Part Two

The Challenge of Financing Development in The Least Developed Countries

Domestic resource mobilization, external finance and vulnerability

Chapter 1

A. Introduction

The issue of development finance in the LDCs involves the analysis of three interrelated themes namely, resource requirements for economic growth, poverty reduction and sustained development; the effort made to mobilize domestic resources; and the need for, and availability and effects of, external sources of finance. This chapter examines resource requirements in the LDCs in the context of their specific structural characteristics, and it assesses the effort made in domestic resource mobilization and the degree of reliance on external sources of finance.

Domestic resource mobilization and reliance on external resource flows are examined from a comparative perspective, in which the patterns in different LDC sub-groups and other non-LDC developing countries are compared. Section B presents an overview of the specific structural characteristics that distinguish the LDC economies from other developing countries. The findings of that section inform the analysis of the resource flows in the subsequent sections in an important way. Lack of attention to country group heterogeneity of the type described in that section has been one of the main weaknesses of policies and prescriptions that address the problem of financing development. Section C examines the domestic sources of finance and the constraints on domestic resource mobilization arising from the special characteristics of the LDCs. It also discusses the resource mobilization effort by the LDCs, as indicated by savings responsiveness, and the responsiveness of domestic resources available for finance in general, to economic growth. Section D assesses the size of external shocks experienced by the LDCs relative to the domestic resources available for finance in those economies. This relationship underlies the high degree of vulnerability of most LDC economies. Section E discusses the degree of reliance on external finance, and sets out the issue that is at the heart of the financing problems of the LDCs – namely, the dominance of external sources of finance in the central accumulation and budgetary processes in the LDC economies. It also examines the requirements for external finance, taking account of the vulnerability of the LDC economies. The main findings and policy implications of the chapter are summarized in the concluding section.

Despite important differences amongst the LDCs in terms of size and resource endowments, they share extremely low levels of income, a low degree of industrialization and human capital development, high levels of export concentration, often in one or two primary commodity lines, and a high level of vulnerability to external shocks.

B. Distinguishing features of the LDCs

Despite important differences amongst the LDCs in terms of size and resource endowments, they share important characteristics, a fact which distinguishes them from other developing countries. These include extremely low levels of income, a low degree of industrialization and human capital development, high levels of export concentration, often in one or two primary commodity lines, and a high level of vulnerability to external shocks. Since most of these variables have formed the United Nations' selection criteria for the LDCs, the average indicators shown in table 6 can provide a broad sketch of the distinguishing characteristics of individual countries in this group as well.

Table 6: Selected economic and social indicators for the LDCs and other DCs

	Year/Period	LDCs	Other DCs
A. Economic indicators			
GNP per capita, PPP	1980	724	2 587
(current international dollars)	1990	1 179	4 078
	1997	1 343	4 598
Share of labour in agriculture (%)	1990	75	32
Share of agriculture in GDP (%)	1997	34	17
Share of primary commodities	1980	86.3	79.6
in total merchandise exports (%)	1997	68.9	31.9
Export concentration index	1997	0.553	0.378
Export instability index	1980–1997	20.3	13.4
Energy consumption (kg coal eq. per capita):			
Coal, oil, gas and electricity	1980	64	508
	1996	69	898
Feulwood and charcoal	1980	212	125
	1996	210	135
Annual population growth (%)	1960–1970	2.4	2.3
	1990–1997	2.6	1.7
Age dependency ratio	1975	0.93	0.88
(dependents to working-age population)	1998	0.87	0.68
B. Social indicators			
Mortality rate, under-five (per 1,000 live births)	1997	108	65
Life expectancy at birth (years)	1990–1995	49	62
Hospital beds (per 1,000 population)	1990	1.1	4.8
Physicians (per 1,000 population)	1990	0.1	1.6
Adult literacy rate (age 15 and above)	1995	48.9	81.4
Gross school enrolment (%):			
Primary	1995	72.0	100.0
Secondary	1995	16.0	65.0
Tertiary	1995	1.6	17.7
Telephone mainlines (per 1,000 population)	1998	4.0	58.0[a]
Telephone average cost of local call ($ per three minutes)	1997	0.1	0.05

Source: UNCTAD, 1999a, and World Bank, *World Development Indicators 2000, UNDP 2000*.
Notes: Export instability index is the simple group average of the standard deviation of annual growth rates of exports (deflated by import price index). Export Concentration ratio is the Hirschman index as calculated by the UN. In the case of energy consumption, the other developing country group also included LDCs.
a All developing countries.

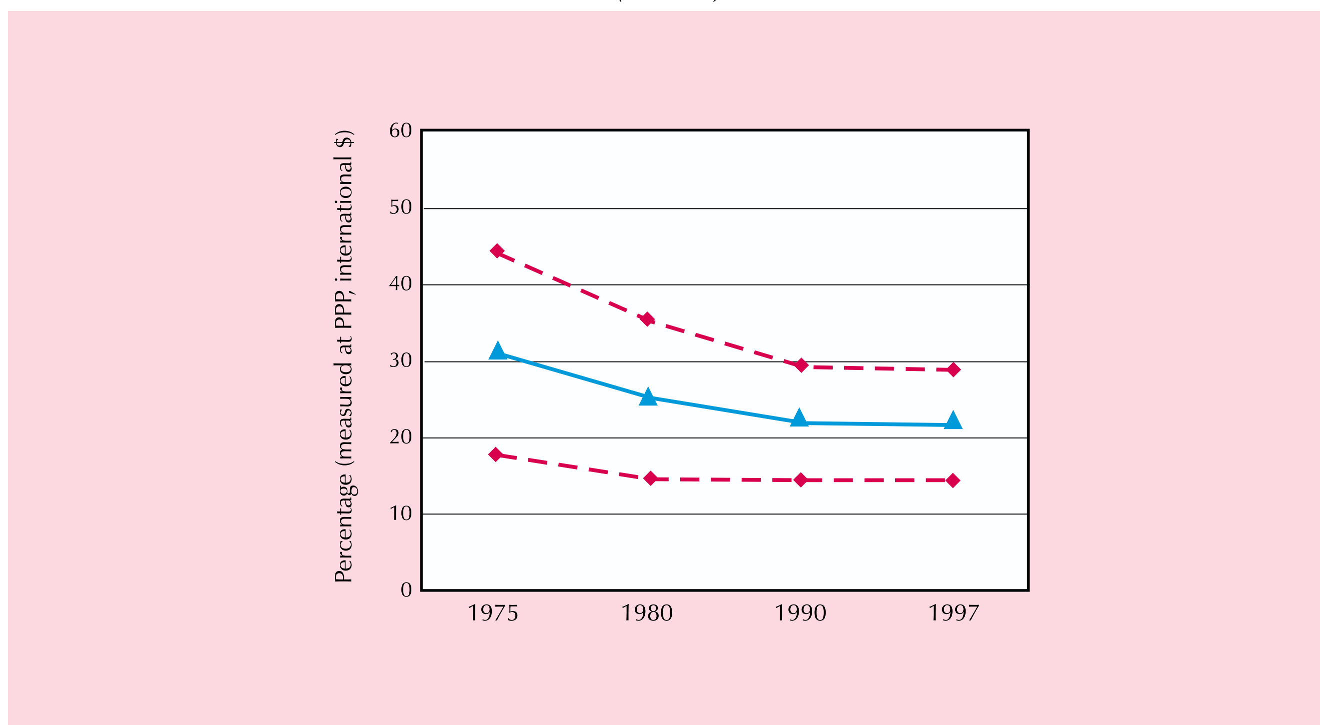
1. Low income and underdeveloped economic structure

On average 44 per cent of the population have a per capita income of under one dollar a day, and about 75 per cent have a per capita income of less than two dollars a day.

The average per capita GNP in the LDCs is only a quarter of the developing country average. In fact, in African and Asian LDCs, where the majority of the LDC populations live, per capita GNP is barely above 20 per cent of the other developing country average levels (chart 14).[1] At the prevailing levels of per capita income, it is not difficult to see that most of the LDC population in sub-Saharan Africa and Asia live close to subsistence level. The available data on a number of LDCs show that on average 44 per cent of the population have a per capita income of under one dollar a day, and about 75 per cent have a per capita income of less than two dollars a day (table 7).

