5

Mobilising External Private Capital for Financing Development

5.1. Observations and Recommendations of the Zedillo Panel Report

Observing that: 'Private capital cannot be expected to finance poverty reduction or human development ... [but it] ... can be an important factor in promoting growth – or in precipitating crises ...' and 'The extent to which FDI bypasses smaller and poorer countries is often exaggerated ... ', ZPR makes the following points in considering the role of FDI and FPI in financing development:

- Developing countries need to continue improving their attractiveness to FDI through *positive* actions (i.e. by upgrading standards of accounting and auditing, transparency, corporate governance and public administration, along with improved infrastructure and application of the 'equal treatment with domestic firms' principle), rather than through tax concessions and lower social or environmental standards. Competitive tax concessions should be regulated and discouraged by an International Tax Organisation;
- Foreign investors in developing countries should subscribe to the UN's Global Compact which highlights nine principles for good corporate citizenship, dealing with human rights, and labour and environmental standards;
- The catalytic role of the MDBs in directing FDI to developing countries should be increased (Volcker Commission) through the provision of partial risk guarantees;
- FPI should be encouraged to diversify the number of options available to countries for financing development. However, such flows need to be properly regulated to avert the risk of macroeconomic destabilisation and financial crisis. To that end the international financial architecture needs to be strengthened to reduce vulnerability, and domestic financial systems need to be strengthened through stronger prudential norms and practices and better standards and codes in a number of areas;
- Developing countries need to be more proactively involved in the design and formulation of prudential norms and improved standards/codes because their implementation can be difficult and costly. Capacity-building assistance is required to implement improved codes;
- Private capital needs to be 'bailed-in' for the management of financial crises by making collective action clauses a standard feature of sovereign bond issues and a queuing process that prevents or slows down flight exit;
- Artificial restriction by industrial countries on institutional investment in emerging markets needs to be removed;
- The prospect of the new Basle proposals for determining the minimum capital requirements of banks making commercial bank loans prohibitively expensive for all but the most creditworthy developing countries should be averted .

ZPR's treatment of the importance of external private capital in financing development (based on treatment by SGR) is regrettably insipid, if not trivial. Its analysis reiterates the obvious while its recommendations do not go far in providing a road-map for reducing the dependence of developing countries on official flows (which are waning) while increasing their reliance on private flows (which are increasing). Even for the poorest developing countries, private capital is likely to continue to increase in importance despite occasional interruptions caused by episodic (but inevitable) financial turbulence.

Except for creating an ITO (an issue dealt with later in this paper), none of ZPR's observations and recommendations pertaining to private capital flows is contestable. For that reason, they can be endorsed and supported by the Commonwealth Finance Ministers. But they are unlikely to be very helpful. The recommendations do not advance any arguments. Nor do they create new pathways and breakthroughs for increasing the scope and reach of private capital in financing development in more countries for more purposes. In a substantive sense (and despite SGR's list of 14 suggestions for enhancing such flows) ZPR/SGR are almost dismissive in their treatment of private flows while over-emphasising the importance of reversing declines in official flows. The sub-sections that follow attempt to redress these weaknesses in offering a wider and more balanced perspective.

5.2 Issues for Commonwealth Finance Ministers to Consider in Mobilising Private Capital

Backdrop and Analysis

The 1990s were a shock in exemplifying the suddenness with which *private capital flows* (PCF) assumed primacy in external resources flows to developing countries. Their impetus led to the total amount of external financing for developing countries increasing substantially. As a consequence, *official finance* became relatively less significant as a flow of resources to the developing world in a shorter time-span than was earlier imagined. In the mid-1990s official flows, especially ODA, fell in absolute terms as well.[25] There was a reversal in PCF between 1998–99 following the Asian crisis (Tables 9 and 10) but they have begun to recover in 2000. Some industrial countries, for example the USA, now see private flows as a substitute for ODA in meeting future FfD needs. That expectation is overplayed and unrealistic. Private capital can play an important role in emerging markets where physical and institutional infrastructure, markets and opportunities exist to attract and absorb such flows productively without running the risk of bidding up asset prices and creating valuation bubbles. These conditions, which influence their value, necessarily limit their role in the developing world.

Private flows are not intrinsically flawed because their nature constrains their reach. On a per capita, rather than per country, basis, private capital is better distributed across the developing world than usually acknowledged. For example, it is often observed that 80–90 per cent of private capital flows are directed to only 10–25 developing countries. That statistic, exhausted from misuse, disparages private flows as being too unfairly concentrated to matter to most developing countries. The implication is

25 That change was even more marked from the 1980s when ODA increased rapidly as a response to the collapse of private finance (in the form of commercial bank loans rather than FDI or FPI) with the onset of the debt crisis in 1982. Rapid increases in ODA between 1982–90 were necessary to finance the burgeoning growth of fast-disbursing structural adjustment and crisis-management programmes in Latin America and Africa. Most of the ODA provided in the 1980s was used to finance external debt service to private creditors (mainly banks in the developed world) in order to prevent failure of the global financial system. It was aimed at short- and medium-term stabilisation and not at long-term development investment. For that rather obvious reason – which unfortunately added to the perception of aid failure – increased ODA in the 1980s went hand in hand with increasing poverty and dispossession in the debt-distressed parts of the developing world. That outcome resulted from the debt-management and structural adjustment policies applied by the Bretton Woods Institutions. When the worst effects of the debt crisis passed, the same quantum of ODA was not required to keep funding external debt service. Hence some decline in ODA was to have been expected.

misleading. The 25 developing countries that absorb 90 per cent of private inflows to the developing world account for over 75 per cent of its population, 70 per cent of its output, 80 per cent of its trade and 80 per cent of its international reserves. Measured thus, the concentration of private flows reflects the distribution of the developing world's 'market capacity'.

It would be odd to expect a different outcome. Eighty per cent of private capital cannot possibly flow to 80 per cent of the number of developing countries. A small island country with a population of less than a million people, and no market to speak of, cannot possibly absorb the same amount of private capital as India or China. There is a case for arguing that the distribution of private capital is skewed when Chile and Malaysia attract larger flows than India or Nigeria, or when India attracts less than 10 per cent of the FDI that China does. But the reasons for these 'distortions' are not difficult to discern. They have little to do with the faults of private capital. They have more to do with flaws in the behaviour of countries that are destinations for investment. ZPR indicates what might be done for such distortions to iron themselves out. But it is not obvious, as ZPR and other proponents imply, that policy choices which deter private capital from entering many developing countries should result automatically in the consequent FfD gap being filled by equivalent amounts of ODA.

Private capital plays a major role in the lives of most people in the developing world. It may not play as significant a role in the least developed economies, although the potential for it to do so (for example in the case of Bangladesh) is greater than generally acknowledged or realised. Least developed countries will depend on ODA flows for some time to come. Their financial systems are too nascent to attract private capital. In some, their debt overhang deters private flows as does their level of development, the structure of their economies, the absence of opportunities and essential infrastructure, and lack of natural resources. In short, their financing needs do not match the investment preferences of private capital. For these reasons, ODA and private flows are not perfect substitutes. But the experience of the 1990s suggests strongly that private capital can replace ODA more widely, deeply and to better effect than was once firmly believed, and is still frequently alleged, in a number of areas.

Private Capital Flows and Development

Experience between 1980–2000 has been instructive about the implications of private capital flows for development. The dangers of commercial bank lending, especially short-term lending, as a source of FfD became clear in the debt crisis of 1982–90. But lessons from that period seemed to have been forgotten when similar dangers materialised in 1994–95 and 1997–98. In contrast, *FDI* has obvious and significant benefits in terms of its contribution to increasing the level and quality of investment, of productivity and associated know-how transfer of both hard and soft technology.[26] FDI is not, however, without costs. It creates long-term liabilities when dividends are remitted and/or interest is repaid to parent companies, and when invested capital (or capital borrowed from the parent) is eventually repatriated.

