UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
UNCTAD

No.78
MAY 2020

POLICY BRIEF

TOPSY-TURVY WORLD: NET TRANSFER OF RESOURCES FROM POOR TO RICH COUNTRIES

The crisis stemming from the coronavirus disease (COVID-19) has turned a spotlight on financial vulnerabilities in developing countries and the limitations they face in mobilizing domestic financial resources to respond to the pandemic at the required scale.[1] This brief takes a step back from the COVID-19 crisis to highlight a longer-standing trend which is adding to the troubles facing developing countries. For the past two decades, net financial resource transfers between developed and developing countries have typically favoured the former and disadvantaged the latter. Overall, more financial resources have gone from developing to developed countries than have been returned. The policy brief looks at the main drivers of this net financial resource transfer to the developed world, including illicit financial flows from developing countries, and offers some policy proposals to address this problem.

Key points

- The COVID-19 pandemic comes after two decades in which net financial transfers have typically flowed from developing to developed countries, leaving many developing countries on a debt treadmill, financially exhausted.
- In 2000–2017, net transfers of financial resources from developing countries to developed economies grew steadily in the years prior to the global financial crisis, eventually peaking at $977 billion in 2012. If illicit financial flows are included, these figures increase considerably, and far exceed net ODA flows to developing countries.
- The measures proposed including a more proactive use of capital controls, recommitment to original ODA targets and a rules-based sovereign debt workout mechanism, will help to reverse this trend in net negative financial resource flows from developing countries.

Introduction

There is general agreement that historically weak capital accumulation in developing countries justifies raising domestic investment rates by securing external resources. However, while advocates of conventional growth theory expected that the necessary external funds would be generated automatically through the workings of free markets and the sensibilities of multinational corporations,[2] others felt that coordinated policy intervention would be required to ensure that sufficient external resource flows would be made available. Thus, in 1961, in a United Nations General Assembly resolution,[3] Member States were called on "to pursue policies that lead to an increase in the flow of development resources, public and private, to developing countries", a view that also led to the definition and espousal of target figures for the delivery of official development assistance (ODA).[4] More recently, the adoption of the 2030 Agenda for Sustainable Development has again focused attention on the vast investment requirements

[1] See, for example, updates to the *Trade and Development Report 2019* of UNCTAD from March 2020, The COVID-19 Shock to Developing Countries, and April 2020, From the Great Lockdown to the Great Meltdown: Developing Country Debt in the Time of COVID-19.

[2] In this view, as developing countries are assumed to have higher anticipated rates of return (profit) on domestic investment than is the case in already high-productivity developed countries, and as their lower incomes are associated with lower savings ratios, a steady flow of funds to developing countries should arise. This would result in a mutually beneficial outcome whereby developed country savers exploit higher returns and developing countries exploit their higher growth potential. Evidently, this theoretical expectation has not been borne out in practice. (See, for example, P-O Gourinchas and O Jeanne, 2013, Capital flows to developing countries: the allocation puzzle, *Review of Economic Studies*, 80:1484–1515).

[3] General Assembly resolution 1710 (XVI), on the United Nations Decade: A programme for international economic cooperation, para. 2 (19 December 1961).

[4] The second session of the United Nations Conference on Trade and Development (UNCTAD II) in 1968 adopted resolution 27(II), on growth, development finance and aid, considered a supplementary target for net ODA of 0.75 per cent of the gross national product (GNP) of developed countries, in addition to an overall target of financial resource transfers "of a minimum net amount of 1 per cent of the GNP". UNCTAD II was instrumental in putting development finance and ODA on the international agenda. In 1970, through United Nations General Assembly resolution 2626 (XXV), a 0.7 per cent of GNP target for ODA was adopted (para. 43), changing to a 0.7 per cent of GNI target in 1993.

UNITED NATIONS
UNCTAD

for its timely implementation and on the need for proactive international cooperation to close the still immense financing gap that is separating ambitious aspirations from their realization. Added to this, the likely vast economic impacts of the COVID-19 pandemic further underline the difficulties developing countries will face in closing this financing gap.

Against this backdrop, it is concerning that net financial transfers (or net resource flows) have typically flowed from developing to developed countries, leaving many developing countries on a debt treadmill, financially exhausted. External resources are deemed necessary to fund development, but this in turn generates return flows of interest payments and profit remittances that have to be funded by the developing country and can outweigh any earnings flows. The persistence of this net outflow has resulted in the notion that developing countries are giving more than they receive.[5]

