Suggestions for defining a new development finance agenda[1]

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[1] This report is prepared for the Development Assistance Committee Secretariat, as an input into defining the shape, directions and key elements of development co-operation as set out in its report "Shaping the 21st Century". Valuable suggestions made by O.E.C.D. and O.E.C.D. Development Centre colleagues during a meeting on 23rd October are gratefully acknowledged.

I Introduction

The objectives of development finance are to contribute to development in the poorer countries, so as to a) reduce the proportion of people living in extreme poverty, b) to enable social investment in key sectors such as primary education and health care and c) to ensure environmental sustainability. Ideally such development should be both participatory and egalitarian.

A pre-condition for development and poverty alleviation is sustained economic growth. Sustained economic growth can best be achieved if a) countries are able to mobilise sufficiently high domestic savings b) full scope is given to the development of the domestic private sector, which includes the development of a sound financial system c) governments provide essential investment in social sectors, spending which is adequately financed by tax and other revenue and d) sound and stable macro-economic policies are pursued, to lower inflation and avoid large imbalances, so as to promote financial and exchange rate stability.

In many of the poorest countries, there is still a large external debt overhang, which constrains growth, imposes a heavy fiscal burden and discourages new private flows. In the case of many low-income countries, a large part of the external debt being serviced is multilateral debt. As a result, the recently announced Initiative for the Heavily Indebted Poor Countries (H.I.P.C.) to provide multilateral debt relief and increase Paris Club debt relief is to be greatly welcomed, as are the links suggested between debt relief and accelerated commitment to economic policy reform. It is to be hoped that sufficient debt relief will be provided to enough countries, so as to help them to achieve overall external debt sustainability, which should contribute to a restoration of growth and strengthening of poverty reduction. To achieve this goal, it is important that the framework for resolving the debt problems of the H.I.P.C.'s - in relation to eligibility criteria, timetables and scale of relief - be handled with a high degree of flexibility; for example, the burden on public finances should be given equivalent weight to the traditional balance of payments criteria in evaluating debt sustainability.

International experience has also shown that sustained growth and development also implies minimising risks of costly Balance of Payments and/or banking crises occurring. As recently illustrated by the Mexican peso crisis, such major disruptions not only have very negative effects on growth and on income distribution (as the burden of financial crisis often is borne disproportionally by the poorest people of the society), but are also fiscally very expensive; increased fiscal spending on debt servicing or on rescuing banking systems also reduces the ability of government to meet essential social and infrastructure spending requirements. Furthermore, there is always the risk that such crises may weaken commitment to the policy reform process. Therefore, macro-economic policies, financial sector development and capital account liberalisation at a national level need to be designed in ways that not only facilitate sustained growth but also make costly "accidents" less likely.

II Development finance broadly defined

D.A.C. has begun to explore a new concept of "total development finance", which would be comprehensive, and thus could include both domestic savings and external private flows. Such a concept would reflect increasingly close links between domestic financial resources and external capital flows, as well as the growing role of external private flows; however, caution needs to be used in making explicit the important qualitative differences between official development assistance, private capital flows and recipient countries' domestic savings.

A Including domestic savings in total development finance

As the D.A.C. Policy Statement on Development Partnerships in the New Global Context rightly says, domestic savings of developing countries are the most important source of investment in their economic and social progress, and therefore are a key source of long-term growth. Furthermore, high rates of savings are increasingly seen as associated with decreased vulnerability to macro-economic and Balance of Payments crisis (see, for example, Summers, 1996).

Though overall the existence of high savings-high growth virtuous circles, as well as low savings-low growth vicious circles is established by empirical evidence, there is less agreement on the direction of causality. Some empirical evidence, including an influential article by Carroll and Weil (1994) concludes, based on a large sample of countries, that savings typically follow, rather than precedes, growth. Stiglitz and Uy (1996) find somewhat more ambiguous results for East Asian countries, where they examine whether income predicts savings or whether savings more accurately predicts income; income growth is reported to be a better predictor of saving in Indonesia, Japan, Taiwan and Thailand, results are ambiguous for Hong Kong and Malaysia, and in Singapore income growth is not a predictor of the rapid increase in saving rates. More broadly, Stiglitz and Uy, op. cit. argue that East Asian governments effectively promoted national savings in several ways, from creating financial institutions and regulating them to running small fiscal deficits or even surpluses.