FPI has the benefit of boosting reserves and money supply in the short-run, and diminishing reliance on commercial bank borrowings and on official finance for managing the external account. But it has *costs* in terms of volatility. In the absence of astute management to control or dampen the impact of inward surges of portfolio capital by monetary and fiscal authorities, such surges can lead to financial system destabilisation and trigger eventual equally swift outflows, with knock-on effects on the real economy.

26 See Chapter 2 of *Global Development Finance 2001*, op cit.

5.2.3. *The Distinction between Foreign Direct Investment and Foreign Portfolio Investment*

These truisms often lead analysts to overplay the real dangers of FPI while being over-sanguine about FDI. It is often the case that risk-management inclines treasurers of TNC affiliates in developing countries to maximise local borrowings against fixed and working capital assets. The surplus liquidity maintained can be quickly shifted abroad in a time of crisis. Risk-management instruments (especially derivatives for hedging against interest rate, currency and price risk) in sophisticated financial markets now permit corporate treasurers of TNC subsidiaries in developing countries, representing the largest amount of FDI, to undertake off-balance sheet transactions that can have the same effect as FPI in financial crises when it rushes in a panic to exit. By the same token, transactions recorded as FPI (for example share-purchases by institutional investors in green-field investments) can actually be a substitute for FDI and be just as stable.

Thus, while the conceptual differences in cost-benefit profiles and volatility-risk between FDI and FPI remain important in theory, their actual costs and dangers in practice can be, and frequently are, misconstrued and misrepresented. For that reason, it is as important for central banks and regulatory authorities in developing countries to monitor the off-balance sheet risk management positions of major foreign direct investors (especially commercial and investment banks) in their countries as it is to monitor flows of FPI and capital flight.[27] In that connection, it should also be noted that domestic corporations and domestic portfolio capital also behave in ways that exacerbate financial crises in the same way as FPI; this is true whether capital accounts are officially controlled or not.

Foreign Direct Investment

Since 1994, FDI has become the single largest source of external financing for the developing world (Table 7). Accompanied by the right macroeconomic policies, FDI has 'crowded-in' other ancillary investments and increased growth rates through the associated transmission of technology, human skills, increased domestic competition and increased exports. Inflows of FDI have grown from 0.14 per cent of the developing world's GDP in 1980 to 0.78 per cent in 1991, rising to 3 per cent in 1998 before dropping back to 2.63 per cent in 2000. In dollar terms FDI inflows have grown from \$4.4 billion in 1980 to \$36 billion in 1991 and \$185 billion in 1999,[28] a remarkable increase by any measure.

The developing world accounted for just a quarter of global cross-border FDI in 1999, although that share peaked at 36 per cent in 1997 before the Asian crisis.[29] It has since fallen back to less than 16 per cent of global FDI in 2000. Against that proportion, the developing world now accounts for 22 per cent of world production measured at nominal exchange rates and for 45 per cent measured at purchasing power parity (PPP) exchange rates (Table 4). Given a presumed differential of about 4–5 per cent in sustainable long-term growth potential between the industrial and

27 The World Bank's Global Development Finance Report for 2000 (GDF-2000) observes: 'FDI flows are also subject to slowdown or reversal in the event of economic difficulties ... increased uncertainty with economic crisesmay cause investors to reduce new commitments, accelerate repayment of affiliates' debts to home office, or take off-setting positions through derivatives. In the latter case, the decline in investors' exposure to the country is not even recorded in the data on FDI. In a limited number of countries, direct investment financed by joint-ventures' external borrowing may be incorrectly classified as FDI, and thus may tend to behave similarly to capital market flows.'

28 *Source: Global Development Finance* (GDF-2000 and 2001-draft), World Bank, Washington DC.

29 The decline from 36 per cent in 1997 to 25 per cent in 1999 was also partly because of unprecedented merger and acquisition activity in the industrial countries in 1999 (UNCTAD, *World Investment Report*, 1999).

Table 7. Net Resource Flows to All Developing Countries 1970–2000
(Amounts in US$ billion)

		1970	1980	1991	1997	1999	2000
Total Net Resource Flows		**11.3**	**82.8**	**119.7**	**334.6**	**250.7**	**280.9**
of which							
Net Official Flows		**5.6**	**34.9**	**60.9**	**42.8**	**45.3**	**47.1**
o/w Grants (excludng. TC)		2.2	13.2	35.1	26.1	28.9	29.6
Memo: TA Grants		1.7	6.3	15.6	15.7	16.6	17.1
Net Private Flows		**5.7**	**47.9**	**58.8**	**291.8**	**205.4**	**233.8**
o/w	FDI	2.2	4.4	35.5	172.6	185.1	176.2
	FPI (Equity)	0.0	0.1	4.6	22.4	21.1	34.8
	Bonds	0.2	1.1	10.9	49.0	25.4	31.1
	Bank Debt	3.3	42.3	5.0	45.1	–24.6	–8.5
	Other	0.0	0.0	2.8	2.7	–1.6	0.2
Memo:							
Interest Payments		–4.1	–48.9	–72.3	–109.1	–135.3	–153.1
Profit Remittances on FDI		–6.5	–23.7	–18.3	–31.4	–41.6	–48.5
Net Transfers		**0.7**	**10.2**	**29.1**	**194.1**	**73.8**	**79.3**
	Official	4.7	28.8	41.1	10.3	–10.2	–24.0
	Private	–4.0	–18.6	–14.8	184.5	85.2	103.1

Source: Global Development Finance Country Tables 1999 (for 1970 and 1980), World Bank; GDF 2000 and 2001 (draft mimeo for 1991–99); World Bank. Figures for 2000 on memo items are estimates from preliminary sources. The table takes into account short-term debt.

developing worlds over the next 20–25 years, it would be reasonable to suggest that the share of global FDI accounted for by developing countries should, *ceteris paribus*, stabilise at an average of about 40 per cent, representing the mid-point in a range of 35–45 per cent over that time-frame, allowing for annual fluctuations.

To some extent, the growth in FDI flows to developing countries was inflated between 1992–97 by one-off factors such as the privatisation of major infrastructure service companies in Latin America. The scope for similar waves of FDI motivated by privatisations in other regions, particularly in South Asia, remains. Even now, Latin America and East Asia account for 75–80 per cent of FDI to all developing countries (Table 8). Eastern and Central Europe and Central Asia account for another 15 per cent. With other regions receiving only 5–10 per cent of the total, there is obviously scope for attracting FDI to Africa and South Asia providing governments in these regions undertake the policy reforms and structural transformations to create more space for private participation in the economy that Latin America and East Asia have already undertaken (although those regions still have some distance to go).

