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Macroeconomic policy questions: financing of development, including net transfer of resources between developing countries and developed countries

Financing of development, including net transfer of resources between developing countries and developed countries

Report of the Secretary-General

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I. Introduction

1. Developments in 1997 have reminded the international community that there are dangers as well as opportunities in the international financial market place. After several years of substantial net transfers of financial resources to developing countries, capital flows to several countries suddenly changed direction. Policy makers were reminded that they need to be concerned not only with the overall size of financial transfers but also with the composition of flows since some flows are more likely to be sustained than others. Although long-term private financing, particularly in the form of foreign direct investment, largely maintained its pace and direction in 1997, short-term financial flows exhibited violent moves. A key question for policy makers thus seems to be how to foster longer-term flows while preventing excessive inflows and outflows of short-term funds.[1] Meanwhile, flows of official development assistance (ODA) continued to shrink, increasing the urgency of the question of how to provide adequate supplies of these essential public funds for development cooperation.

2. These are the main concerns to emerge from a review of the most recent data and estimates of the net flows and transfer of financial resources between developing and developed countries, which the General Assembly requested in its resolution 51/165. The present report elaborates upon and updates monitoring of the net transfer of financial resources in the *World Economic and Social Survey*[2], as also requested in resolution 51/165.

3. As noted in the previous report of the Secretary-General on net transfer of resources between developing and developed countries (A/51/291), the net transfer of financial resources to developing countries had shifted from negative to positive in 1991. The developing countries remained net recipients of financial transfers for six years, with several countries, particularly in East Asia and Latin America, benefiting from a strong inflow. Countries that received net financial transfers were able to import more goods and services than they exported to the rest of the world and expand their investment beyond what domestic saving would otherwise have financed. The sudden reversal of net transfers in 1997 to countries that were affected by the Asian currency crisis significantly reduced their spending capacity and forced them to take sharp adjustment measures. Indeed, concern about precisely this kind of eventuality was expressed in the Secretary-General's 1996 report (see A/51/291, para. 22).

4. The important point is not that the net transfer became negative, per se. Negative net transfers of financial resources – a net movement of financial resources out of a country – does not necessarily denote an adverse economic outcome. A country with a record of rapid economic growth, for example, may exhibit a "negative" financial transfer because domestic saving (roughly, the supply of financing) increases faster than domestic investment (roughly, the demand for financing). China is a case in point; it transferred $47 billion abroad in 1997, principally through accumulation of reserve assets (e.g., purchases of treasury bills of reserve-currency countries). The problem in the current episode is that in several countries, there was a sudden and very large shift of external flows from a net inward transfer to a net outward transfer. This, in turn, resulted in substantial currency devaluations and required a sudden contraction of trade deficits.

5. The turmoil began in East Asia but spread to other parts of the developing world. In several cases, however, the financial disruption was contained, as some Governments, particularly in Latin America, quickly responded to the threat of contagion: they increased interest rates to defend their currencies and restrain domestic spending, while they also tightened fiscal policy. In addition, a lesson from the Mexican peso crisis of 1994–1995 was well learned: Latin American banking systems had been strengthened and a historically high stock of official reserves accumulated. The willingness to confront currency speculators with

large reserves and increased domestic interest rates thus reduced the extent of the disruption, at least for a time and at least for some countries. Even so, growth of all the affected economies has slowed appreciably.

6. As of mid-1998, moreover, volatility of international financial flows had not subsided for more than short periods. Several Asian currencies, then the Russian rouble, the South African rand and even the Chilean peso were hit by the exit of short-term funds. There was thus considerable uncertainty about how international financial flows would develop in the rest of 1998 and over ensuing years.

II. Recent developments in the net transfer of resources to developing countries

7. From July 1997, when the Asian currency crisis erupted in Thailand, through December 1997, when it struck the Republic of Korea, the swing in Asian international financial flows dominated the changes in the net transfer of financial resources of developing countries. As a result, the net transfer on an "expenditure basis", which had been positive since 1991, suddenly became negative in 1997 (see table 1).[3] While the net transfer to all developing countries shifted from an $8 billion inflow in 1996 to an outflow of $27 billion in 1997, the net transfer to Eastern and Southern Asia dropped by about $53 billion. While China transferred $28 billion more overseas in 1997 than in 1996, mainly through the aforementioned reserve accumulation, much of the rest of the shift in Asia reflected the beginning of the very difficult situation in East Asia. On the other hand, Latin America and the Caribbean, which was thought to be highly vulnerable to such an external shock, continued to attract financing sufficient to produce a positive net transfer of over $17 billion in 1997.