The implication in our context is that : Correct policies and financial development can only partly contribute to raising domestic savings, as growth seems to be a major determinant of domestic savings. In countries caught in a low growth-low savings trap therefore, a double pronged approach is necessary. Firstly, governments and donors must maximise efforts via technical assistance to help generate and mobilise domestic savings; however, continued aid flows may be required for some time to help quick start economic growth, as increasing domestic savings seems to require a previous significant period of long-term growth.

As regards the types of policies that contribute to increase domestic savings, policy experience and research can lead us to conclude that:

1. Increasing public savings is an effective and direct way to raise national savings, as the evidence shows that public saving does not crowd out private savings, as the pure Ricardian equivalence would suggest. Indeed, recent evidence seems to show that the private sector offsets each dollar of public savings by dissaving only $0.50 or less (Schmidt-Hebbel, Serven and Soliman, 1996).

Therefore, an important area for policy action is to increase public savings, particularly by increasing tax revenue, but also by reducing non-essential public spending and by privatising loss-making parastatals. If public savings is increased by cutting public expenditure, care must be taken that spending essential for poverty alleviation and human capital formation (such as on education and health) is not cut back, and - if possible - is increased.

Increasing tax revenue (including reduction of tax evasion) is an important area for low-income governments, where technical assistance financed by development cooperation could be very valuable; similarly, support for restructuring budgets to reduce non-essential government spending would also be useful. Furthermore, technical assistance to help design budgetary processes is also very valuable.

2. Appropriate development of the financial sector is also an important way in which domestic savings can be increased, as well as it can be channelled in a higher proportion to productive investment. Recent literature (Pagano, 1993; Stiglitz and Uy op. cit) has stressed that though financial development in general tends to increase the productivity of investment, only certain types of financial development actually contribute to increases in overall savings. For example, excessive and unregulated development of consumer credit markets may discourage household savings, as occurred in Mexico in the early 1990's (Griffith-Jones, 1996).

On the other hand, strengthening banks, and developing appropriate savings institutions may help increase savings, the proportion of it channelled to investment, and increase the productivity of investment.

Particularly in low-income countries (but also more widely), it is crucial for governments to strengthen banks. As Michel Camdessus rightly pointed out (I.M.F. Survey, 1996), "Banks form the core of financial systems. Thus, whether a country's financial system is safe and sound or not depends in large part on the soundness of the banking system".

A key priority in low-income countries is to strengthen banks via support for bank privatisations as well as better supervision and regulation (accompanied by better enforcement). A key issue is to clear excessive bad bank debts in ways that: a) avoid excessive fiscal cost, b) avoid moral hazard, that is the recurrence of the problem, in the same banks as seems to occur a great deal in low-income countries. As the experience in the transition economies of Eastern Europe shows (see for example, Griffith-Jones and Drabek, 1995), overcoming successfully the problem of banks' bad debts also requires privatisation and restructuring of enterprises.

Technical assistance, funded by development cooperation, can be very valuable in i) development of bank regulatory and supervisory frameworks, as well as their implementation, ii) improvement of accounting and auditing in banks, iii) training of private bank credit officials in risk evaluation, iv) support for development of laws and the legal system to improve contract enforcement, and to facilitate borrowers offering collateral. It is worth mentioning that in other somewhat related fields, e.g. monetary policy, the IMF provides fairly systematic technical assistance to low-income countries. There is, however, no equivalent action on bank regulation. It would seem appropriate that institutions like the BIS and/or the OECD (drawing on its' experience of technical assistance in transition economies) provide more technical assistance in bank regulation and related matters to low-income countries.

As pointed out above, sound banking systems will help avoid costly banking crises, that are not only fiscally very costly (Reisen, 1996) and disrupt credit to the private sector but also undermine trust in domestic banks as vehicles for savings.

An important aspect to bank development, which not only encourages savings and its efficient investment but also can play an important direct role in poverty alleviation, is effective credit to small and medium enterprises (S.M.E.'s) and micro-enterprises. Such lending should be done in ways that: a) reach a significant part of entrepreneurs in those categories b) do not lead to major repayment problems and c) is done at positive real interest rates.