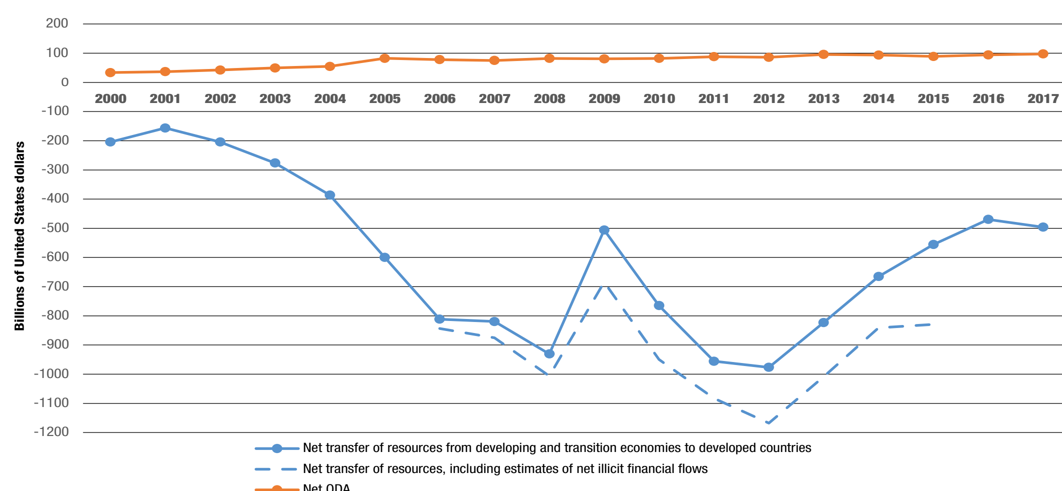
Net financial resource transfers from developing countries: 2000–2017

The net transfer of financial resources is defined here as the difference between net capital inflows and net income payments to foreign capital, including net changes in international reserves. It is the financial counterpart, but with the opposite sign, to the balance of trade in goods and non-capital services.[6] As this is a net position, a negative sign means there is a loss of domestic resources and, therefore, some part of the value of domestic production is unavailable for domestic use.

The figure below depicts the aggregated net resource transfers from developing to developed countries between 2000 and 2017 for 134 developing countries, with and without net illicit financial flows, as well as, separately, net ODA (defined as ODA, excluding loans and credits for military purposes).

Several general observations can be derived from these data. First, while the aggregate data reflect the balance of total receipts and payments relating to financial and other resource inflows and outflows, there is a clear and persistent transfer of financial resources from developing to developed countries year-on-year. In fact, net financial resource transfers from developing countries grew steadily in the years prior to the global financial crisis, reaching $931 billion in 2008. Following a somewhat improved position in 2009, enabled by a partial but quick recovery of exports and a surge in private portfolio capital inflows, net resource transfers worsened again to their largest value in the period of observation ($977 billion in 2012). The subsequent years saw some improvement in the net negative position of developing countries – in part a consequence of the depletion of their international reserves – only for the trend to reverse again downwards from 2016.

Net resource transfers from developing to developed countries*



* Includes net resource transfers, net illicit financial flows from developing countries to developed countries and ODA flows.

Sources: UNCTAD secretariat calculations, based on the UNCTADstat and OECDStat databases, World Development Indicators and Global Financial Integrity (2019).[7]

[5] Kregel, quoting a conversation recorded between ex-Chilean Finance Minister Valdés and President Nixon in 1969 (see Kregel J, 2014, *Economic Development and Financial Instability: Selected Essays*, Anthem Press, New York, p. 17).

[6] This definition follows United Nations, Department of Social and Economic Affairs, 2011, *World Economic Situation and Prospects 2011* (United Nations publication, Sales No. E.11.II.C.2, New York).

[7] Global Financial Integrity, 2019, *Illicit Financial Flows to and from 148 Developing Countries: 2006–2015*, Washington D.C.

Second, the persistence and size of net financial resource transfers from developing countries is closely related to the liberalization and rapid growth of private capital flows since the mid-1990s, and the concomitant strong expansion of developing country gross external assets and liabilities. The increase of the external assets and liabilities of developing countries were directly linked, as the former were largely borrowed. This particularly pertains to the accumulation of foreign-exchange reserves as a means of self-insurance, designed to contain the adverse effects of sudden reversals of non-resident portfolio capital inflows. Following the financial crises of the late 1990s and early 2000s, developing countries have tended to accumulate foreign-exchange reserves (safe assets) and attempted to reduce their exposure to foreign-currency denominated debt liabilities (while generating equity liabilities), at least until the onset of commodity price and other exogenous shocks after 2012. As creditors in safe assets and debtors in risky ones, the returns on external assets received are generally lower than the payments made on external liabilities,[8] resulting in an ongoing net transfer of financial resources from developing to developed countries.

Third, and unsurprisingly, when estimated data on net illicit financial flows – available up to 2015 for country aggregates – are added to the (official) data on net financial resource transfers, overall net resource transfers from developing countries are even steeper. Of course, aggregate estimates of illicit financial flows vary widely due to the hidden nature of these flows and differing methodologies.[9] The estimate used here includes funds that are illicit, in the sense of being illegally earned, transferred or utilized across borders, as well as proceeds from aggressive and illegal tax practices, crime and corruption. However, alternative estimates will change the size of the gap between the straight and dotted blue lines in the figure above, depending on definitions and measurement methodologies, but will not close it.