The extremely low levels of per capita income in the LDCs are, of course, a reflection of the underdeveloped structures of these economies as compared with other developing countries, and their meagre stock of capital. On average, more than two thirds of the population and labour force in the LDCs live in the countryside and work in the agricultural sector, and the share of agriculture in

Chart 14: Average per capita GNP in African and Asian LDCs relative to other DCs, 1975–1997
(Per cent)



Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 1999*.
Note: The dashed lines show one standard deviation band.

Table 7: Incidence of poverty in selected LDCs

	Survey year	Percentage of population with per capita income	
		Below $1 a day[a]	*Below $2 a day*[a]
Bangladesh	1996	29.1	77.8
Burkina Faso	1994	61.2	85.8
Central African Republic	1993	66.6	84.0
Ethiopia	1995	31.3	76.4
Gambia	1992	53.7	84.0
Lesotho	1993	43.1	65.7
Madagascar	1993	60.2	88.8
Mali	1994	72.8	90.6
Mauritania	1995	3.8	22.1
Mozambique	1996	37.9	78.4
Nepal	1995	37.7	82.5
Niger	1995	61.4	85.3
Rwanda	1983–1985	35.7	84.6
Sierra Leone	1989	57.0	74.5
Uganda	1992	36.7	77.2
United Republic of Tanzania	1993	19.9	59.7
Yemen	1998	5.1	35.5
Zambia	1996	72.6	91.7
Average LDCs [b]		**43.7**	**74.7**
Average 55 other DCs [b]		**13.1**	**34.6**

Source: UNCTAD secretariat estimates, based on World Bank, *World Development Indicators 2000*.
a Measured at purchasing power parity exchange rates. *b* Simple averages.

gross domestic product (GDP) is more than double the average for other developing countries. The low level of industrialization in the LDCs is also reflected in the extremely low levels of modern sources of hydrocarbon-based energy use, as compared with other developing countries. The per capita consumption of combined coal, oil, gas and electricity in the LDCs is on average one tenth of the prevailing levels in the developing countries as a whole. In contrast, fuel-wood sources of energy still constitute the bulk of energy consumption in the LDCs (table 6).

While many other developing countries are completing their population transition phase and on average have had rapidly declining population growth and dependency rates over the past few decades, the LDCs have witnessed an acceleration in the rate of population growth with increasing dependency rates. This, amongst other things, has important implications for savings generation, and for the provision of education, health and other basic needs.

The underdeveloped production structure of the LDC economies is also reflected in the composition of their exports, with on average close to 70 per cent of exports consisting of primary commodities – more than double the primary export share for all the developing countries. The export concentration ratio in the LDCs is also much higher than in other developing countries, indicating the high degree of dependence of export revenues on a single product or a narrow range of products, mostly agricultural commodities and minerals. The decline in the share of primary products during the period 1980–1997 has been by and large the result of the collapse in the value of primary exports rather than the faster growth of non-primary exports.[2]

The growth and structure of population in the LDCs also show distinct characteristics as compared with the other developing countries. Population growth in LDCs is on average about one percentage point higher than the developing country average. While many other developing countries are completing their population transition phase and on average have had rapidly declining population growth and dependency rates over the past few decades, the LDCs have witnessed an acceleration in the rate of population growth with increasing dependency rates (table 6). This, amongst other things, has important implications for savings generation, and for the provision of education, health and other basic needs.

2. Poor socio-economic infrastructure

The LDCs substantially lag behind other developing countries with regard to health indicators such as infant mortality and life expectancy, and there is an even greater gap with respect to health care provisions such as the number of physicians and hospital beds per head (table 6).

The LDCs also substantially lag behind other developing countries with regard to educational attainment and other aspects of human capital development. The latest available data indicate that the adult literacy rate is on average 49 per cent in the LDCs as compared with 81 per cent in other developing countries. Primary and secondary school enrolment rates in the LDCs are respectively, on average, about 30 and 50 percentage points below the other developing country averages, and tertiary enrolment rates are on average a tenth of those of other countries (table 6). These indicators also suggest that the LDCs are fast falling behind other developing countries with respect to human capital formation, despite their meagre initial stocks. Considering that the vast majority of the LDC population are either rural-based or recent migrants to urban sectors, and taking into account the degree of economic regression in a number of LDCs during the past two decades, the gap between these countries and other developing countries in terms of the stock of human capital is likely to be even more glaring than the educational attainment data suggest.

Another outstanding characteristic of the LDCs is their exceedingly weak physical infrastructural base, which is particularly exemplified by the gap in their

TABLE 8: TRANSPORT INDICATORS FOR THE LDCS AND OTHER DCS

	Year/ period	LDC average[b]	Other DCs country average	t-test for the Difference between the means
Roads, normalized index[a] (LDC index=100)	1997	100	160.3	2.46
Paved road, normalized index[a] (LDC index=100)	1997	100	248.5	4.26
Railways, goods transported (1000 ton-km. per PPP $ million of GDP)	1990–1997	34.4	321.0	2.91
Railways, 1000 passenger-km. (per PPP $ million of GDP)	1990–1997	24.6	84.7	3.85
Air transport, passengers carried (per PPP $ million of GDP)	1990–1997	46.2	58.9	0.465
Air transport, freight (1000 tons. per km.) (per PPP $ million of GDP)	1990–1997	1.5	1.8	0.631

Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators 1999*.
a Normalized taking into account population, area, population density, per capita income and special regional dummies.
b Simple averages.

telecommunications and transport facilities as compared with other developing countries. For example, the number of telephone lines per thousand people in the LDCs is about four, which is one fifteenth of the average for other developing countries, and the cost of local telephone calls in the LDCs is a hundred per cent higher than the average for the latter.[3] The considerable disparity in the development of telecommunication infrastructure between the LDCs and other developing countries is likely to lead to increasing marginalization of the LDCs in the global economy with the growing importance of information and telecommunication technologies in all spheres of economic activity.

A similar situation exists with regard to the development of transport infrastructure in the LDCs. The poor state of that infrastructure in sub-Saharan African LDCs is well documented.[4] The problem of lack of development of transport infrastructure, however, is not confined to the African LDCs although it is particularly acute in those countries. As shown in table 8, even after one normalizes for population, area, per capita income and regional specificities, other developing countries on average have 60 per cent more road networks and almost two and a half times more paved roads compared with the LDCs. To this should be added the much poorer quality of roads and road transport facilities in the LDCs. A similar picture is conveyed with regard to rail transport, although the gap in air transport indicators in the two country groups does not seem to be significant (table 8). Another aspect of the transportation problems of the LDCs, which exacerbates the problem of poor internal transport facilities, is that a large number of them are landlocked countries, depending on long transit routes through neighbouring countries with similarly poor transport facilities, which are often subject to closures because of political instability.[5] The island LDCs face transportation problems of their own, arising from their small size, isolation and remoteness, and the existence of sizeable economies of scale in transportation.[6] The weak transportation infrastructure in the LDCs, apart from

reducing international competitiveness and adding to export instability, leads to fragmentation of the national markets and imposes prohibitive transportation costs on a large segment of the rural population – a problem which is particularly acute in the sub-Saharan African LDCs.[7]

3. Economic vulnerability

The low income levels, underdeveloped economic structures and poor state of infrastructure have made the LDCs highly vulnerable to external shocks resulting from natural causes or those arising from fluctuations in the world economy. LDCs have been subject to numerous natural disasters such as cyclones, floods, droughts and earthquakes. It is estimated that during the period 1975–1999 there have been 1,138 instances of natural disasters in the LDCs, directly affecting more than 600 million people, and inflicting direct damage of close to $16 billion.[8] While some of the LDCs have had more than their fair share of natural disasters in terms of both frequency and intensity, what really makes the difference in their case compared with other countries is that because of their economic vulnerability such events can have much more persistent and deeper economic and social consequences. Poor peasants with meagre resources may never recover from the loss of assets resulting from a drought, flood or cyclone. By encroaching upon their fragile environment as a survival strategy, they are likely to further intensify their economic vulnerability. The next mild natural mishap can easily assume disaster proportions. Similarly, natural disasters can divert a disproportionately large amount of government resources from essential developmental investment, thus seriously hampering the long-term growth prospects in an LDC economy. Another example of the vulnerability of the LDC economies to natural shocks is the rapid spread of contagious diseases, often assuming disaster proportions, because of low levels of sanitation, and inadequacy of information and education. The spread of AIDS in a large number of sub-Saharan African LDCs is a prime example of this type of vulnerability.[9]

The low income levels, underdeveloped economic structures and poor state of infrastructure have made the LDCs highly vulnerable to external shocks resulting from natural causes or those arising from fluctuations in the world economy.