A valuable use of aid funds could be to provide seed money for high administration costs (particularly in the initial stages) of lending by banks to large numbers of very small, and medium enterprises; however, care should be taken that aid funds are not used for covering banks' commercial risk. For this purpose, appropriate incentives for effective repayment should be created amongst bank employees, borrowers and others (Mosley and Hulme, 1996)

It needs to be stressed that development of the financial sector is clearly linked to development of the private non-fianancial sector.

Recent literature (for example, Singh 1994) has shown the important role that stock exchanges play in developing countries, even in some low-income countries, as sources of capital formation for large enterprises. Stock exchanges also facilitate privatisation processes and help attract private foreign capital. Furthermore, stock exchanges - like banks - contribute to channelling savings to more illiquid, and more productive investments, thus helping raise the average productivity of the economy (Saint Paul, 1992). On the other hand, particularly, but not only, when capital markets are very thin (Faber 1996), they can become quite volatile, volatility which can have negative effects on the rest of the economy. Furthermore, though developments of markets in public sector debt are an important element in developing capital markets, prudence needs to be exercised to avoid foreign investors purchasing a very high proportion of very short-term government debt, so as to avoid the risk of a massive non-renewal of government paper leading to major foreign exchange outflows, as occurred with Tesobonos' non-renewal during the Mexican crisis (Griffith-Jones, 1996; I.M.F., 1995).

Technical assistance, funded by aid, can be valuable in helping develop stock exchanges in low-income countries. Emphasis needs to be placed not just on development of capital markets, but also on appropriate regulation, (for example to ensure transparency, good custodian arrangements, etc.). Assistance with analysing the macro-economic implications of the development of stock exchanges would also be helpful, so as to help minimise risks of negative effects, as well as maximise positive effects.

3. Sound macro-economic policies need to be pursued for long periods, to help - among other important objectives - encourage an increase in domestic savings.

Development cooperation is already providing important support towards achieving the crucial target of sound and stable macro-economic policies.

B Including external private finance in total development finance

In a broadly defined context of total development finance, it can be argued that not just official flows but also private capital flows should be included, particularly as the latter seem to have a clearly growing trend. However, there are important qualitative differences between official and private flows, as well as between different categories of private capital flows, which need to be carefully considered.

In particular there is a great deal of evidence that certain private capital flows, especially F.D.I., contribute more to development than other private flows (such as short-term debt or possibly portfolio flows). Reisen (1996) provides evidence that F.D.I. contributes to growth; a cross-country regression for the 1970-89 period shows that for each percentage point increase of the F.D.I./G.D.P. ratio, the rate of economic growth increases by 0.8 percentage points (Borensztein, De Gregorio and Lee, 1995); on the other hand, Cohen (1993) finds, also with cross country regressions, that borrowing by developing countries does not seem to contribute to capital accumulation, and thus to growth. Foreign direct investment (particularly greenfield investment) would seem to have three types of advantages over other types of private capital flows: a) it seems to lead to higher investment, whereas there is evidence that other private capital flows may often lead to higher consumption, as well as macro-economic distortions such as over-valued exchange rates, b) F.D.I. leads to higher productivity of investment by bringing in technological and managerial know-how and c) F.D.I. seems, on the whole, far less volatile than other categories of capital flows (see, for example, Turner, 1991). Physical investment is to an important extent irreversible; once the capital stock is installed, it cannot be sold without incurring a substantial economic cost (Dixit and Pindyck, 1994).

We can conclude that on the whole F.D.I. flows seem to play a more positive role in development than other private capital flows and that they are perhaps more similar to official flows. It is interesting that certain analysts including private sector ones (for example, Barings 1995 Report) have defined as a crucial variable to measure country's attractiveness, the "fundamental balance", which is the current account deficit minus foreign direct investment. On the other hand, it should be said that F.D.I. is not that different from other capital flows (such as medium and long-term borrowing) and indeed that in some cases it is difficult to distinguish completely clearly between F.D.I. and other flows.