8. The recent experience in Latin America contrasts sharply with the net-transfer "shock" that Latin America underwent in the early 1980s, when the debt crisis ushered in the "lost decade" of Latin American development. That is, whereas the six largest economies of Latin America together had a positive net transfer of about 1.2 per cent of gross domestic product (GDP) in the period 1975–1981, they then underwent a negative net transfer of 3.5 per cent of GDP during 1982–1990. The total change in net transfer to these countries in the aftermath of the 1994 Mexican crisis was much more limited, equivalent to about 1 per cent of GDP (the countries are Argentina, Brazil, Chile, Colombia, Mexico and Venezuela).

9. Indeed, the net-transfer shock in East Asia is of a comparable magnitude to the earlier one in Latin America. The net transfer to the five countries most affected by the financial crisis (Indonesia, Republic of Korea, Malaysia, Philippines and Thailand) was equivalent to an annual average of about 2 per cent of GDP in the 1990–1996 period. With the onset of the crisis, the net transfer to these countries has become a negative 2.5 per cent of GDP for 1997–1998, for a total net-transfer shock of about 4.5 per cent of GDP.

10. In West Asia, which had been a source of substantial financial transfers to the rest of the world in the 1970s, recent years have been a time of significant resources inflows. In 1997, however, that region's net transfer dropped to zero. This resulted partly from various efforts by Governments in the region to consolidate their fiscal deficits and partly from improved oil revenues. However, economic recession in Japan, the Republic of Korea and South-East Asia in 1998, among other factors, has depressed oil prices, which may once again worsen the trade and fiscal balances of oil-exporting countries, again making the region a net absorber of financial resources.

11. In 1997, much of the African continent was bypassed by the Asian currency crisis. In particular, sub-Saharan Africa did not suffer a deterioration in net financial transfers in 1997. The least developed countries, many of which are in sub-Saharan Africa, even saw a small improvement in the net transfer. In 1998, however, both groupings could be said to warrant additional resource inflows to compensate for the negative impact on the terms of trade of the fall in commodity export prices, owing in part to the continuing Asian crisis. But for most of the affected countries, the requisite additional financial flows are not expected to materialize.

A. Financial dimensions of the net transfers

12. Since it is important to examine the financial composition of net transfers as well as the overall levels, data with the requisite detail have been brought together for 105 net-debtor developing countries. As measured for this grouping, the net transfer was negative in 1997 for the first time since 1990. However, in part this reflects reserve accumulation decisions by Governments, which withdrew over $53 billion on a net basis from net financial inflows and added them to official reserves. Excluding these reserve changes, the net financial transfer from abroad was positive. Indeed, while less than half the 1996 figure, it nonetheless amounted to $46 billion (see table 2).

13. Many countries added to their reserves in 1997, which in several cases were already at a "healthy" level in 1996, measured in traditional terms of the months of import coverage.[4] All the regions identified in the tables here added to official reserves on a net basis in 1997 (see tables 3-6). In Asia, however, the figure must be interpreted with caution since it combines the large build-up of official reserves, especially by China, with the substantial loss of reserves by other countries, especially in South-East Asia. By the end of 1997, moreover, some of the lost reserves were replaced by a net official credit inflow of $28 billion (see table 6), largely the result of a set of rescue packages put together by the International Monetary Fund.[5]

14. The massive change in the net transfer of financial resources in 1997 mainly took the form of an unprecedented swing of short-term borrowing and net domestic outflows in Asia (see table 6).[6] While other forms of private transfer did not exhibit large movements, net short-term transfers went from an inflow of $10 billion in 1996 to an estimated outflow of $92 billion in 1997, a swing of more than $100 billion. Since one of the major items in this category is short-term trade-related financing, this large swing entailed a sudden shortage of the credits necessary to conduct international trade. It also reflects the flight of portfolio funds and short-term bank lending, the latter having caused major banking and corporate liquidity crises in the countries losing the funds.