The World Bank reports that developing countries have made progress in improving the climate for FDI between 1992–99.[30] They have eased/removed licensing requirements, opened

30 See GDF-2001 (draft mimeo) pp.10–11.

Table 8. Private Flows, ODA Flows and External Debt and Debt Service 1998

					Official Development Assistance			
	PRF ($ billion)	FDI ($ billion)	XDT ($ billion)	XDS ($ billion)	Amount ($ billion)	($)	LGNP (%)	IODA/GDI (%)
All Developing Countries *of which*	267.7	170.9	2,536	296.1	38.4	(8)*	0.6%	0.83
Low-income Countries	12.2	10.7	419	26.5	18.5	(7)*	2.1	3.15
Middle-income Countries	255.5	160.3	1,957	269.6	19.9	(12)*	0.4	0.45
East Asia and Pacific	67.2	64.2	668	78.1	6.8	(4)*	0.4	0.37
South Asia	7.6	3.7	164	14.7	4.8	(4)*	0.8	1.31
Europe and Central Asia	53.3	24.3	481	45.6	6.4	(14)*	0.6	1.02
Middle East and North Africa	9.2	5.0	208	20.3	4.4	(18)*	0.7	1.25
Sub-Saharan Africa	3.5	4.3	230	14.5	12.4	(21)*	3.9	7.65
Latin America and Caribbean	126.8	69.3	786	123.0	3.5	(9)*	0.2	0.28

Note: PRF = Net Private Resource Flows; FDI = Net Foreign Direct Investment; XDT = Total External Debt Outstanding; XDS = External Debt Service for that Year; IODA = Investment-related ODA; LGNP = GNP of Developing Countries
*Dollar figure in brackets shows ODA per capita.
Source: GDF-2000. World Bank, Washington DC

up sectors previously closed to foreign investment, eased up on restrictions limiting the share of foreign investment in domestic firms, liberalised current and capital account regimes for foreign investors, strengthened laws on the protection of intellectual property rights, improved the regulation of domestic financial markets and made tax systems more neutral between domestic and foreign investors; indeed they have extended the 'equal treatment' principle across-the-board. Most developing countries no longer have severe regulatory impediments for foreign investment. Many have regimes that are more liberal than those of several OECD countries. The regional variations in how far developing countries have gone in these directions remain quite large with the regions receiving the largest FDI flows having made the most progress. Yet FDI flows have not responded to these reforms with as much alacrity as might have been anticipated. Why is this?

A low level of development, insufficient physical and social infrastructure and the lack of market opportunity and natural resources in many countries provides part of the answer. But another part appears to lie in the continued prevalence of corruption, failure to remove unnecessary regulatory requirements, complicated and non-transparent administrative procedures and insufficient protection of property (and collateral recovery) rights because of malfunctioning legal systems that do not provide civil redress in real time. Corruption has a greater effect on FDI than on FPI (thus discouraging the wrong flow) with recent studies[31] indicating significant correlations between corruption and lack of transparency, on the one hand, and FDI flows on the other.

Actions to Encourage Foreign Direct Investment Flows

What might be done to encourage FDI inflows

31 See, for example, Hoekman, B. and Saggi, K. 'Multilateral disciplines for investment related policies' in Guerrieri, P. and Sharer, H. E. (eds). *Global Regionalism and Economic Convergence in Europe and East Asia: The Need for Global Governance Regimes*. Rome: Institute for International Affairs, 1999; Drabek, Z. and Payne, W. 'The Impact of Transparency on Foreign Direct Investment' (mimeo) 2000.

Table 9. Foreign Direct Investment in the Developing World 1970–2000
(Amounts in US$ billion)

	1970	1980	1991	1997	1998	1999	2000
FDI to All Countries	60	93	160	473	683	982	1,118
FDI to Developing Countries	2	4	36	173	177	185	176
Developing Countries' FDI Share	2.9%	4.3%	22.1%	36.5%	25.9%	18.8%	15.8%
FDI as Percentage of GDP For All Developing Countries	0.25%	0.14%	0.78%	2.67%	2.95%	2.93%	2.63%
East Asia and Pacific	0.20%	0.30%	1.43%	3.32%	3.84%	3.02%	2.86%
South Asia	0.08%	0.08%	0.10%	0.91%	0.64%	0.53%	0.51%
East Europe and Central Asia	0.01%	0.01%	0.31%	2.12%	2.52%	2.51%	2.76%
Middle East and North Africa	0.71%	–0.86%	0.38%	0.87%	1.14%	0.24%	0.69%
Sub-Saharan Africa	0.16%	0.02%	0.33%	2.54%	2.05%	2.59%	2.36%
Latin America and Caribbean	0.68%	0.82%	0.68%	3.35%	3.710%	4.64%	3.62%

Source: GDF-2000 and 2001(draft) (World Bank)

to developing countries other than regime changes that will only take effect in the medium or long term? The obvious impediments notwithstanding, there is much that can be done about encouraging greater flows of FDI to developing countries, and especially the low-income and least developed groups, despite their obvious disadvantages as destination countries. It simply requires more imaginative thinking than has been done by SGR or ZPR. The central problem pivots around risks in these groups of countries exceeding (or being perceived as exceeding) those that private investors are prepared to take because of starting conditions prevailing in these countries. That problem begs the question: is there not a considerable amount of unexplored space for imaginative combinations of risk-sharing between private and public capital in these countries to overcome the reluctance of private investors? With the intellectual capacity that exists in the private sector, and similar capacity alleged to exist in the MDBs (and their affiliated investment corporations such as IFC), it should be possible to design project-specific, as well as generic, schemes for risk-sharing that pave the way for private capital to enter countries where it otherwise might not be prepared to take full exposure risk on its own.

In that connection, the World Bank has already opened the door to partial policy risk guarantees. But neither private investors nor developing countries are rushing through it. Also, although the ostensible value of the Multilateral Investment Guarantee Agency (MIGA) and the International Centre for the Settlement of Investment Disputes (ICSID) has been advertised, these agencies have not really added much value in encouraging incremental flows of private investment. Their impact has been minuscule. That suggests difficulties with the way in which these agencies work and the way in which the policy-risk cover concept has been applied in practice, rather than with the concept itself.

All the MDBs (and their investment affiliates) need to be encouraged to develop bolder schemes for encouraging and supporting private capital flows – through appropriately tailored guarantees as well as equity-risk sharing by their investment affiliates – to low-income and least developed countries. Such activity should be given equal priority to direct loans by MDBs, for which their preference remains undiminished. At least 65 per cent of the number of operations of MDB-related investment corporations, such as the IFC, should be concentrated in low-income and least developed countries, instead of 75 per cent of them being in middle-income or industrialised low-income countries, such as India, in which FDI is prepared to flow of its own accord without any help from the MDBs. Such corporations, for example the IFC, often take the easy way out by preferring transactions in countries that do not need them (and often annoy the private institutional investors they displace by doing so) on the grounds that these are necessary to retain the quality of their portfolios. That argument has some merit, but it is grossly overused.

There is a powerful case for MDBs and their investment affiliates being more proactively involved in encouraging FDI inflows to low-income and least-developed countries by acting as spearheads on the unfinished business of privatisation, especially in South Asia, Central Asia and Africa, as well as in the SDIS of the Caribbean, Indian and Pacific Oceans. As Latin America and East Asia have already demonstrated, considerable opportunities exist in these regions to expand FDI inflows by a multiple of their present values by assisting countries with privatisations in which MDBs/ICs can start the ball rolling. These multilateral agencies should assume the perceived high initial risks (on equity and debt) accompanying such privatisations. They can do so by structuring transactions, i.e. financial engineering, and creating instruments, for example convertibles and call options on shares, during the phases of corporatisation and restoration of public sector enterprises to profitability before their eventual floatation.

Such transactions are unlikely to succeed unless MDBs/ICs bring in private operating partners (as well as private investment banks) who have a global market stake in particular areas of infrastructure, for example electricity, telecommunications, broadcasting and media, water supply, sewerage and waste disposal, and all types of transport services – air, waterborne and land – as well as infrastructure provision such as toll roads, bridges, tunnels, ports and airports. The same applies in privatising industrial units that are usually found in the public sector, for example in food and beverages, heavy industries such as cement, steel, metals refining and beneficiation, oil/gas, coal, chemicals and petrochemicals, and in textiles. The overall design under which private operators are brought in to revamp and manage these services, while MDBs/ICs take the initial capital risks, should eventually result in the private partners exercising options to assume equity control when the risks have been reduced to levels that private investors feel comfortable with.