As regards private capital flows, an important issue is to establish what levels of current account deficit - and private capital flows - are sustainable. Concern has grown that a large proportion of private flows can become reversible, as was illustrated by the Mexican crisis; this concern which was initially mainly expressed by academics (for example, Ffrench-Davis and Griffith-Jones, 1994) is, particularly after the Mexican crisis, broadly shared by the main international financial institutions (I.M.F., 1995, B.I.S., 1995).

Appropriate criteria and indicators need to be systematised to define levels of capital flows and current account deficits that are not excessive, and that therefore imply little risk of foreign exchange crisis. Useful suggestions are that net liabilities, - or their growth - should not exceed more than 200% of exports, - or their growth (Dadush, Dhareshwar and Johannes, 1994). Also, of importance for determining the maximum level of current account deficit that is "safe" are variables such as rate of economic growth, levels of domestic savings, levels of reserves and levels of debt (Williamson, 1995; Reisen, 1996).

Low-income countries will face two opposite challenges once their excessive external debt burdens are sufficiently reduced. Firstly, they must ensure that sufficient private flows (and sufficiently stable flows such as F.D.I.) are attracted to their countries, to allow them to increase investment and its productivity significantly. Secondly, they must avoid excessive and unsustainable liabilities being incurred, so as to avoid risks of "old style" debt or "new style" foreign exchange crises occurring For this purpose, appropriate surveillance needs to be exercised.

Technical assistance, funded by development cooperation can make a valuable contribution to both these objectives. Firstly, they can help design policies and measures to help attract sufficient private flows, especially F.D.I. and other long-term flows. Secondly, they can help with careful monitoring of capital flows (by improving the quality and timeliness of data), and with establishing criteria for maximum levels and preferred composition of private capital flows, in different country contexts, as well as policy suggestions on the complex issues of managing capital flows.

As regards encouraging long-term flows, an area where development cooperation could play a valuable role is in that of private financing of infrastructure (both external and domestic) flows. Assistance can be helpful in making operations transparent and in clearly defining the distribution of risks (commercial, political, etc.) between investors, operators and governments. Where necessary, special guarantees (or even guarantee facilities) granted by governments to cover non-commercial risks can be established. Lessons can be drawn from the experience of developed countries, for example the recent creation by the European Commission of the European Investment Fund to help encourage private finance of Trans-European infrastructure.

An important aspect of private infrastructure projects is that more projects in developing countries will probably be at the local level (I.F.C., 1996). This requires improving the creditworthiness of municipal and local governments, possibly by enhancing local finances. For this purpose again technical assistance will be valuable, partly drawing on the rich experience of developed countries (the U.S. - in particular - funded much infrastructure by private sector finance raised by municipalities and local governments). These issues need to be linked to assistance for overall monitoring of total external liabilities, to ensure that liabilities incurred by local governments are included in total external liabilities (as they often are not). Technical assistance may also be required for the related issue of local resource mobilisation, examining issues such as the extent to which fiscal revenues should be collected/distributed in a decentralised way.

III Data issues

A Monitoring issues

1. The rapid growth of private flows to developing countries, and the fact that the modalities through which they come change rapidly, implies that private flows - as well as their composition - are difficult to measure accurately. Particularly difficult to measure

accurately are equity flows, including foreign purchases of government paper, as well as short-term debt and money market instruments. Technical assistance to developing countries to improve their monitoring of such flows would seem to be a high priority.

2. Particularly important is establishing the scale and composition of private capital flows to Sub-Saharan Africa, which according to some analysts (Kasekende, Kitabire and Martin, 1996) may be significantly higher than recorded in both national and international sources. These discrepancies arise mainly for two reasons: a) large amounts of capital inflows by residents and non-residents are apparently misrecorded in the current account under a residual item, "private transfers", item which has risen dramatically and whose composition is unknown, b) short-term trade finance, which has grown considerably in recent years, is not properly monitored and - in many S.S.A. countries - is not properly recorded.

Technical assistance is thus urgently required to help establish the real scale and composition of private inflows to S.S.A. If it is true, that private capital flows are significantly higher than recorded till now, the news needs to be widely disseminated as this will be an encouraging fact, that should increase confidence of both domestic and foreign investors.

3. There is a fairly rapidly growing category of intra-L.D.C. private flows. These are particularly large within Asia, but seem to be rapidly growing within Latin America (with for example, flows from Chile to other Latin American countries being surprisingly large). Reportedly private flows from non-developed Asian countries to Sub-Saharan Africa are growing significantly (interview material).