The LDCs' degree of vulnerability to exogenous shocks arising from sharp fluctuations in real export revenues, either because of supply shocks or external demand and price shocks, is also very high. To begin with, the LDCs, because of the nature of their export specialization, are subject to much more acute export instability than other developing countries. The export instability index in the LDCs is at least 50 per cent higher than in other developing countries (table 6).[10] As we shall demonstrate in the next section, the intensity of the external shocks, as measured by maximum annual income losses relative to the resources which can be mobilized to cope with them, is also many times greater in the LDCs than in other developing countries. However, as in the case of natural disasters, what really distinguishes the LDC economies from other developing countries is their higher degree of vulnerability to such shocks, which is due to lack of flexibility in their production structures. For example, as the experience of other developing countries shows, economies that have a higher degree of export diversification have been in a much better position to deal with adverse terms-of-trade shocks. As well as having foreign exchange implications, such shocks in the case of the LDCs often directly strike at the main source of government revenues. In the absence of compensatory foreign financing, they can have serious debilitating effects on the developmental role of LDC Governments (see chapter 6 on aid effectiveness).

To sum up, the above discussion highlights three broad aspects of the LDC economies, which have an important bearing on the issue of financing

development. First, a major part of the LDC population lives in countries with very low per capita incomes and underdeveloped production structures. Second, extremely low levels of social and physical infrastructure inhibit the efficient use of productive resources in these countries. And third, largely as a consequence of the first two characteristics, the LDCs are highly vulnerable to external shocks arising from the vagaries of nature or those arising from external, international economy-related factors. These factors have important financing implications in terms of the magnitude of resource requirements for development, the availability of domestic finance, and the required degree and characteristics of external financing. We shall begin with domestic financing issues in the next section.

C. Domestic sources of finance

1. The scope of development finance in an LDC context

Development finance is understood here as the mobilization of resources and their effective use for the expansion of production capacities as well as for better utilization of existing capacities. Conventionally, domestic sources of finance are defined as gross (net) domestic savings, which are measured as gross (net) investment minus the net inflow of external finance. This is the same as gross (net) domestic product minus consumption expenditure. Adding net factor incomes from abroad gives a measure of national savings. In the conventional national accounting framework, investment is measured as the additions to physical capital stock (both fixed capital and additions to inventories), which is intended to measure additions to the production capacity of the economy. The determinants of savings are normally analysed after being appropriately disaggregated into private and government savings.[11] Disaggregated data on private and government savings for the LDCs do not exist, and even the available aggregate data on domestic or national savings should be treated with due care. Since they are estimated as the residual between two relatively large national accounting variables, the data on savings in the LDCs are likely to be subject to large measurement errors.[12] Before the evidence on savings is discussed, a number of other caveats regarding this conventional measure of domestic finance should be entered.

First, the conventional measures of net investment in national accounts take into account only the depreciation of man-made physical capital, thus ignoring the effect of the depletion of natural assets and environmental resources on the productive capacity of the economy. The ongoing work on “green national accounting”, which aims at measuring and including environmental resource depletion in national accounts, is intended to address this caveat.[13] Although measures of environmental resource depletion for the LDC economies do not exist, this is likely to be an important source of overestimation in net investment – and net domestic savings, given net capital inflows – as indicators of additions to productive capacities in these economies. The evidence on the extent of environmental resource depletion through deforestation, soil degradation and desertification in the LDC economies suggests that such effects can be quite substantial. Another important source of likely overestimation of investment and savings in the LDC statistics is the fact that aid-financed expenditures are conventionally recorded as development expenditure or public sector investment, although a large part of these expenditures are in fact recurrent – a point which we shall elaborate in chapter 6. These factors can indeed go a long

way in explaining the lack of commensurate response of output to investment in the case of some LDCs and in cross-country regression analyses involving such countries.[14]

Another shortcoming of the conventional measures of investment and savings is that they take into account only physical capital formation and exclude human capital formation. The importance of human capital formation in enhancing productive capacities is being increasingly recognized in the economics literature. With the increasing importance of automated and knowledge based technologies, education is becoming an even more important component of human capital formation than before, and the additions to the educational stock should play a significant role in enhancing production capacities in the economy. By excluding investment in human capital, the conventional definition of investment and savings in the national accounts is therefore, likely to miss an important component of development finance. Public expenditure on education, after adjustment for its efficiency, should be included as an important element of development finance as defined above.

With the inclusion of human capital formation as an important component of investment and savings, other components of social expenditure necessary for the preservation and upkeep of the stock of human capital should be also included as a part of development finance. For example, consider the case of a country, not untypical of many LDCs, where owing to low levels of public resources spent on health and education, a relatively large part of the working age population is incapacitated because of the prevalence of AIDS and other infectious diseases. This loss, whether it entails total or partial withdrawal from the labour force or lost efficiency, should be treated as a depreciation of the stock of human capital. On the same grounds, preventive and curative expenditure on health, which is necessary in order to prevent the depreciation of the human capital stock, should be treated as a component of development finance.[15] Since in developing countries the most important component of preventive health expenditure is in the public sphere, a basic minimum amount of government expenditure on health, adjusted for its efficiency, becomes an important component of development finance.

Our broad definition of development finance, which in addition to capacity creation includes the financing necessary for efficient utilization of existing capacities, encompasses even broader categories of public expenditure than those mentioned above. For example, minimum expenditures necessary for the maintenance of an efficient civil service, the enforcement of law and the maintenance of stable social relations within civil society all become essential elements of development finance. In the absence of those elements, not only would additions to physical productive capacities be ineffective in increasing production, but also the existing production capacities would remain underutilized. For example, in a country where lack of finance prevents the Government from providing these prerequisites for development, but at the same time various aid agencies are busy creating new capacities through numerous investment projects, the latter effort is unlikely to lead to increased output and productivity. In the long run, by burdening the Government with large debt service payments and hence further diverting resources from the prerequisites for development, such aid can even prove counter-productive. Similarly, in situations where owing to the lack of an effective central Government the country has regressed to social chaos and factional armed conflict, large direct investments by multinational companies in mineral resources clearly cannot help national economic development, and can even be counter-productive by helping to perpetuate the conflict (e.g. diamonds in

Africa). The allocation of at least a certain minimum necessary funding for efficient public service provision is thus an essential element of development finance. Of course, not all government expenditure plays such a developmental role, and the efficiency of public service provision is central to our definition. However, in situations where the inefficiency of public expenditure is due to shortage of funds in the first place, an initial increase in the allocation of funds to public services would be a prerequisite for economic development.

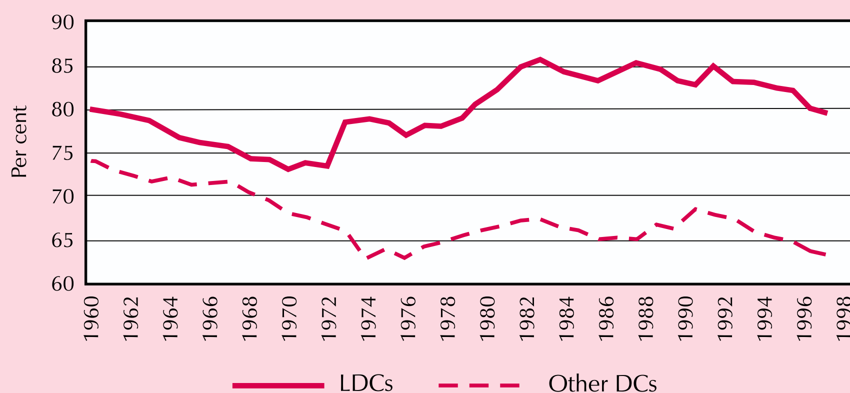
2. Private consumption and savings effort

In poor economies where a large part of the population survives at near-subsistence levels of consumption, private consumption forms a major share of GNP and resources available for finance are constrained by the ability to save. It would be instructive to begin by examining the trends in private consumption in the LDCs in comparison with other developing countries during the past four decades. Chart 15 shows the average private consumption-to-GNP ratio for the LDCs and other developing countries for the period 1960–1997. As can be seen, since the early 1970s a large gap has developed in average consumption ratios between the two groups of countries. Throughout the 1980s and the 1990s, the average consumption ratio for the LDCs has fluctuated at around 80 to 85 per cent, about 20 per cent higher than the average for other developing countries. The African and Asian LDCs have had average consumption ratios of about 85 per cent during the past two decades, while the island LDCs, starting from relatively lower consumption ratios in the 1980s, have rapidly climbed to the 80 per cent level during the 1990s (table 9.A).