These types of operations are likely to have associated spin-offs by encouraging collateral private investment, domestic and foreign, in supplier and ancillary industries that feed off large public units that are being privatised. They can also result in profitable spin-offs as large public enterprises are unbundled to focus on core competencies and as a climate is created to crowd-in private investment generally. None of this is fanciful generalisation. It has already been done in middle-income countries where initial political and public resistance was even stronger, as was scepticism about whether such radical solutions would work. It has been proved beyond any doubt that they can work. Such transactions, repeated in HIPCs, can help to reduce debt overhangs through swaps of official debt (held by bilateral and official multilateral agencies) for equity in public enterprises that can be prepared for privatisation. But if the generalisation is to become a reality, there must be political will on the part of the developing countries concerned and more imaginative management and vision in the MDBs/ICs than has been displayed so far.

5.2.5.7 Such involvement in promoting FDI inflows more proactively will open up opportunities for MDBs/ICs to expand FPI flows through such avenues as: (a) guarantees for bond issues by sovereigns and sub-sovereigns in the developing world; and (b) bond issues as well as regional/global equity placements by their instrumentalities that are being first corporatised and then privatised. Going further, MDBs can encourage FPI by floating their own bonds in the domestic capital markets of countries where confidence is lacking in the sovereign issuer as a benchmark. The proceeds from such issues can be earmarked for spending in the same countries for both physical and social infrastructure. The example of the European Bank for Reconstruction and Development (EBRD) floating bonds in borrowing member countries, for example Hungary, for financing local infrastructure is salutary. It needs further examination and selective emulation by other MDBs.

In middle-income developing countries, as well as some low-income countries like India, MDBs/ICs can go further by creating and making markets in derivative instruments that can be specifically tailored or traded over the counter. Such instruments would allow private investors to hedge risks on either a long-term or rolling basis in developing country currencies and interest rate movements. In particular, they can help to design and (together with global investment banks) make markets in instruments that might prevent private institutional portfolio investors from exacerbating financial crises through their own exaggerated involvement in inward and outward surges of short-term capital.

These types of arrangements might, for example, require foreign institutional investors to purchase options contracts at the time of entry that would result in large financial losses if the same investors indulged in double-plays or in putting undue speculative pressures on currencies and interest rates during times of financial crisis. Again, these are not fanciful suggestions. They are based on what has been tried in the crises that occurred in 1994–95 and 1997–98. The lessons learnt from these crises on the kinds of instruments that might be developed should not be lost. MDBs/ICs have a public interest role to play in helping to create and trade instruments that will encourage FDI flows and stabilise FPI flows.

Implications for Commonwealth Countries – Foreign Direct Investment

The regional variations in FDI (indicated in the tables above) are reflected across the Commonwealth. Its developing members can learn much from its developed members, and particularly from their provincial development and investment promotion agencies, about how to attract FDI and use it as a powerful weapon to assure sustainable development accommodating diversification and growth. The use of FDI by Singapore to promote growth and development is legendary in the annals of economics. Other developed Commonwealth countries have been among the most successful OECD countries in attracting FDI, not least the UK, which is regarded as the most competitive and attractive destination for FDI in Europe although stealth taxation, some recent policy measures and meddlesome administrative actions appear to be eroding its competitiveness.

Among Commonwealth developing member countries, Malaysia and Mauritius have developed FDI regimes that have proved successful, although these need to adapt and evolve to keep pace with ongoing changes. Mauritius needs to go several steps further toward fusing its domestic and offshore investment regimes and opening the whole island to unrestricted FDI in a fashion similar to Singapore for the next phase of its development. The Commonwealth's South Asian members lag far behind (as the tables above show) in the FDI stakes. Their investment regimes are being opened too slowly and reluctantly. This is due to inertia in public administration as well as political reluctance to forego rent-extraction opportunities. The factors mentioned above (corruption, lack of transparency and malfunctioning legal systems that do not settle commercial disputes and enforce property rights expeditiously) play a large role in inhibiting FDI flows to the Indian sub-continent. Private flows could be much larger, approaching the FDI flows being attracted by China which are ten times as large, if the constraints that presently operate in South Asia were overcome.

This observation also applies to most of the Commonwealth's African members. In these countries much progress has been made with improving regimes and policies but without much effect as yet on improving FDI inflows. In Anglophone Africa (with the exception of South Africa) FDI inflows are still geared to the hydrocarbon, mining, plantation and services (tourism, finance and transport) sectors, with little FDI gravitating toward manufacturing. Although the traffic lights for FDI are being fixed in Africa under the pressure of adjustment programmes, there is less FDI traffic than there might be. Foreign investors are deterred by internecine conflict, political instability, absence of communications infrastructure and exceptionally low standards of public administration. FDI in Africa is also inhibited because many countries have national markets that are not viable in size. For FDI (or any private investment) to increase dramatically in that continent, sub-regional and regional market integration will need to accelerate.

The greatest challenges in attracting FDI for sustainable development (in areas other than tourism) are confronted by the island economies of the Caribbean, the Indian Ocean (although, as noted above, Mauritius is an interesting exception) and the Pacific. These economies have relied on SDT preferences for a long time but have not yet been able to attract the kind of FDI that has enabled them to diversify their production base. The limitations of micro-markets and of vast distances to be covered by sea and air lead to prohibitive transport costs deterring investment. At the same time, the recent threat posed by the OECD's harmful tax competition initiative, aimed at curbing the operation of offshore financial centres, on which many island economies of the Commonwealth are dependent, will affect FDI adversely in these economies. It is not clear what will take the place of the offshore finance industry if OECD countries succeed in achieving their misguided objectives at the expense of small defenceless countries with very few options.

Belief in the need to maintain SDT preferences for these SDIS remains unshakeable. But tenacious clinging to SDT may have retarded development and diversification in these economies instead of promoting it.[32] With the exception of Barbados, the Bahamas and Mauritius, there is no evidence to suggest that the time bought by SDT has been well used to secure the future by the other island economies. As noted above, the solution for SDIS probably lies in economic integration with neighbouring trade blocs, under arrangements that provide for free labour mobility as the *quid pro quo* for opening their investment regimes to investors within those blocs. To attract more foreign investment, SDIS members of the Commonwealth (especially in the Pacific) should reconsider their reluctance to permit foreign investment in land and remove restrictions that are presently imposed on FDI in order to protect indigenous ethnicity. These countries have to face the reality that a globalising world does not permit sovereign preferences to be exercised when sources of earnings are limited to very few opportunities (unlike the oil-rich countries of

32 See Page and Hewitt, 2001, op. cit.

Table 10. Portfolio Flows from Capital Markets to Developing Countries 1991–2000[33]
(Amounts in US$ billion)

		1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total	Gross	79.9	88.2	158.8	153.7	201.4	272.0	323.6	196.4	198.8	241.1
	Net	*23.3*	*44.1*	*57.3*	*67.5*	*71.0*	*112.3*	*119.2*	*96.5*	*20.3*	*66.9*
Bonds	Gross	11.0	20.1	50.1	45.7	52.6	97.6	114.3	73.0	70.3	77.2
	Net	*10.9*	*11.1*	*36.6*	*38.2*	*30.8*	*62.5*	*49.0*	*40.9*	*25.4*	*31.1*
Banks	Gross	61.3	54.0	57.5	72.8	112.7	125.2	179.1	107.8	94.0	115.9
	Net	*5.0*	*16.2*	*3.4*	*8.7*	*30.5*	*33.7*	*45.1*	*50.0*	*–24.6*	*0.7*
Equity	Gross	7.6	14.1	50.9	35.2	36.1	49.2	30.2	15.6	34.5	47.9
	Net	*4.6*	*6.0*	*8.1*	*17.0*	*8.0*	*13.7*	*22.4*	*8.6*	*21.1*	*34.8*
Other	*Net*	*2.8*	*10.8*	*9.2*	*3.6*	*1.7*	*2.4*	*2.7*	*–3.0*	*–1.6*	*0.3*

Source: GDF-2001, op. cit. Tables 2.2 and 2.6

the Gulf and Brunei) and depend entirely on tourism and attracting FDI.

