income countries (about \$600 billion). At the UN Conference on Financing for Development in Monterrey (Mexico, March 2002) a number of high-income countries made new commitments on aid that, if realized, would raise ODA's total in real terms by about \$15 billion by 2006 (see Chapter 17).

Use Table 13.1 and Data Table 1 to calculate which donor countries spent the largest and the smallest shares of their GDP on official development assistance. Do you think that your country should spend a larger share of its GDP to aid developing countries in their fight against poverty?

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 countries. A significant part of the 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—can depend on the enactment of certain policy reforms that donors see as beneficial for recipient countries' economic growth and poverty reduction. For example, aid to transition countries is often tied to the speed of market reforms. That partially explains why such rapidly reforming countries as the Czech Republic and Poland received more official assistance (relative to their population and GDP) than other transition countries that were slower to reform (see Data Table 4).

The main problem with conditionalities is that, even if the donors' concept of beneficial reforms is fundamentally correct, the recipient government may not accept these reforms as its own priority. Conditionalities imposed on developing countries can weaken their governments'

“ownership” of reforms and make these reforms’ implementation but formal, superficial, and unsustainable. On the other hand, donors are legitimately concerned that their aid may not be used efficiently enough in the countries with poor policy environments and particularly in those suffering from high levels of corruption among government officials. Large amounts of development aid can be wasted in such countries, while they could have brought considerable improvements to people’s lives in other countries.

An important example of policy-based development assistance is the program launched by the International Monetary Fund and the World Bank in 1996 and aiming to reduce the unsustainable burden of foreign debt of the “heavily indebted poor countries”, the HIPC’s. In order to qualify for assistance under this

program, countries must be not only poor (**low-income countries**, by World Bank criteria), and not only severely indebted (with the sum of foreign debt exceeding 150 percent of their export returns). They must also be able to show their ability to develop and implement their own poverty reduction strategies. The goal is to make sure that the budget funds that will be freed up from servicing those countries’ foreign debt will indeed be used in the interests of their development rather than diverted to other uses (such as military).²

Would you agree that the quality of national policies aimed at economic growth and poverty reduction should as a rule govern donors’ decisions to provide aid to this or that country? Which other ways of improving ODA’s effectiveness would you suggest?

²Developing countries spend on military purposes about \$200 billion annually.