The average private consumption ratio for the LDCs has fluctuated at around 80 to 85 per cent of GNP, about 20 per cent higher than the average for other developing countries.

The difference between GDP and private consumption is, as a matter of accounting identity, equal to domestic investment plus government expenditure and investment abroad. We may refer to this residual as “domestic resources available for finance” (DRAF). For a number of reasons the examination of DRAF – in conjunction with, or in addition to the conventional savings concept – may be particularly fruitful in the case of the LDCs. First, as noted above, the measurement of government investment in the LDCs can include a large

Chart 15: Private consumption as a share of GNP in the LDCs and other DCs, 1960–1997
(Per cent)



Source: As for tables 9 and 10.
Notes: LDCs exclude island economies. Average refers to simple means.

TABLE 9: AVERAGE PRIVATE CONSUMPTION RATIO AND DOMESTIC RESOURCES AVAILABLE FOR FINANCE IN THE LDCS AND OTHER DCS, 1960–1997

	African LDCs	Asian LDCs	Island LDCs	LDC average	Other DCs
A. Average private consumption as percentage of GNP					
1960–1965	77.7	86.6	..	..	72.5
1965–1970	72.3	88.8	..	..	70.5
1970–1975	73.7	90.9	72.7	75.9	65.9
1975–1980	77.6	85.2	78.4	78.6	64.5
1980–1985	83.9	84.2	71.5	81.7	66.6
1985–1990	85.9	85.1	70.9	81.6	65.8
1990–1997	84.6	84.0	80.0	82.2	66.3
B. Domestic resources available for finance (DRAF) as percentage of GNP					
1960–1965	22.3	13.4	..	..	27.5
1965–1970	27.7	11.2	..	..	29.5
1970–1975	26.3	9.1	27.3	24.1	34.1
1975–1980	22.4	14.8	21.6	21.4	35.5
1980–1985	16.1	15.8	28.5	18.3	33.4
1985–1990	14.1	14.9	29.1	18.4	34.2
1990–1997	15.4	16.0	20.0	17.8	33.7

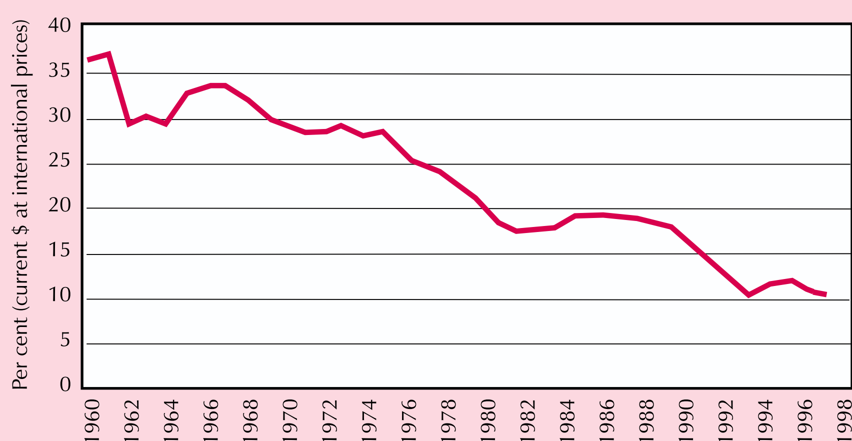
Source: UNCTAD secretariat calculations based on World Bank, *World Development Indicators 1999*.
Notes: Averages refer to simple group and period averages. DRAF is measured as defined in the text.

element of recurrent expenditure, and hence the savings data can contain a large systematic measurement error. In the case of DRAF, however, the data at least correspond more closely to what they are supposed to measure. Secondly, in the absence of data on private income and private savings, DRAF can be used to illuminate the constraints on financing development from the real side in the case of poor economies where a large part of the population live at near-subsistence levels of consumption.[16] Finally, since, in contrast to savings, DRAF is a positive magnitude in most LDCs and is relatively more stable than savings, it is more suitable for use as an accounting magnitude relative to which the size of external shocks (vulnerability) can be compared across countries.

The above trends in private consumption-to-GNP ratios indicate that in the case of the LDC economies the domestic resources available for finance represent a much smaller share of GNP than in other developing countries. In fact, the DRAF-to-GDP ratio in the LDCs has on average varied between 15 per cent (in the case of Asian and African countries) and 20 per cent (for island LDCs) during the 1980s and the 1990s. In contrast, the domestic resources available for finance in other developing countries were on average about 34 per cent of GNP over this period.

Before considering the consequences of this phenomenon for financing development, we need to investigate further some of the underlying reasons for these contrasting trends. The first important point to note is that the rising private consumption ratios in the LDC economies are not due to rapid rates of growth of private consumption in these economies, financed by the availability of concessionary aid, as is sometimes alleged.[17] On the contrary, both relative to other developing countries and in absolute terms, per capita consumption in the LDCs has exhibited a declining trend. In particular, precisely during the period when LDC private consumption ratios were rising, per capita consumption in these countries relative to other developing countries showed a steep decline, falling from 30 per cent of the average of other developing countries in the late 1960s to a mere 15 per cent by the 1990s (chart 16 and table 10). In absolute

CHART 16: AVERAGE PER CAPITA PRIVATE CONSUMPTION IN THE LDCS RELATIVE TO OTHER DCS, 1960–1997



Source: As for tables 9 and 10.
Notes: LDCs exclude island economies. Average refers to simple means.

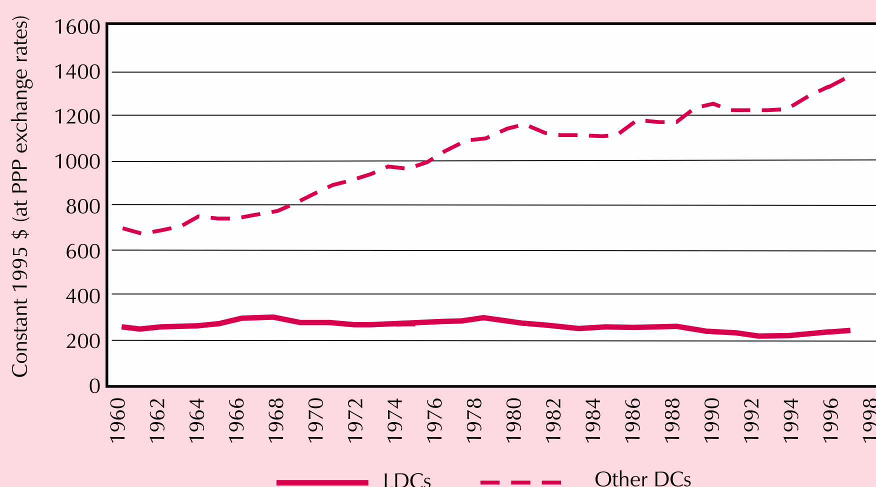
TABLE 10: AVERAGE PER CAPITA PRIVATE CONSUMPTION IN THE LDCS AND OTHER DCS, 1960–1997