Foreign Portfolio Investment

Gross foreign portfolio flows from capital markets to developing countries surged from $80 billion in 1991 to a peak of $324 billion in 1997 before falling to an average of $197 billion annually in 1998–99 (the aftermath of the Asian crises) and then recovering slightly in 2000 to $241 billion. The corresponding net flows were $23 billion in 1991, $119 billion in 1997 and $20 billion in 1999 recovering to $67 billion in 2000 (Table 10). Such flows include: (a) the proceeds of bond issues (sovereign and corporate) of developing countries, their instrumentalities and their private corporations on global bond markets; (b) commercial bank lending of both a medium-term nature (maturities of 3–5 years), as well as short-term bank lending (maturing in less than a year); (c) portfolio equity flows going to/from the securities markets of developing countries (or emerging markets); and (d) a balancing item to reconcile the inevitable discrepancies that arise with the recording of such flows.

Table 10 demonstrates how volatile gross and net FPI flows can be, a characteristic that applies to every component of such flows but mostly to commercial bank lending. As the table shows, net FPI (which is what counts in terms of financing for development in any particular year) rose from a low of $23 billion at the beginning of the decade of such flows, escalated to over five times that amount by 1997, fell back to below the 1991 level in 1999, and recovered sharply again in 2000 when it became clear that crisis-affected Asian economies had rebounded. The pattern demonstrates how sensitive such flows are to financial turbulence and how they may serve as a transmission channel for contagion.

For obvious reasons, such flows are concentrated in countries with well-developed capital markets of their own. It should come as no surprise that the share of middle-income countries in such flows is over 96 per cent or that 85 per cent of such flows are concentrated in 10 countries. The exception to this rule is China, which has been able to attract an enormous amount of portfolio equity investment, despite having capital markets that are not as well

33 Derived from Tables 2.2 and 2.6 in GDF-2001. These tables in the GDF were found to be wrong because the gross and net flow figures for portfolio equity investments had been confused and transposed i.e. the figures for gross equity in Table 2.6 should have been in the net figures shown in Table 2.2 and vice-versa. The totals in both these tables shown in GDF-2001 were therefore also wrong and have been amended above.

developed as, for example, India's and are far behind South Africa's.

Against these portfolio capital inflows, developing countries currently hold international reserves (mostly in US dollars with the balance in SDRs, gold, Japanese yen and a few European currencies) of over $850 billion. Such reserves represent *official* holdings on the portfolio capital account that run counter to portfolio inflows from capital markets to developing countries. The bulk of these reserves, however, are held by East Asian countries, with Greater China and Singapore estimated to hold over $500 billion.

The volatility of FPI affects only a handful of developing countries directly, although these account for the bulk of the developing world's population. It affects many more indirectly when financial crises are spread through contagion. In these instances, even countries that have been cautious about attracting FPI get caught in the backwash. All the financial crises triggered in the developing world in the 1990s have been linked to surges of FPI, first inward then outward. Such crises have been exacerbated by simultaneous over-indulgence in short-term foreign currency bank borrowing by domestic corporations. Inward FPI surges can, in the absence of sound reserves management and sterilisation strategies, have an impact on expanding local money supply and emit signals on exchange and interest rates that are contradictory. These do not correspond to signals in the real economy, such as prices and wages, and may exacerbate fuelling the growth phase of an economic cycle in an unsustainable fashion. This, in turn, can lead to generalised inflation or the rapid inflation of asset values, such as those of equities and property prices, fuelling the wrong kind of investment (in unproductive assets) and/or consumption booms triggered not by income growth but by asset price, exchange rate and interest rate signals that no longer reflect economic fundamentals.

Once triggered, these booms are difficult to rein in by orchestrating finely-tuned soft landings. Instead they usually result in economic dislocations, i.e. hard landings. When the effect of such dislocation begins to show, portfolio capital that seeks to maximise short-term returns and minimise short-term risk makes an equally dramatic exit. This has the inevitable effect of triggering a run on reserves, resulting in interest rates being dramatically raised, usually under IMF/World Bank pressure, to protect exchange rates and stem capital outflows. Asset values then collapse, leading to sudden distortions on corporate balance sheets that can trigger bankruptcy and unemployment. It also results in choking off investment, public and private, very sharply in the face of interest rate pressures that do not justify borrowing for investment. Together, these tendencies result in a collapse of demand and economic recession, putting pressure on an over-stretched fiscus (by reducing revenues and increasing expenditures simultaneously) that usually cannot take the strain. In such circumstances, everything gives. The bottom falls out of fiscal, monetary and exchange rate policy with the government losing control over the levers of macroeconomic policy and management. Resort to the IMF, resulting in the imposition of harsh stabilisation conditionalities, makes matters worse in the short term before the economy bottoms out and begins a long, slow painful recovery.

Many lessons were learned in the 1990s about the need to manage surges of private capital more intelligently in order to combat the temporary failure of markets as herd instincts are exercised both at times of inward and outward flows. It is odd, therefore, that there remains a marked reluctance on the part of *developed* country governments to consider ways of moderating hot FPI flows at source, especially during the inward surge (for the receiving country) part of the cycle, through a system of hoisting yellow and red flags. Such signals could be reinforced by publicising in advance changed rules of the game in the course of crisis management. Instead, OECD governments seem disinclined to discourage markets from failing through erroneous beliefs about the wisdom of relying entirely on *laissez-faire* in such instances.

The implicit position of developed country governments on FPI seems to be that: (a) private capital flows should be free from any kind of government or inter-governmental intervention; and (b) the world community should react only after a crisis. Extrapolating from repeated experience, another implicit position seems to be that the price of correcting market failure in the aftermath of a crisis should be paid entirely by the developing countries concerned, and usually by their poorest people. That presupposes that only they were at fault and that injudicious over-borrowing can occur without imprudent over-lending. If a moral hazard has been created with the way in which financial crises have been managed, it has not been in encouraging dissolute behaviour on the part of developing countries. It has instead been created by encouraging irresponsible behaviour and market-failure at the originating end through repeated IMF/World Bank organised and financed bail-outs of private portfolio investors and commercial banks, ostensibly to avert systemic risk.

Although the gravity of the problem should be recognised, together with the fact that something sensible should be done to ameliorate it, care has to be taken that neither developed nor developing countries act in ways that reduce or impair the flow of private capital. That would be in no one's interest. If emerging markets are to grow much faster than developed markets, global capital has to be permitted to flow to opportunities of high returns and to take the attendant risks. Obviously, such flows must be based on the explicit understanding by investors and developing countries that some risks will materialise and that many individual investments will fail. That is how markets work. The issue is not one of safeguarding against all investment failure but of averting situations where system risk is created that induces entire financial systems to fail because of herd instincts resulting in transient market failures.