15. In contrast to the volatility of short-term borrowing and other domestic outflows, foreign direct investment (FDI) in developing countries increased in 1997. Net transfers on FDI flows to Latin America and the Caribbean region, in particular, reached about $22 billion, a record level (see table 3). This reflected continuing confidence of transnational corporations in the prospects of the region, together with the successful implementation of many privatization programmes, as well as implementation of economic liberalization and deregulation measures. FDI in Asia did not decline drastically either since much of this investment is based on long-term profit expectations, rather than opportunities for short-term gain.

16. In 1998, however, smaller net inflows are expected in Asia. This is not because the attractiveness of the region has declined as a location for production.[7] Rather, the recessionary conditions and uncertainties have been reasons to postpone implementing investment plans. In addition, the considerable FDI flows in Asia made by transnational corporations based in other countries in the region are expected to be held back by the regional domestic financial turmoil.[8]

17. One positive development in 1997 that will be significant, if sustained, is that Africa received net transfers through medium-term and long-term borrowing from private sources for the first time since 1988 (see table 4). Some countries in North Africa received together about $7 billion in portfolio investment and other forms of long-term capital. Owing to this investment flow, net transfer to the region on a financial basis reached more than $13 billion, the highest level in the decade. That figure would have been even higher, however, had the size of the net transfer on official flows not become smaller yet again in 1997.

18. The stringency in official flows hit especially the sub-Saharan region (defined here to exclude Nigeria and South Africa in order to focus on the smaller and generally lower-income countries). Official flows make up almost half of the total financial transfer to these countries, though the share is declining (see table 5). Except for a slight increase in medium-term and long-term borrowing, the main categories of financial flows did not exhibit any major deviation from recent trends, i.e., there were smaller official inflows and there was very little foreign direct investment.

III. Recent developments in official financial cooperation

A. Official development assistance

19. Member countries of the Development Assistance Committee (DAC) of the Organisation for Economic Cooperation and Development (OECD) have always been the largest sources of official development assistance. However, they have provided almost the entire aid flow since the early 1990s, when the economic situation deteriorated in certain major oil-exporting countries and in the European countries with economies in transition from central planning to market structures. It is thus especially disconcerting that DAC aid flows have also begun to decline in recent years.

20. According to OECD, DAC aid fell 14 per cent in dollar terms in 1997.[9] However, about half of the decline is attributed to the fall in the exchange rates of various donor-country currencies against the United States dollar. In addition, a discontinuity was introduced into the data since DAC decided to cease counting aid flows to Israel and certain other economies as part of ODA, beginning in 1997 (it had made other, small reclassifications in 1996). Even so, counting only the countries currently classified as “developing” by DAC and taking account of exchange rate changes and inflation, total ODA still fell 3.2 per cent in 1997. Thus, the trend of declining ODA flows from 1993 to the present continues. Indeed, over this period the cumulative decline in ODA at constant prices and exchange rates has reached almost 25 per cent (it remains over one fifth for ODA flows to countries currently deemed to be aid recipients).

21. Total DAC aid fell to 0.22 per cent of the combined gross national product (GNP) of DAC countries in 1997, putting them the farthest they have been from the United Nations aid target of 0.7 per cent of GNP since the target was adopted as part of the International Development Strategy for the Second United Nations Development Decade (see General Assembly resolution 2626 (XXV), para. 43).

22. Since cuts in the aid budgets of some of the countries in the Group of Seven major industrialized countries account for almost all of the recent decline in ODA, it appears that longstanding international cooperation commitments are being re-examined. The United States of America, once the largest donor, now ranks third, behind Japan and France (see table 7). The United States aid ratio has fallen to 0.08 per cent of GNP, a new low.[10] There have also been major aid cutbacks as a share of GDP in France, Germany and Italy, taking these countries farther from the United Nations target.