	African LDCs	Asian LDCs	Island LDCs	LDC average[a]	Other DCs
A. Average per capita private consumption, constant 1995 dollars					
1960-65	266.5	191.6	..	261.2	711.1
1965-70	292.3	196.7	..	286.6	778.2
1970-75	286.9	172.0	..	277.1	923.7
1975-80	298.6	152.0	460.5	283.1	1056.8
1980-85	275.4	165.6	480.1	265.3	1130.1
1985-90	261.5	185.6	485.3	255.5	1167.8
1990-97	230.9	212.1	507.1	228.9	1256.7
B. Average per capita private consumption as percentage of other DCs					
1960-65	32.5	34.5	..	32.6	100
1965-70	31.9	34.0	..	32.0	100
1970-75	28.8	23.7	..	28.7	100
1975-80	25.4	15.3	44.1	24.5	100
1980-85	18.7	13.3	30.1	18.7	100
1985-90	18.5	14.8	33.4	19.0	100
1990-97	13.3	11.5	27.2	13.1	100

Source: UNCTAD secretariat calculations based on World Bank, *World Development Indicators 1999*.
Notes: *a* Refers only to Asian and African LDCs.
Averages refer to simple group and period averages.
Part B percentages are measured at current international dollars.

terms, the average per capita private consumption in the LDCs was lower in the 1990s as compared with the 1960s and the 1970s (chart 17). The decline was particularly noticeable in the case of African LDCs, while average per capita consumption in Asian LDCs remained more or less stagnant with signs of moderate recovery in the 1990s, and with island LDCs showing moderate increases over the past two decades (table 10). Even in the case of the island LDCs, however, average per capita consumption levels declined precipitously relative to other developing countries, falling from about 44 per cent in the late

CHART 17: AVERAGE REAL PER CAPITA PRIVATE CONSUMPTION IN THE LDCS AND OTHER DCS, 1960–1997



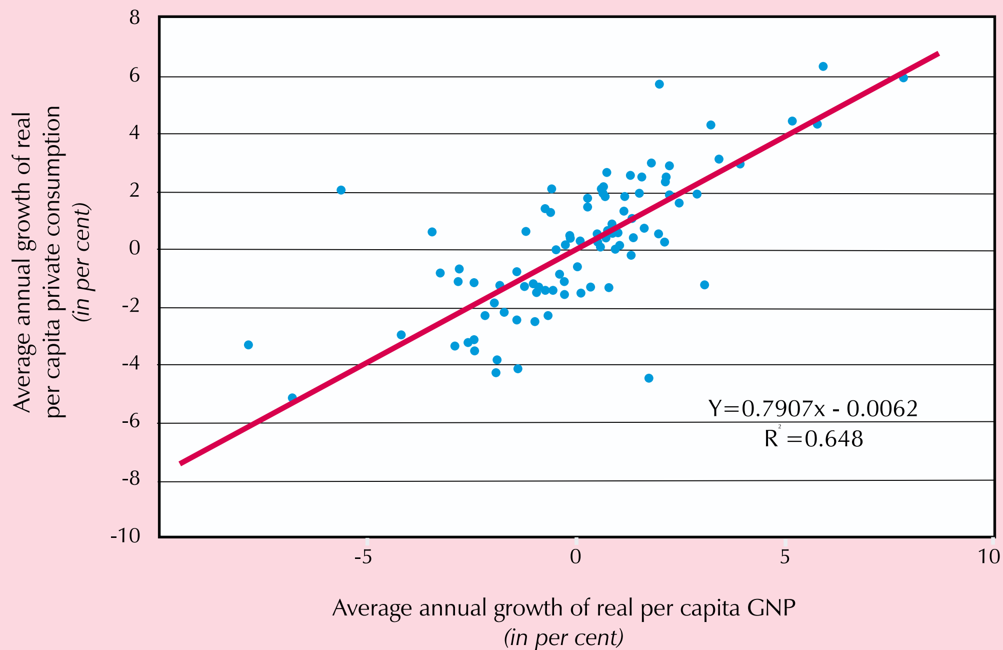
Source: As for tables 9 and 10.
Notes: LDCs exclude island economies. Average refers to simple means.

1970s to 27 per cent in the 1990s relative to average per capita consumption in other developing countries.

These two phenomena, namely the increasing private consumption ratio and the declining per capita private consumption levels in the LDC economies, are both explained by sluggish, and for long sub-periods for most countries negative, per capita GNP growth rates. For example, the rapid increases in the private consumption ratio, combined with falling consumption levels in sub-Saharan African LDCs during the past two decades, have been associated with falling average per capita incomes in this group. Similarly, the decline in the private consumption ratio that coincided with the increase in the real per capita consumption level in Asian LDCs during the 1990s was concomitant with the growth of per capita GNP in those countries during that period. This association can be clearly seen in chart 18, which shows the long-run relationship between the average annual growth rate of per capita private consumption and per capita GNP for the LDC economies for four sub-periods during 1960–1997.[18] The fitted trend line in chart 18 shows a robust long-term relationship between private consumption and income, with an income elasticity of consumption of about 0.8.[19] The implication is that as per capita income rises in the LDCs, private per capita real consumption increases and the consumption ratio falls, or the DRAF ratio rises.[20] The same relationship implies that as per capita income rises, the resources made available for finance (DRAF) in the LDCs rise in real per capita terms by a faster rate than per capita income. More precisely, at the prevailing DRAF rates of about 20 per cent in the LDCs, it is easy to see that on the basis of the relationship in chart 18, the income elasticity of real per capita DRAF is just below 2. That is, as real per capita GNP increases by 1 per cent, the domestic resources made available for finance rise by about 2 per cent.

This suggests a high degree of development effort, as defined by the LDC economies'propensity to refrain from consumption as their income level rises. A similar conclusion is arrived at if we define development effort in terms of conventional savings propensities, as discussed in the annex to this chapter. The

CHART 18: THE RELATIONSHIP BETWEEN PRIVATE CONSUMPTION AND GNP GROWTH IN THE LDCS DURING THE 1970S, 1980S AND 1990S
(Per capita, in real terms)



Notes: Annual growth rates refer to average 10-year trends during the 1970s, 1980s and 1990s.

econometric estimates in the annex indicate a relatively high marginal propensity to save in the LDCs as compared with other developing countries. According to these estimates, an increase of $20 in per capita income leads to a 1 per cent increase in the domestic savings ratios in LDCs, whereas for other developing countries an equivalent percentage increase in per capita income (i.e. an increase of $100) leads to a 0.44 per cent increase in the domestic savings ratio. It is not difficult to see that given the prevailing DRAF (or savings) elasticities, with sufficiently high rates of growth of per capita incomes, the LDCs would in due time achieve self-sustained growth. The prevailing financing crisis in the LDC economies does not seem to be due to lack of development effort as defined by low savings propensity, but is by and large the result of a long period of slow and in many cases declining per capita income growth. As can be seen from the turning points in charts 15 and 16, the growth and financing crises in the LDCs date back to the first half of the 1970s. During the 1970s the LDCs, together with other developing countries, faced major adverse external shocks arising from significant negative terms of trade movements, combined with a decline in export volumes as a result of the world recession, and rising interest rates in the industrial countries. For most primary-commodity exporters this also heralded a long period of declining terms-of-trade which has continued up to the present. In addition, since the early 1970s developing countries have increasingly been faced with major adverse income term-of-trade shocks, which in the case of the LDCs have put considerable pressure on available resources.

The prevailing financing crisis in the LDC economies does not seem to be due to lack of development effort as defined by low savings propensity, but is by and large the result of a long period of slow and in many cases declining per capita income growth.