Dealing with the issue, despite a decade of mixed experience, is not easy. Facile solutions are to be regarded with caution. In that context, the experience both of Malaysia Hong Kong (in intervening in the stock market to deter harmful speculation) provide case studies for public intervention that other Commonwealth countries need to understand and learn from. Malaysia's approach – derided by the international financial community at the time – eschewed traditional IMF prescriptions. It designed its own adjustment programme. An initial devaluation was followed by a fixed exchange rate regime with controlled domestic interest rates and the reimposition of temporary controls on movements of portfolio capital. Malaysia avoided an unnecessarily harsh fiscal and monetary squeeze of the kind that did so much damage to the rest of Asia. Its approach proved remarkably effective in bringing about necessary adjustment without unleashing the destructive forces that were experienced in Indonesia and Korea. Similarly, Hong Kong's monetary authorities broke with accepted tradition and intervened massively in the stock market to burn speculative investors indulging in pernicious double-plays (explained below) that may have led to a more serious financial collapse in Hong Kong than was, in the event, actually experienced.

It may be premature to reach immediate agreement on an internationally co-ordinated regime involving direct interaction among governments and financial market regulators (rather than the intrusive and heavy-handed intermediation of the Bretton Woods Institutions) to govern global private portfolio capital flows. Nevertheless, the world community would be negligent if it did not flag this issue at UNCFD and embark on a programme that would result in better approaches by the IFIs with more acceptable outcomes. The aim should be to avoid tedious repetition of financial crises in the developing world. What should be agreed is that the standard template applied by the IMF to financial crisis management in all instances (hotly denied on every occasion, contrary to the evidence at hand) needs to be overhauled.

The aim of such a change should be to ensure that the eventual costs of dealing with any financial crisis are borne as much by portfolio investors, domestic and foreign, and by foreign and domestic banks, which are usually culpable of irresponsible lending, as by the country and entities which receive such investment or borrowing. The continuation of crisis management protocols that still provide preferential treatment for foreign investors and foreign banks during a crisis, and encourage the draining of a country's reserves, should be discouraged. Thought should be given to requiring investors and foreign banks interested in inward FPI to purchase appropriately designed prophylactic derivative contracts (for example buying options contracts on currencies and interest rate futures at the time of making inward investments) that would discourage the same foreign banks and portfolio investors from indulging in counterproductive currency speculation to drive the currency down or the interest rate up; or to indulge in *double or triple plays* in equity, debt and currency markets in the midst of a crisis, thus exacerbating it.[34]

For example, in some Asian countries in 1997–98 (Thailand, Malaysia, Hong Kong) foreign institutional investors and banks did simultaneous transactions in the derivatives and physical segments of the markets that drove interest rates up and currencies down, while short-selling equities and equity-indexes in those markets. The net result was that they made extraordinary profits when equity prices automatically fell, in the face of a draconian interest-rate squeeze and currency collapse. Apart from discouraging or banning those sorts of 'double-plays', the size and terms of the IMF rescue packages in a crisis should be sufficiently large and sensitively designed so as to minimise the damage inflicted on the economy in the stabilisation and adjustment phases that precede recovery. In particular, such rescue packages should be designed to avoid any risk of inflicting unnecessary and unjustified pain on the poorest segments of society in affected countries by ensuring sufficient funds and fiscal protection to erect safety nets.

Crisis management should avoid destabilising developing country governments that are in the midst of managing crises. They should not be used to pursue hidden agendas for using a financial crisis as a convenient opportunity to induce political regime changes (as seemed to be the agenda in Indonesia). Enough has been learnt to make this possible, providing sufficient political will exists to implement the measures needed, to design instruments appropriately and to ensure changes in the policies and *modus operandi* of the IFIs. These institutions should be prevented from inflicting unnecessary pain, which they often do in the false belief that it is essential for them to convince markets that they are being suitably harsh and disciplinarian, or simply because they have not thought things through carefully enough.

In addition to measures that can be taken by multilateral institutions and their affiliated investment corporations to encourage private capital flows, industrial and developing coun-

34 Some thoughtful ideas along these lines have been advanced by Avinash Persaud, a global currency expert, in two articles, 'The Disturbing Interaction between the Madness of Crowds and the Risk Management of Banks', paper commissioned for the Commonwealth Conference on Developing Countries and Global Financial Architecture, Commonwealth Secretariat, London , June 2000 and 'Sending the Herd off the Cliff Edge: The Disturbing Interaction between Herding and Market-sensitive Risk Management Practices'.The latter article won first prize in the Year 2000 Essay Competition held by the Institute of International Finance, Washington DC.

tries can both take actions to enhance the *push* effect (i.e. encouraging private capital to flow outwards from OECD countries) and the *pull* effect (providing an attractive environment for private capital in developing countries). Industrial countries can do more to encourage private flows to emerging markets through suitably designed tax credits, deductions and allowances for capital investment in the least developed countries (which could be treated on a par with either charitable deductions or incentive-driven investment). Special and differential tax treatment could also be applied to the receipt of profits and dividends by corporate, as well as individual, investors in emerging market funds (whether for a country, a region or the emerging market universe as a whole). In the latter case, tax benefits to mutual funds and asset management companies specialising in investing in emerging markets could be passed through to individual unit holders. Clearly, such tax measures would need to be calibrated to provide maximum tax benefits for investments flowing to the poorest (and the highest-risk) countries with a tiered reduction of the special treatment accorded to investment in more developed, middle-income emerging markets.

A caveat is however necessary when considering options through which industrial countries can induce private capital to flow to developing countries. The history of experience with using differential tax treatment, i.e. tax breaks, to achieve specifically targeted social, development or environmental objectives, domestically or internationally, has been mixed. It is not clear that the tax loss incurred, i.e. the cost of providing the impetus, is worth the benefit derived, or that tax incentive driven investment is necessarily the most efficient or productive. Moreover, in this instance, the cost of providing tax breaks would be socialised (by token of its being incurred by the fiscus of a particular OECD country), while the short-term gain accrues to another country and is privatised at both ends – i.e. the benefit accrues to a private investor in the industrial world and to private entities in the developing world. When these investments begin to yield returns, some gains will also be derived by the OECD country providing the tax break, by way of a reverse flow of repatriated capital, profits and dividends over the long term that would be subject to tax. Thus such tax breaks represent revenue deferral rather than revenue loss.

But despite this caveat there may be a case for providing special and differential tax treatment in OECD countries to encourage private flows to the developing world for a transitional period. There is another reason for doing so: most OECD governments have fallen far short of the ODA target of 0.7 per cent of GNP. Meeting such a target would mean raising tax resources or increasing domestic borrowing to finance ODA. If private capital outflows from a particular country can be considered, in a similar context, to contribute toward FfD (though obviously not substituting for ODA on a one-for-one basis) there is a justification for providing a tax break if it lessens the pressure on the source country to provide amounts of ODA that it cannot afford fiscally. Taxes collected to finance ODA or taxes foregone to encourage private flows are, in a limited conceptual sense, equivalent.

Asking OECD countries to make a major effort to encourage private capital outflows to developing countries is unlikely to be beneficial if the latter do not themselves create the right environment, not just for attracting private capital, but ensuring that it is effectively deployed. This no longer means providing tax holidays to compete for foreign investment. In fact, the value of tax breaks at the receiving end has virtually been played out as an attraction for FDI. Foreign investors are not looking for tax breaks in developing countries so much as a business environment in which they can do business without wasting time, effort and money. They are more interested in a long-term entry that enables them to compete for domestic, as well as global, market share.

In particular, it requires developing countries to deliver on the wish-list elucidated in ZPR: (a) the elimination of corruption and rent-extraction; (b) putting in place effective and timely mechanisms for dispute resolution and global standards of judicial recourse, as well as for collateral recovery and closure; (c) changing laws, rules and regulations that constrain normal commercial market activity, such as the right to hire and fire workers based on market conditions and the profitability and economics of the firm and without excessive hindrance imposed by labour laws, or the right to purchase commercial and residential property, or the right to borrow and raise equity locally; and (d) increasing investment in basic infrastructure for power, telecommunications, water supply and transport at a more rapid pace than might have been necessary without the pressures of globalisation.