23. However, ODA from Japan, the largest donor, increased by 9.6 per cent in constant prices and exchange rates, despite Japan's economic difficulties. Its ODA-to-GNP ratio also increased from 0.20 per cent to 0.22 per cent. Nevertheless, in June 1997 the Government adopted a proposal that will cut ODA by 10 per cent in yen terms for the fiscal year starting in April 1998. The proposal might also reduce ODA further after 1998, a possibility that is more likely to occur in the light of Japan's economic difficulties in 1998. Japan's ODA spending, which had been one of the fastest expanding items in the budget, thus faces a future of limited growth.

24. Out of eight DAC donors reporting relatively large increases in ODA in real terms in 1997, four countries had ODA flows of $500 million or more, namely, Canada, Spain, Japan and Austria. In addition, Portugal, Luxembourg, Ireland and New Zealand registered increases in ODA flows. But only four countries, as in previous years, met the United Nations aid target in 1997 (Denmark, Norway, the Netherlands and Sweden).

B. Managing bilateral ODA

25. As ODA has become more limited, donor Governments have increasingly examined ways to increase the potency of their aid programmes and curtail overhead expenses. This has included reorganization of the agencies that are responsible for the administration and management of development aid. The result has often been sweeping organizational reform.

26. In the United States, for example, reforms started in 1992 and focused on the reorganization, realignment and reduction of personnel at the Agency for International Development, cutting management layers and overseas offices. Sweden's development cooperation programme has been consolidated, as four development cooperation agencies were merged into one. Belgium's aid agency, the General Administration for Development Cooperation (managing 60 per cent of aid) has been completely overhauled. In Italy, aid management reforms featured the preparation of country programmes specific to major recipients of aid, as well as measures to increase transparency in aid operations. Canada completed the second phase of its reform initiative in 1996, streamlining the structure of the Canadian International Development Agency and recentralizing aid management. In Austria, non-governmental organizations now initiate and implement a large portion of grant-financed bilateral aid, rather than an official agency.

27. There also seems to be a trend towards strengthening the coherence of aid and other policies of donor Governments vis-à-vis developing countries. In the United Kingdom of Great Britain and Northern Ireland, a new Department for International Development has been created, with cabinet rank and broader authority than its predecessor, the Overseas Development Administration. In France, aid reform has included the appointment of a State Secretary in the Ministry of Foreign Affairs to, among other functions, ensure a link between aid and foreign policy. Australia, however, abolished the position of Minister of Development Cooperation and placed the administration of the aid programme with the Ministry of Foreign Affairs.

C. Multilateral ODA

28. The shrinking flows of ODA are being reflected, quite naturally, in the concessional flows from multilateral institutions to developing countries. In particular, the resource commitments of the operational agencies of the United Nations system, which are on a grant basis, have dropped from their high of $3.9 billion in 1995 to $3.5 billion in 1997.[11]

29. It has been a difficult period as well for the International Development Association (IDA), the World Bank's concessional lending affiliate. Donors reached an agreement in August 1996 on their contribution to IDA funding for the period 1997–1999, to which the World Bank added $1.2 billion from its own income in the fiscal year that had just ended in June 1996. The amount was more than four times the $250 million that the Bank added in 1995, and represented an effort to maintain IDA programmes despite disappointing new donor commitments.[12]

30. In part reflecting these funding problems but also reflecting the implementation of new policies at the World Bank on greater selectivity in choosing projects and decentralization of operations, IDA commitments fell in 1997. The 1997 total is 27 per cent lower than the peak of $7.3 billion reached in 1994.

31. Concessional lending commitments by most of the regional development banks also fell in 1997, a notable exception being a strong increase from the African Development Fund (ADF), which had received a $2.6 billion injection of funds for concessional lending from donor members for the period 1997–1999, after disagreement over administrative and shareholding questions were resolved in May 1996.[13]

32. In addition to funds for general purpose lending, multilateral lending institutions have made arrangements for special funding of the multilateral debt-restructuring component of the joint World Bank/International Monetary Fund initiative for the heavily indebted poor countries (HIPC).[14] World Bank participation in the HIPC initiative is effected through the HIPC Trust Fund, which also serves as a key channel for carrying out debt relief by other multilateral lenders. As of June 1998, the Bank had committed a total of $750 million to the trust fund from its net income in fiscal years 1996 and 1997, and an additional allocation out of 1998 income was anticipated. The Trust Fund can also hold contributions from individual donor countries. As of July 1998, it has obtained more than $275 million in bilateral contributions on pledges from 15 countries.