D. External shocks and vulnerability

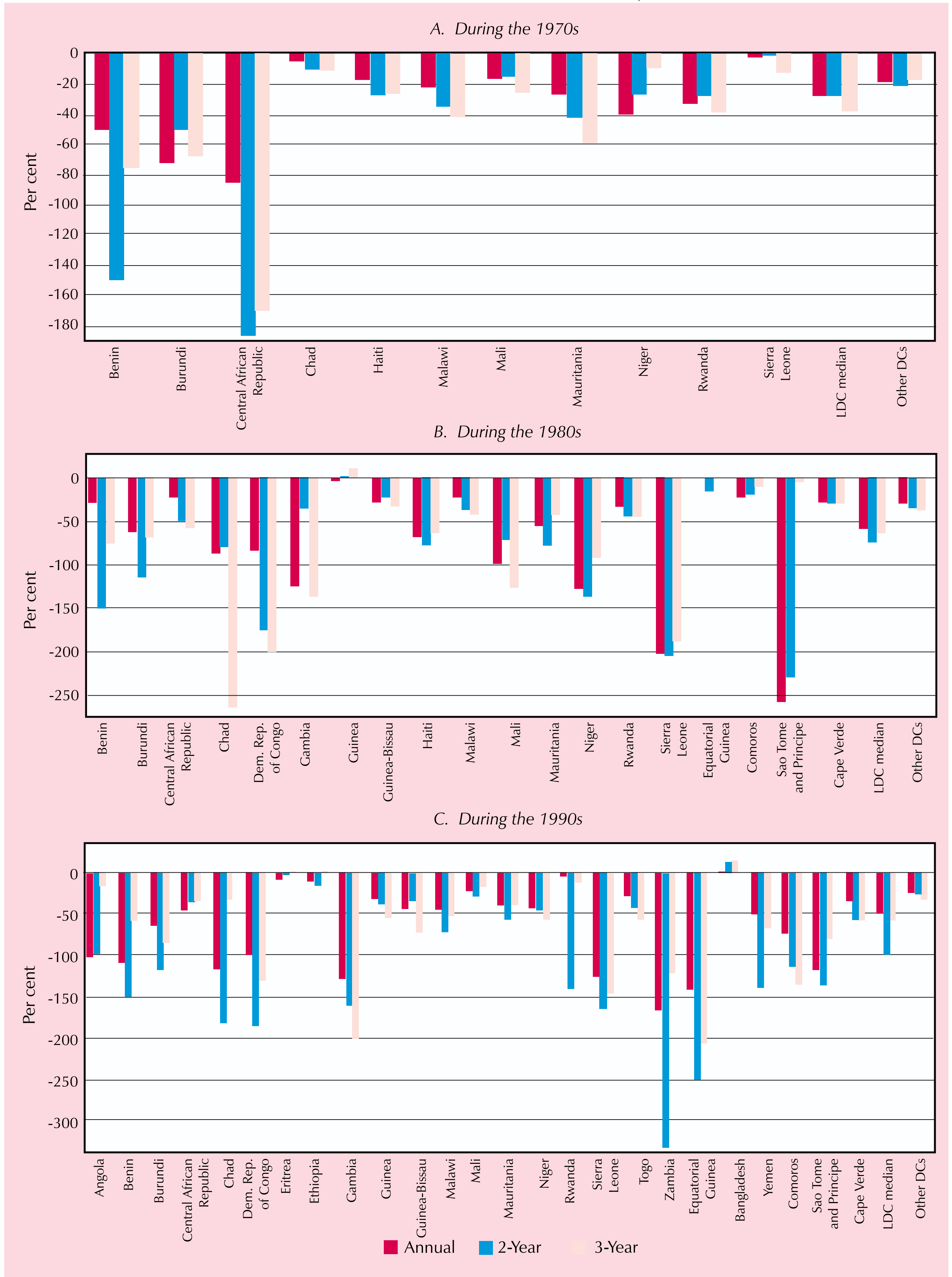
Chart 19 shows the magnitude of maximum annual terms-of-trade loss during the past three decades relative to resources available for finance (DRAF) for a number of LDCs.[21] It also shows the median ratio for the LDCs and other developing countries. The negative terms-of-trade shocks are measured in terms of annual income losses, and in order to demonstrate the persistence of such shocks, two- and three-year maximum income losses are also shown in chart 19.[22] As can be seen, relative to the size of its DRAF, the average LDC economy has been exposed to adverse external shocks, with an impact in the worst years of more or less double the developing country average.

The relatively higher average ratio for the LDCs is largely due to their higher degree of openness relative to their meagre DRAF base. This can be seen by noting that in relation to GDP or private consumption the maximum adverse terms-of-trade shocks do not seem to be significantly different between the LDCs and other developing countries (chart 20). With the diminution of their DRAF base over the years, the impact of external shocks as measured by the income terms-of-trade losses as a ratio of DRAF in the LDC economies has been increasing rapidly, as shown in Chart 19. The short-term income losses due to terms-of-trade effects in many LDC countries during the 1990s is indeed staggering. For example, in 8 out of 28 LDC countries for which data are available, the maximum annual shocks during the 1990s led to income losses of over 100 per cent of their DRAF in one year. In 14 out of 24 LDCs for which data are available, the maximum two-year income losses during the 1990s were over 100 per cent of DRAF. It is also important to note that the adverse external shocks are often persistent, in the sense that the two- and three-year maximum income losses are often larger than those resulting from the annual shocks. In addition, as we have seen in the previous section in the discussion of the vulnerability of the LDCs, the frequency of external shocks in the case of the LDCs is also much higher than in other developing countries.

Without access to appropriate external financing, the distributional tensions resulting from such large external shocks would inevitably give rise to mounting instabilities.

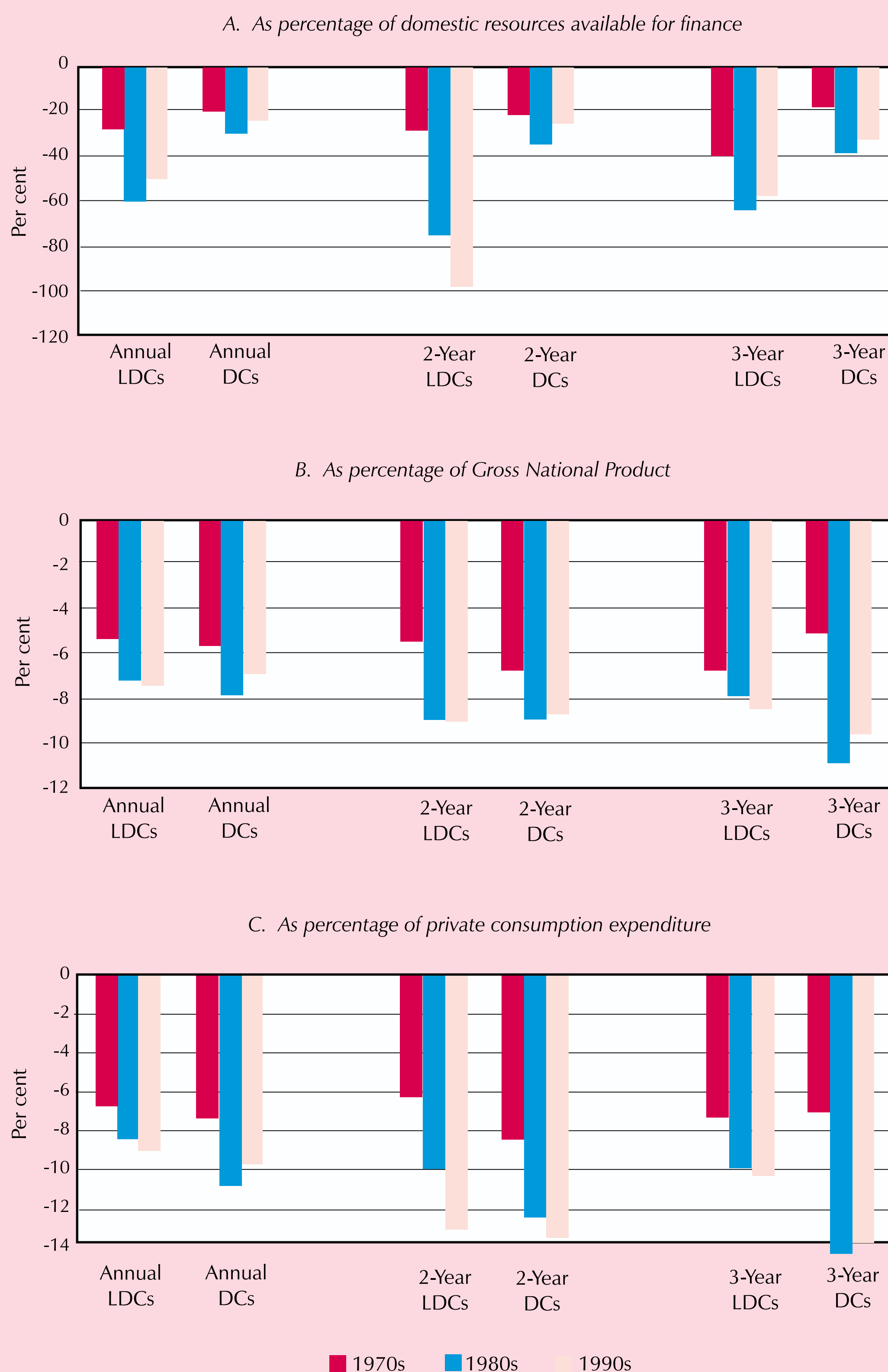
Other developing countries with higher levels of DRAF, per capita income and private consumption, as well as more diversified export structures, than the LDCs, have been in a better position to cope with these adverse external shocks, although, as we shall see, not without recourse to large amounts of external resources. With near-subsistence levels of private consumption, and meagre resources available for finance, the LDC economies also would certainly not be in a position to cope with adverse external shocks without access to sufficient and timely external finance. Without access to appropriate external financing, the distributional tensions resulting from such large external shocks would inevitably give rise to mounting instabilities as reflected in rising inflationary pressures, widening budget deficits, foreign exchange rationing and widening parallel-market foreign exchange premiums, and foreign trade contraction.[23] Not only the amount of foreign resources available, but also the timing of the inflow, and the mechanisms for access to and control over such resources are crucial elements in avoiding such instabilities. We shall start in the next section by examining first the relative magnitude of external resource inflows and the nature of external resource requirements in the LDCs.