Finally, net transfers of financial resources from developing to developed countries far exceed any compensation by net ODA flows to developing countries, as can easily be gleaned from the figure. For example, in 2017 net transfers of financial resources from developing to developed countries amounted to $496 billion, while net ODA amounted to $97 billion. This is not helped by the commitments of Development Assistance Committee (DAC) member States remaining, on average, far below the 0.7 per cent of their gross national income (GNI) target for ODA, reaching only 0.30 per cent in 2019.[10] For perspective, UNCTAD estimates that unfulfilled ODA commitments from some DAC member States cumulatively amounted to $2.7 trillion between 2002 and 2017.

The chronic nature of these flows is closely linked to the financial fragility inherent in the external indebtedness of developing countries.[11] As developing countries usually have a negative current account balance, the debt service and amortization on growing stocks of net foreign claims can only be covered by additional foreign capital inflows – essentially a "Ponzi scheme" in design, whose stability depends on the willingness of creditors to continue to lend. Given the enormous economic, social and reputational costs of entering into a financial crisis, developing country debtors work to bolster lender confidence, often by meeting externally set criteria for lender confidence to remain intact. Building up foreign-exchange reserves is part of this assurance to lenders; another is undertaking fiscal austerity. A successful highly indebted country will be rewarded with a low-risk premium for enhancing its "financial" capital. But enhancing financial credibility in this way risks undermining the growth of real capital and productive capacity, ultimately limiting the debtor countries' ability to finance its borrowing through own external earnings – a vicious cycle that contributes to the persistence of net negative resource transfers for developing countries.

Recommended policies, not least in the time of COVID-19

With the onset of the COVID-19 crisis, major developing countries have seen a record outflow of international non-resident portfolio capital flows from their economies, far above the levels seen during the global financial crisis of 2008/09 and earlier developing country financial crises.[12] What is often overlooked is that such capital flow reversals have taken place against a systematic backdrop of sustained net negative financial

[8] UNCTAD, 2019, *Trade and Development Report 2019: Financing a Global Green New Deal* (United Nations publication, Sales No. E.19.II.D.15, Geneva), pp. 118–120.

[9] Since 2018, UNCTAD has worked with the United Nations Economic Commission for Africa and the United Nations Office on Drugs and Crime to develop a methodological approach for the measurement of the flows to address Sustainable Development Goal indicator 16.4.1. For details, see https://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=2222.

[10] Organization for Economic Cooperation and Development, 2020, Aid by DAC members increases in 2019 with more aid to the poorest economies, Paris, 16 April. While ODA increased in 2019 by 1.4 per cent in real terms compared to 2018, this represented 0.30 per cent of the combined GNI of DAC members, compared to 0.31 per cent in 2018.

[11] Kregel J, 2014, *Economic Development and Financial Instability: Selected Essays*, Anthem Press, New York, pp. 89 and 92.

[12] See the UNCTAD updates to the *Trade and Development Report 2019* from March 2020, The COVID-19 Shock to Developing Countries, and April 2020, From the Great Lockdown to the Great Meltdown: Developing Country Debt in the Time of COVID-19, p.3 and p.6, respectively.

resource flows from developing to developed economies. While not exhaustive, the following policies provide the potential to change the size and direction of financial resource transfers between developing and developed countries and to help developing countries to exit the external debt treadmill:

1. Rechannelling of external liabilities (debt) into productivity-enhancing domestic investment, building "real patient capital" at home to support and enable domestic structural transformation.

2. Systematic use of capital controls as an essential part of the macroeconomic toolkit of developing countries,[13] not only as a measure of last resort, but as a mechanism to ensure a competitive exchange rate for exporters and to be used in conjunction with other macroprudential measures.

3. Reinstitution of special drawing rights as a source of development finance, linking their use and expansion to development goals and the core objectives of climate change mitigation.

4. Recommitment to ODA targets, including a substantial increase in ODA to support debt relief programmes.

5. Reinvigoration of a rule-based sovereign debt restructuring mechanism that addresses the developmental needs of developing countries in a more systematic fashion.[14]

Contact

Mr. Richard Kozul-Wright,

Director,

Division on Globalization and Development Strategies

41 22 917 56 15

richard.kozul-wright@unctad.org

Press Office
41 22 917 5828
unctadpress@unctad.org
www.unctad.org

UNITED NATIONS
UNCTAD

UNCTAD/PRESS/PB/2020/2 (No. 78)

[13] UNCTAD, 2019, *Trade and Development Report 2019: Financing a Global Green New Deal* (United Nations publication, Sales No. E.19.II.D.15, Geneva), p. 128.

[14] Ibid, p. 101.