33. In line with the HIPC initiative, the African Development Bank has established a $150 million supplementary financing mechanism to assist highly indebted, low-income African countries to service their loans from the Bank. The funds would be drawn from the African Development Fund. Meanwhile, the International Monetary Fund (IMF) has made arrangements to extend its own contribution through the Enhanced Structural Adjustment Facility (ESAF), its soft loan "window".

D. International Monetary Fund

34. The multilateral institution that typically deploys the largest amount of international loans, albeit with relatively short maturities, is IMF. As the international community's chief emergency funding mechanism, it may undertake sudden bursts of lending. One such instance occurred in response to the Mexican crisis in 1995 and a second in response to the Asian currency crisis in 1997–1998. Indeed, in years in which there were no surges in IMF lending, the net transfers from multilateral lending institutions were small or even negative (see table 8).

35. Being able to respond quickly to crisis situations of the type that affected Mexico in 1994 requires being able to take decisions unusually quickly. For this reason, IMF set up an Emergency Financing Mechanism (EFM), and in July 1997 approved its first loan using EFM – a $1.1 billion loan to the Philippines.

36. In December 1997, IMF took an additional step to provide emergency resources beyond its standard loans when it established the Supplemental Reserve Facility (SRF) to quickly disburse large amounts of financial assistance to countries in serious financial crisis when it is judged that strong adjustment policies and adequate finance can lead to the correction of a payments imbalance. The Republic of Korea was the first beneficiary of an SRF loan, which was a part of a $21 billion IMF standby facility for the Republic of Korea.[15]

37. More generally, to be able to deploy resources on a large scale, IMF requires that its own funding be adequate. One measure of Fund resources is the total value of member quotas in the Fund. Because it was agreed that the total value of quotas was no longer adequate, in September 1997 the IMF Executive Board agreed to propose an overall increase of 45 per cent in quotas under the Eleventh General Review, which would raise total quotas to 209.5 billion special drawing rights (SDR) (almost $280 billion at end-June 1998 exchange rates).[16] IMF's Board of Governors agreed to this proposal in February 1998. At that time, the Board of Governors also approved an amendment to the articles of the Fund to enable a one-time "equity allocation" of a special form of Fund-created liquidity, called "special drawing rights" (SDRs). The extra allocation, totalling SDR 21.4 billion in value, would double the volume of SDRs and distribute them so that all members would end up with the same ratio of SDRs to IMF quotas (29.3 per cent). As of July 1998, acceptance by three fifths of IMF members having 85 per cent of the vote (the minimum required to give effect to this amendment) had not been obtained.

38. It has long been understood that in dire emergencies, IMF might need to deploy more lending than it could mobilize from its own resources. For these situations, the Fund has had an emergency credit line that it recently sought to expand. In January 1997, the IMF Executive Board agreed to establish a New Arrangement to Borrow (NAB), under which IMF could borrow funds to forestall or cope with financial crises similar to the one that affected Mexico in December 1994. Under the NAB, a total of $48 billion, including $24 billion from the pre-existing General Arrangements to Borrow (GAB), would be available in loans to IMF from 25 countries and institutions that agreed to participate in the plan. NAB would become operational for five years (and be subject to renewal) when adopted by participants whose credit commitments totalled about $40 billion, on condition that the five largest participants had joined the pool. As of mid-1998, however, only France and Germany had ratified the agreement.

39. In addition, in September 1996, finance ministers, meeting in the Fund's Interim Committee, endorsed the IMF Executive Board agreement on ways to finance the Enhanced Structural Adjustment Facility (ESAF) for the period 2000–2004. ESAF financing will come from bilateral contributions; if needed, funds could also come from the "optimization of reserves management".[17] The ESAF agreement enables IMF to participate fully in the HIPC initiative noted above. Nevertheless, at the April 1998 meetings, IMF and the World Bank urged that additional pledges be made to ESAF and stressed the need to intensify efforts to obtain full financing of the ESAF facility.