Recording of these flows is patchy and incomplete. It would seem useful if the O.E.C.D. - or another international institution - could monitor intra-developing countries' private flows.

4. Last but certainly no least, a key issue relating to private flows is their use within recipient countries. To what extent do they contribute to increase consumption and to what extent do they contribute to increase investment? To what extent does the additional investment generated go into tradeables, and thus generates additional future foreign exchange?

Though there are methodological difficulties (linked for example to the fungibility of a fairly large part of the capital inflows), it seems valuable for governments to monitor the use and the impact of private flows on their economies. This should be done in ways that are not intrusive or onerous on the private investors. Technical co-operation in this field could again prove very valuable.

B Country classification

Given changing trends in domestic and international finance, the issue arises whether new analytical country categories would be helpful. A number of issues seem to arise:

1. Should, for example, indicators of domestic financial development be one criteria for classifying countries (Berthelemy and Varoudakis, 1996)? But appropriate indicators need to be developed, which effectively reflect countries' ability to mobilise more savings and channel it more productively to investment?

2. Should access to certain types of more stable, private flows (e.g. using F.D.I. as a proxy), be included as an important criteria?

3. More broadly, it seems helpful to, in stylised terms, think of three categories of countries;

a) Countries where virtuous circles of high and sustained growth and high domestic savings have been fairly firmly established. Given this virtuous circle, usually accompanied and preceded by sound and stable macro-economic policies, such countries tend to attract high and fairly stable private flows, a large part of which are long-term (especially F.D.I.). External debt or foreign exchange crises seem to be either rare or non-existent (though there is no absolute guarantee that they will not occur).

As regards the role of aid and official flows in those countries, it has to be clearly focused, for example if there are legitimate human and social development needs, that cannot clearly be met via other financing mechanisms. It is likely that in these countries official flows can mainly play their role best here by helping catalyse private flows (either domestic or foreign) or by providing seed money for capacity building. Where financial markets work really effectively, donors' best policy may be to stay out so as to avoid crowding out private sector activity. Official flows will also need to play a role in the unlikely (but possible) event that external private flows fall rapidly.

b) Countries with relatively low domestic savings, a short history of stable macro-economic policies and fairly low, but particularly volatile, growth. The structure of private capital flows tends to be more biased towards the more short-term and volatile; in the periods of boom, high access to private flows. Problems with domestic banking sectors and Balance of Payments crises are far more common.

In this second category of countries, the role or aid and official flows should focus on human and social development needs, which tend to be higher than in the countries in the former category. Official flows can, where feasible, work by catalysing private flows (either foreign or domestic) or by providing seed money for capacity building. Official flows may need to play an important role if banking and/or Balance of Payments crises occur. However, maximum efforts (e.g. via reinforcing national bank and financial market supervision, monitoring of capital flows, good macro-economic policies to include discouragement of short-term private capital flows where required) need to be made to make crises less likely.

c) There is a third category of mainly low-income countries with very low domestic savings and very low growth. They have also a short history of stable macro-policies and large unmet needs of human and social development. They have apparently low - and relatively short-term - private flows.

Aid and official flows need to play a far more important role in these countries, by financing essential activities directly, by catalysing private inflows and by building capacity, for example by providing seed money for financial sector development. Aid needs to be used not just to help fund the crucial investment in human capital (health and education) but also to help provide technical assistance (and, where required funding) for activities which will generate additional revenue almost immediately. An example is support for creation of export credit agencies. As regards funding for infrastructure, aid should be used only in those sectors where private investors are unwilling or reluctant; in some sectors - such as telecommunications - it seems far more easy to attract private finance, and any aid required may either be to provide technical assistance, for example to help design guarantees and/or appropriate regulations.

The difficult but important challenge is to use aid to help stimulate higher growth, higher domestic savings and more long-term private capital flows in those countries. This would enable countries from category (c) to move towards the "virtuous circle" (a) category. It should be a source of encouragement that some countries seem to have moved up at least one category; thus, for example, it would seem that Chile has in important aspects, (though not totally) moved from category (b) to (a).

Annex 1

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