In the short term, accelerated private flows may pose as many, if not more, problems than they solve for many developing countries. Nonetheless, such flows are indispensable if the pace of development and growth is to take off and be sustained in a fashion that achieves convergence. In a globalising world, developing countries need foreign investors if they are to capture shares of global markets in emerging industries and products and gain access to essential technology and know-how.

Implications for Commonwealth Countries – Foreign Portfolio Investment

FPI flows pose a problem (and an opportunity) for a relatively small number of Commonwealth countries. In SDIS that operate offshore financial centres, their impact is exaggerated because they transit through these economies without affecting them in any significant way, except for the domestic income that their booking and handling generates. But every Commonwealth country appears anxious to attract FPI through accelerated development of its *national* capital market, and especially its equity market. In most of these countries, such markets operating at the national level are neither efficient nor effective. They are too small, likely to list only a few issues, and have very limited market-making capacity and very high overhead operating, administrative and regulatory costs. They suffer from a lack of economic size, depth, width and liquidity. Markets such as these are more likely to fail than to succeed and to generate, rather than solve, resource mobilisation problems.

If such markets do succeed in attracting FPI, it is likely to be harmful rather than productive. The urge to establish unviable capital markets individually in each Commonwealth country, and especially in the SDS and SDIS, should be resisted. With the advent of new communications and information technology in global financial markets, and with electronic exchanges replacing trading floors (thus making time, location and distance irrelevant in the processes of price discovery and matching trades), more thought needs to be given by smaller countries about how to associate with suitable financial centres in *regional* capital markets. That option is likely to take them further in the development of their financial systems, and provide greater protective bulwarks, than attempting to go it alone.

Private Voluntary Flows

PVF provided through non-governmental organisations[35] is usually associated with (and

35 NGOs such as, for example, CARE, Oxfam, Save the Children, Christian Aid, Bread for the World, CARITAS and their equivalents in continental Europe, the USA and Japan, as well as churches, mosques and religious organisations around the world. The NGO movement is characterised by an extraordinary mix of solid and temperate organisations with vast and long experience of development support for the poorest and humanitarian relief, alongside less benevolent NGOs focused on animal rights, environmental issues, labour rights, the pro-life and pro-choice movements and a host of similar clusters of concerns that occasionally coalesce (for example at Seattle) to develop an anti-capitalist, anti-market, anti-society, almost anarchist hue. 36 Development Initiatives 'White Paper on Globalisation: Background Note on Global Development Assistance: The Role of Non-Governmental Organisations and other Charity flows', UK Government, 2000, also referred to in GDF-2001 (draft mimeo).

also counted as) ODA rather than with private commercial capital. In large part this is because NGOs often obtain matching funds from their governments in OECD countries to complement the amounts they raise voluntarily. Agencies such as UNICEF and the Red Cross and Red Crescent, as well as the Rotary and Lions Clubs, raise much of their funding through National Committees that obtain voluntary donations in developed and developing countries. In recent years, very large private foundations, such as the Gates and the Turner Foundations, have also become significant sources of grant PVF and crucial co-financiers with UN agencies and governments in funding specific initiatives such as the Global Alliance for Vaccines Initiative (GAVI).

Although associated loosely with governments, funds mobilised by NGOs are, in large part, *private* and *voluntary*. They are not raised through taxation except for the proportion that governments choose to channel through NGOs to reach the poorest people in developing countries directly. Most importantly, they are not government-to-government transfers. For that reason, they are mentioned briefly in this section of the paper rather than the next.

According to a recent study,[36] PVF has become a large element in the FfD mix. Equally, its intermediaries, the NGOs, have become increasingly (and disproportionately) influential voices in determining global development preferences, policies and strategies. Their influence derives largely from the power they exercise over their own governments, and over inter-governmental institutions. Such power derives from their capacity to influence votes at times of elections through their powerful advocacy of single issues. For developing countries, NGOs represent: (a) an opportunity and a channel for humane people-to-people connections that sidestep bureaucracies and the procedural inhibitions of governments and private corporations; (b) an extra-governmental channel for recourse and redress; and (c) an element of potential intervention or interference in the domestic social and political affairs of developing countries that sometimes infringes their sovereignty and can violate the rights of legal corporate entities, if not of individuals, who disagree with their views.

Most vexing is the fact that NGOs appear to feel no obligation to exhibit the same standards of humility, transparency, accountability and responsibility that they militantly demand from governments and private corporations. Yet they are neither elected nor have the broad public mandate that they often claim. Instead they have the the dedicated support of single-issue lobbies that can be fanatical in expressing their beliefs and in pressing them aggressively on those who do not share them. The challenge for both industrial and developing countries lies in maximising the benefits from (a) and (b) above, while avoiding the pitfalls of (c), and at the same time retaining the value of PVF in the FfD mix. It is an unfortunate omission that neither SGR nor ZPR addresses this concern at all.

That is surprising because PVF is not insignificant in total financing for development. OECD-DAC statistics show PVF from NGOs averaging \$3.3 billion annually through the 1980s and \$6 billion annually through the 1990s (\$6.7 billion in 1999). These amounts were equivalent to about 7 per cent of ODA in the 1980s and 12 per cent in the 1990s. Other studies[37] suggest that total expenditures in developing countries by NGOs are higher – \$15.5 billion in 1998 vs. \$5.6 billion recorded by DAC, which would represent an amount

36 Development Initiatives 'White Paper on Globalisation: Background Note on Global Development Assistance: The Role of Non-Governmental Organisations and other Charity flows', UK Government, 2000, also referred to in GDF-2001 (draft mimeo).

37 Development Initiatives 2000, op. cit.

equivalent to over 31 per cent of total ODA provided in that year. The discrepancy is resolved if total expenditures by NGOs are seen to equal the amount they raise privately, plus the amount they get from matching grants provided by governments, which are already counted as official ODA. Thus, while not adding to ODA resource flows between 1997–2000, NGOs may have been responsible for spending between 40–45 per cent of what all OECD bilateral aid agencies together were responsible for disbursing, and for a larger *net transfer* of resources than the total *net transfer* intermediated by all the MDBs together.[38]

No reliable estimates are available of the amounts that NGOs in developing countries mobilise by way of private voluntary contributions in domestic resources. It would be surprising, however, if the aggregate amount they raised in all developing countries was less than the amount transferred by NGOs in OECD countries. In all likelihood it is significantly more. The picture is even more confused by the fact that many global NGOs (for example the Red Cross) raise funds in both the industrial and developing worlds. Thus, there is a significant domestic PVF component in financing development that is rarely acknowledged. It is usually ignored altogether although it may be as, if not more, significant than PVF through NGOs recorded by OECD-DAC. Equally there is no reliable estimate of PVF through NGOs flowing from one developing country to another.

Is there much scope for increasing PVF? Would developing countries wish to see even greater involvement by NGOs in intermediating funding (whether private or official) for development? These questions are difficult to answer. Although there has been a definite increase in the level of PVF between the 1980s and the 1990s, the level of such flows through the 1990s has been stagnant, reflecting the same inertia as ODA. This does not suggest that public resistance in industrial countries to increasing ODA via increased taxation is being offset by private voluntary giving for assistance to developing countries (which represents a fraction of less than 10 per cent of total PVF for all purposes). The figures in Table 11 establish this point.