CHART 19: MAXIMUM INCOME TERMS-OF-TRADE LOSS AS PERCENTAGE OF DOMESTIC RESOURCES AVAILABLE FOR FINANCE DURING THE 1970S, 1980S AND 1990S



Source and methods: As explained in the text.

CHART 20: MAXIMUM INCOME TERMS-OF-TRADE LOSS AS PERCENTAGE OF DRAF, GNP AND PRIVATE CONSUMPTION FOR MEDIAN LDC AND OTHER DC GROUPINGS DURING THE 1970S, 1980S AND 1990S



Source and methods: As explained in the text.

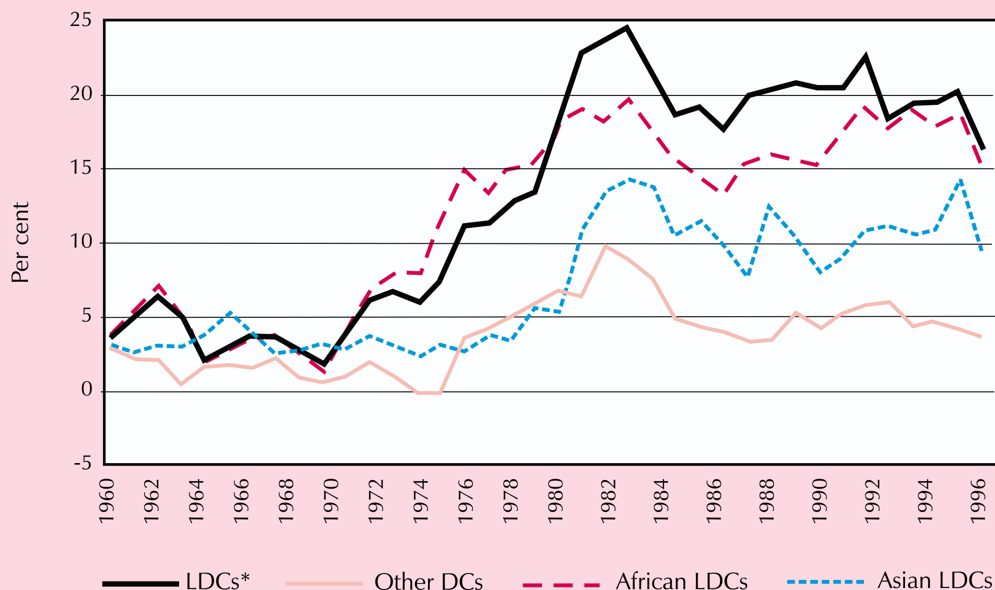
E. External resource flows and requirements for finance

With the prevailing levels of resources available for finance, very low levels of per capita income and private consumption, and vulnerability to frequent and large external shocks, it would not be surprising to find that the LDC economies have been reliant on large amount of external financing. As shown in chart 21, the LDC economies on average have relied on external financing equivalent to about 20 per cent of their GDP since the early 1980s. The average for African LDCs has fluctuated between 15 and 20 per cent in this period, while for the Asian LDCs the external resource gap has fluctuated around the 10 per cent mark. As noted above, the LDCs' financing crisis began in the 1970s. As shown in chart 21, there was a steep increase in resort to external financing in the LDCs and in other developing countries during that period. With the onset of the debt crisis of the early 1980s, the external finance-to-GDP ratio in the other developing countries stabilized at about 5 per cent, and the LDC average ratio stabilized at about 20 per cent. There are, of course, wide variations in the intensity of external resource dependence among different LDC sub-groups.

The LDC economies on average have relied on external financing equivalent to about 20 per cent of their GDP since the early 1980s.

As shown in table 11, the island LDC economies are overwhelmingly dominated by external resource inflows, with a financing gap of over 40 per cent of GDP on average. In these economies the external resource inflows are far larger than gross domestic investment and government consumption expenditure. As explained in box 1, this arises from the special characteristics of the small island economies which distinguish them from other LDC economies.

CHART 21: EXTERNAL RESOURCE GAP AS A PERCENTAGE OF GDP IN AVERAGE LDCS AND OTHER DCS



Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 2000*.
Notes: External resource gap is defined as current account deficit excluding official transfers.
* LDC average includes Island LDCs. Average refers to simple means.

Table 11: External resource gap as share of investment, government expenditure, government consumption expenditure and GDP in the LDCs and other DCs, 1980–1998

	African LDCs	Asian LDCs	Island LDCs	LDC average	Other DCs
Percentage of gross domestic investment					
1980-85	99.3	55.8	117.6	101.8	27.8
1985-90	85.5	53.6	123.6	94.6	16.5
1990-95	93.5	44.4	133.0	92.5	21.2
1995-98	82.7	41.7	124.7	79.3	22.5
Percentage of total Government expenditure					
1980-85	70.5	75.4	121.2	86.2	24.5
1985-90	57.6	52.3	111.1	72.2	14.0
1990-95	72.2	43.3	97.5	75.1	19.7
1995-98	61.9	43.6	84.0	62.0	21.4
Percentage of Government consumption expenditure					
1980-85	104.4	118.9	146.7	116.7	41.1
1985-90	101.1	101.5	144.8	113.4	22.6
1990-95	109.2	85.2	193.1	119.4	32.8
1995-98	117.4	89.7	211.5	123.0	37.6
Percentage of GDP					
1980-85	17.1	13.0	42.7	21.6	6.9
1985-90	14.9	10.2	42.7	19.6	3.7
1990-95	17.5	9.9	48.7	19.9	5.0
1995-98	17.2	10.8	42.1	18.1	5.5

Source: UNCTAD calculations based on World Bank, *World Development Indicators 2000*.
Notes: Averages refer to simple group and period means.

However, even in the case of the African and Asian LDCs, where the GDP share of external resource inflows is relatively much smaller than that of the island economies, the investment and budgetary processes have been clearly dominated by external resource inflows. The external resource gap in the case of the average sub-Saharan African LDC has fluctuated at between 80 and almost 100 per cent of gross domestic investment over the period 1980–1998, while the same ratio in the case of the Asian LDCs has been between 40 and 55 per cent over the same period. External resources also formed between 60 and 70 per cent of total government expenditure for the average sub-Saharan African LDC, and 40 to 75 per cent for the average Asian LDC (table 11). Although there are considerable variations across individual countries in relation to these average ratios, the group averages are characteristic of the degree of external resource dependence of the individual LDC economies within each sub-group, as well as being good indicators of their distinct differences in this regard in comparison with the rest of the developing countries.