Notes

[1] This question is a major focus of the report of the Secretary-General on global financial flows and their impact on developing countries (A/53/__).

[2] See, *World Economic and Social Survey, 1997* (United Nations publication, Sales No. E.97.II.C.1), chap. III; and *World Economic and Social Survey, 1998* (United Nations publication, Sales No. E.98.II.C.1), chap. III; and associated tables in the statistical annexes of the respective editions. The present report also draws upon recent analyses and publications of the International Monetary Fund, the World Bank and the United Nations Conference on Trade and Development.

[3] The net transfer on an expenditure basis is, in essence, the financing of the balance of trade in goods and services; for more details, see *World Economic and Social Survey, 1986* (United Nations publication, Sales No. E.86.II.C.1), annex III.

[4] See *World Economic and Social Survey, 1998* ..., table A.26.

[5] The international community, led by the International Monetary Fund, put together rescue packages for Indonesia, the Republic of Korea and Thailand, totalling $117.6 billion; for a summary of the packages, see IMF, "The IMF's response to the Asian crisis", July 1998, available on the IMF Web site at:

www.imf.org/External/np/exr/facts/asia.htm

[6] It should be cautioned that this item is calculated as a residual; it includes not only measured short-term capital flows but also components that were not separately identified under the IMF balance-of-payments framework or the World Bank's debtor-reporting system.

[7] On the one hand, following the depreciations of the currencies in East Asia, local assets when measured in dollars became considerably cheaper than before the crisis. On the other hand, taking a longer-term perspective, transnational corporations think that East Asia will remain a profitable investment destination, according to a survey conducted by the United Nations Conference on Trade and Development and the International Chamber of Commerce; see TAD/INF/2746, and UNCTAD, "The financial crisis in Asia and foreign direct investment", background note, available on the Internet at:

www.unctad.org and www.iccwbo.org

[8] See *World Economic and Social Survey, 1998* ..., chap. III.

[9] OECD, "Aid and private flows fell in 1997", news release, Paris, 18 June 1998.

[10] United States ODA is recorded as having fallen by $3.2 billion in 1997, although $2.2 billion of this resulted from removal of aid to Israel from 1997 ODA.

[11] See *World Economic and Social Survey, 1998* ..., table A.31.

[12] The refunding agreement ("IDA-11") is unique in that it applies only to the second and third years of the replenishment period. The first year was to be covered by an interim fund in which the United States would not participate (nor would United States firms be eligible to compete for procurement contracts on IDA projects funded from the interim fund). Instead, the United States Government pledged to pay its arrears under IDA-10, which required adoption of legislation by the United States Congress to appropriate $934 million for the arrears payment. By February 1998, the United States had paid its arrears in full and had disbursed $800 million, or half, of its total $1.6 billion contribution to IDA-11.

[13] In fact, $1 billion of the $2.6 billion will come from recycled funds, loan cancellations and arrears on earlier pledges, rather than from new money.

[14] Progress in implementing the HIPC initiative has been tracked in the annual series of reports of the Secretary-General on the external debt crisis and development; for the 1998 report, see A/53/__.

[15] Financing under SRF can be in two or more tranches, but drawings under SRF will be of shorter maturity (one to one-and-a-half years after the date of each disbursement) and more expensive (3 per cent above the average IMF rate on loans, which was 4.6 per cent as of June 1998.

[16] The SDR is the Fund's unit of account (worth about $1.33 at end-June 1998), as well as the name of a supplementary reserve asset issued by IMF (see below). Regarding the quotas per se, since they no longer reflect members' relative positions in the world economy, it was decided to distribute 75 per cent of the quota increase in proportion to the existing quotas of members, 15 per cent according to "calculated" quotas that better reflected members' positions in the world economy, and the remaining 10 per cent to those countries whose "calculated" quotas were higher than their actual quotas.

[17] The term “optimization of reserves management” is an oblique reference to the sale of IMF gold to augment ESAF funding. The proposal, involving sale of up to 5 per cent of IMF’s gold reserves (totalling 103 million ounces), has since been shelved due to disagreement among IMF members.