Taking these tendencies into account, are resource flows from NGOs desirable from a developmental point of view? It is axiomatically assumed that they are. Most of these flows are aimed at the most difficult challenge of development – reaching the poorest people directly. Governments and multilateral institutions have concluded that their own bureaucratic *modus operandi* is unsuitable for tackling that interface:

> *NGOs' advantage lies in greater flexibility and use of specialised local knowledge to intermediate between official agencies and local communities. Often NGOs can deliver assistance that official donors are not equipped for. NGOs have gained prominence as aid has broadened its focus beyond strictly economic objectives to include goals of empowerment, social justice, sustainability, and accountability in governance. At the same time, because of their large numbers and the diverse religious, cultural, humanitarian and commercial interests they represent, NGOs amplify the difficulty of co-ordinating official aid.*
>
> (GDF-2001 draft mimeo, op. cit., World Bank, Chapter 4, pp. 16–17)

38 OECD statistics invariably refer to net resource flows and not net transfers. Net resource flows are the difference between gross flows from donor to developing countries minus the reverse flow of principal repayments. Net transfer also takes into effect reverse flow payments of interest and other charges on loans. Thus while the net resource flows (concessional and non-concessional) from all multilateral sources was $21.3 billion in 1998, the net transfer was only $7.4 billion. Indeed for 1994–96 the total ner transfer from multilateral sources was –$7.3 billion, i.e. in those three years developing countries were actually transferring net resources to official multilateral agencies instead of receiving resources from them. The situation was even worse with bilateral net transfers on the debt account.

Table 11. Private Voluntary Flows to Developing Countries 1983–99
(Amounts in US$ billion)

	Annual Average 1983–84	Annual Average 1988–89	1992	1993	1994	1995	1996	1997	1998	1999
PVF/NGOs	**2.5**	**4.2**	**6.0**	**5.7**	**6.0**	**6.0**	**5.6**	**5.2**	**5.6**	**6.7**
Memo: Net Official Resource Flows										
Bilateral	14.1	25.3	41.4	39.4	41.3	40.6	39.1	32.4	35.2	37.9
Multilateral	11.2	15.7	12.0	14.9	10.0	10.9	13.0	21.1	21.3	20.0
Memo: Net Official Transfers on Debt										
Bilateral	10.6	18.8	1.6	–0.7	–9.1	–6.5	–27.0	–23.7	–11.1	–15.4
Multilateral	8.8	7.4	–0.4	1.9	–3.5	–3.0	–0.8	8.2	7.4	4.2

Source: OECD-DAC Annual Report 2000 Statistical Appendix. GDF 1999,2000,2001 World Bank (for figures on multilateral flows and net transfers)

What appears axiomatic cannot, however, be taken for granted despite popular perception – a perception created by NGOs themselves through astute management of positive media images. The perception belies the many problems that NGOs pose; not least, their lack of transparency, accountability and the proportion of funds absorbed by their own administrative costs. It is almost impossible to evaluate properly the overall developmental impact or the sustainability, over the long run, of NGO-provided assistance. They are too numerous, diverse, and employ entirely different standards of disclosure and accounting. The projects and activities they finance are small and often ephemeral.

Most evaluations of NGO-funded operations have been left to the NGOs themselves. It would be cost-ineffective to undertake independent external reviews of all their operations. The few studies carried out (in the Nordic countries, Australia, the USA and the UK) to evaluate the contribution NGOs have made to poverty reduction, humanitarian relief and the sustainability of what they started, have yielded mixed conclusions. Similarly, a review of NGO involvement in World Bank projects attributed unsatisfactory outcomes to unrealistic project design and weaknesses in NGO-partner capabilities. Thus the extent of NGO value-addition is unknown. It may be quite different from widespread public perception.

Without doubt, NGO activities have contributed much to relieving human distress and suffering in the short term, especially in handling refugees and relief in conflict zones. For that reason alone they may be worth supporting. But it is unclear exactly what (and how) NGOs have contributed to long-term, sustainable development. Many developing country governments, especially those of an authoritarian hue, have found NGO involvement in their countries uncomfortable to live with. But their discomfort has not been openly expressed for fear of further alienating the media and public in major industrial countries. Before categorical conclusions can be reached about value addition by NGOs to development, and to FfD, it is difficult to assert that PVF through NGOs is unquestionably good and needs to be significantly increased.

Similar to the increase in private capital flows to developing countries in the 1990s has been the upswing in contributions by private philanthropic foundations in industrial countries to programmes with cross-border benefits that impinge on developing countries. These are now estimated to exceed $1 billion annually, having grown at about 8 per cent annually through the 1990s.[39] This amounts to about 2 per cent of annual ODA flows (up from about 1 per cent in the 1980s when flows from private foundations totalled between $300–400 million annually). Philanthropic foundations have played a special role in development since 1950 with the Ford, Rockefeller, and Carnegie Foundations making valuable contributions in encouraging the development and diffusion of untried technologies, for example pioneering the 'green revolution' in the developing world. The boost in philanthropic flows in the 1990s has come from new foundations set up by entrepreneurs in the 'new economy', for example Bill Gates of Microsoft and Ted Turner of CNN and Turner Communications. These have sponsored work on developing vaccines against infectious diseases, eradicating polio and vaccinating children worldwide, and financed computers in schools. Thus, private foundations have been especially valuable participants in financing international public goods in a pioneering way, breaking a path for official agencies and governments to follow.

Growth in philanthropic flows has been supported by tax laws in the USA that encourage charitable giving by permitting tax deductions that reduce taxable income. European countries have lagged behind, with a societal preference for public, rather than private, philanthropy. European tax laws provide little incentive for private charitable contributions on the American scale, though this is changing, for example in the UK. Annual contributions by members of the European Foundations Centre increased by 43 per cent to 4.8 billion Euros between 1998 and 1999.[40] The Japanese situation falls between these two with international giving by Japanese foundations rising in the 1990s despite a collapse in the Japanese stock market and in corporate earnings.

As with NGOs, there is little reliable information available on domestic resource contributions made by philanthropic foundations (private and corporate) in developing countries themselves. In India alone, where local private and corporate philanthropy has been established for over 150 years, crude estimates of resource flows (compiled from reports filed with the Charity Commissioners) from private philanthropic foundations suggest that they amount to $2–3 billion annually. This is characteristic of many developing countries where such foundations have compensated for the scarcity of public resources (and for the failure of governments) by creating townships and financing infrastructure, health-care, education, social services, pensions and welfare benefits on a sustainable long-term basis, albeit on a limited, and occasionally self-interested, scale.

It would not be surprising if a serious study, aimed at aggregating the resource flows that go toward financing development from private philanthropic foundations *within* the developing world, arrived at an estimate of more than $20 billion per year. It is essential for such a study to be undertaken in the context of an understanding that private philanthropic flows are not simply a feature of industrial world largesse, but a significant feature of *domestic* resource mobilisation for financing development.

In the FfD framework that emerges for the twenty-first century it may be worthwhile for all countries, industrial and developing, to reconsider refining their tax codes to enhance

39 The Foundation Center: *International Grantmaking: A Report on US Foundation Trends* (1997) and *International Grantmaking II: An Update on US Foundation Trends* (2001), sourced through http://www.fdncentre.org.

40 European Foundation Center: *Independent Funding: A Directory of Foundation and Corporate Members of the EFC* (2000), sourced through Orpheus Prgramme Publications (www.efc.be).

private voluntary flows aimed at financing social goods and services, particularly those aimed at the poorest. This would facilitate achieving IDG-2015 targets with more productive outcomes being achieved at the local level through community action on poverty reduction, especially as private social initiatives and philanthropic funding combine to augment and complement the efforts of governments and NGOs. Relying on government action alone is likely to continue to prove as disappointing as it has over the past half-century. That is because the incentive and decision-making structures that operate in large public bureaucracies are not conducive to addressing the problems of poverty alleviation with the speed, imagination, sympathy and flexibility that their solutions demand.