The relatively much higher degree of dependence of the LDC economies on external sources of finance is not merely a quantitative difference between the LDCs and other developing economies. As argued in the subsequent chapters of this Report, this has introduced important qualitative differences in terms of mechanisms of control in the accumulation and government service provision processes between the LDCs and other developing countries, with significant implications for efficiency of resource use and overall developmental potential. Chart 22, which shows the long-term relationship between savings and investment in the LDCs and in other developing countries, helps to shed light on

Box 1: External resource requirements of the island LDCs.*

The island LDCs, with an average external resource gap of over 40 per cent of GDP, are among the most highly aid-dependent countries in the world. In addition, as shown in Chart 23 (panels (e) and (f)), investment rates and government expenditure shares in these economies are amongst the highest in the world. These phenomena are a direct result of the peculiarities of island economies, discussed in section B, which cause serious balance-of-payments constraints for them. As pointed out, because of their small size and extreme limitations as regards agricultural land and other resources, most of these economies are highly dependent on imports for a major part of their consumption and production requirements. Unless they can find high-value export niches – high value in relation to transport costs and to domestic labour requirements for production – these economies are bound to remain dependent on external resources to bridge their balance-of-payments gap, even with low standards of living. Such an inflow of external resources would, of course, allow higher rates of investment and government expenditure without the need to curtail private consumption. The question of the optimal allocation of resources between investment, private consumption and public services in these economies needs to be dealt with at the specific country level. A key element in such allocation, from a strategic point of view, should be the development of the export potential of these economies, which can allow the creation of viable economies with the possibility of self-sustained growth at some future date. Maldives and Cape Verde, and to some extent Samoa and Vanuatu, have taken relatively successful steps in this direction by developing their tourist industry. But this option may not be open to some other island economies. At a general level it seems good policy for these countries to concentrate a major part of their development effort in building up their human capital base through education. The increasing significance of knowledge-based industries and services, and the rapid growth of global telecommunications systems and modern information technology, may provide new opportunities for these economies in the future if in the meantime they can muster the necessary skills and infrastructure to take advantage of this. As shown by experience, there is likely to be a high rate of brain drain amongst the educated population in these countries. However, having a large number of educated and skilled workers living and working in other countries with links to their home country can do the island economies more good than harm. With the creation of a critical mass of educated people, new technologies may provide these countries with as yet unforeseen opportunities for generating the high-value export niches that have so far eluded most of them.

* The list of island LDCs used in the statistical analysis in this Report is given in note 1.

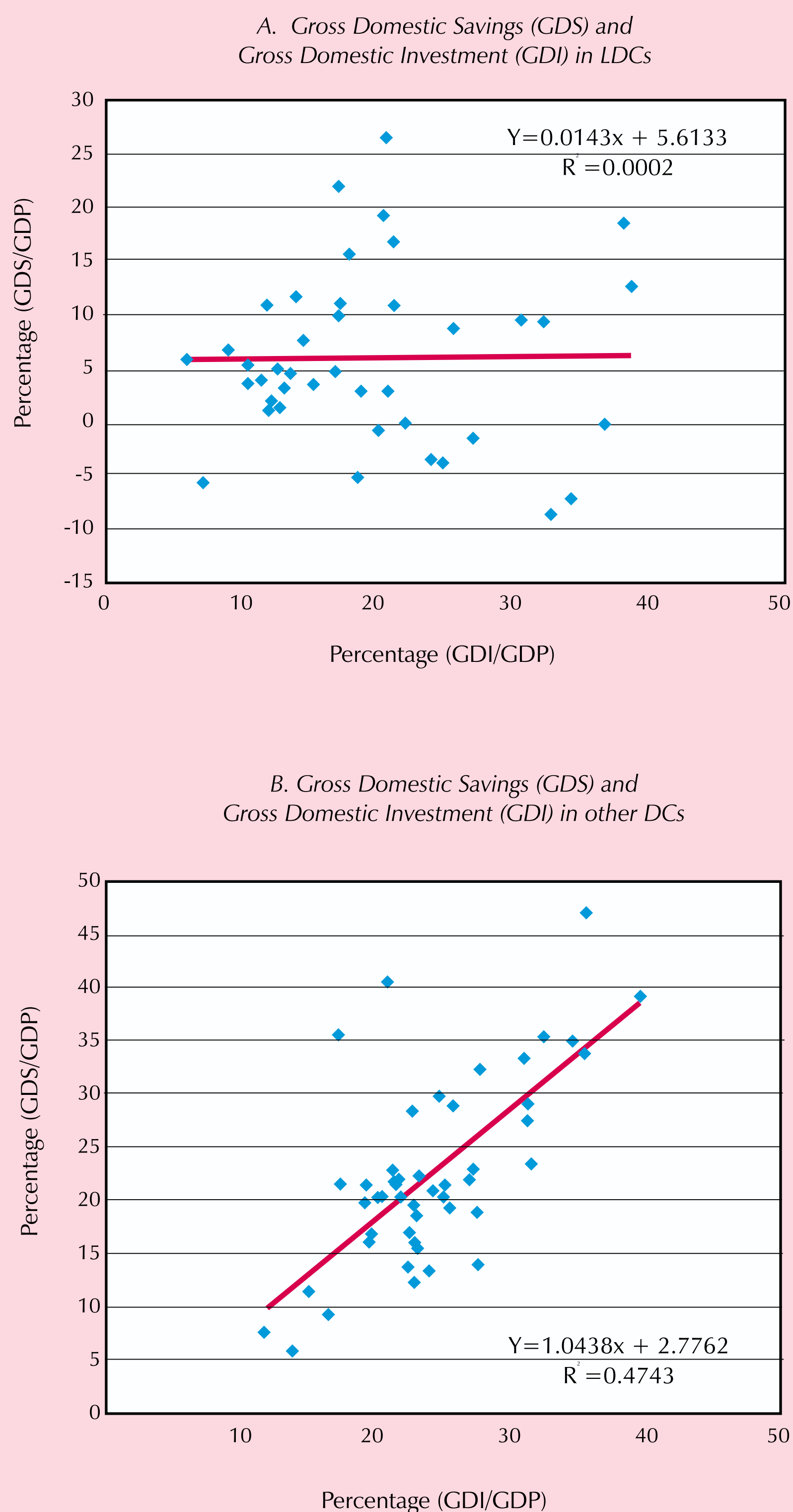
aspects of these relationships. As can be seen from chart 22(b), the long - term relationship between savings and investment in other developing countries shows the familiar picture as painted for examples, by, Feldstein and Horioka (1980) and others for different samples of countries, including the OECD countries; namely, a robust positive relationship between savings and investment rates, which some have interpreted as indicative of lack of perfect capital mobility across the countries.[24]

As shown in chart 22(a), however, this relationship breaks down in the case of the LDCs. This breakdown in the long-term relationship between savings and investment highlights two important aspects of the accumulation processes in these economies. First, investment in them is driven by external resource inflows rather than by internal processes. Second, the “investment - growth - savings” nexus in these economies does not work well. While in other developing economies greater investment leads to higher economic growth and hence higher savings rates, in the case of many LDCs this chain appears to be broken in at least one of its links. The most likely point of rupture in this relationship in the case of the LDCs is the “investment - growth” link; because as observed in the previous section, the existing evidence suggests that the “growth – savings” link in the LDCs seems to be relatively robust. The issue that lies at the heart of the financing problems of the LDCs, therefore, appears to be the lack of effectiveness of the externally driven accumulation processes in these economies.

The issue that lies at the heart of the financing problems of the LDCs appears to be the lack of effectiveness of the externally-driven accumulation processes in these economies.

Before the question of the efficiency of resource use is addressed, it may be helpful to examine also the issue of sufficiency of resources that is, the extent to which the available domestic and external sources of development finance have catered for the minimum developmental requirements of the LDCs. This is not a straightforward question to answer, as the minimal development finance

CHART 22: LONG-TERM RELATIONSHIP BETWEEN SAVINGS RATE AND INVESTMENT RATE IN THE LDCS AND IN OTHER DCS, 1970–1997



Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 1999*.

requirements are not easy to define precisely, and, in addition, resource requirements are not independent of the efficiency of resource use. Furthermore, issues of this type can be best addressed within an individual country context. It can be instructive, however, to pose the issue of resource requirements in the LDCs in a comparative context, where the actual investment and government expenditure rates are compared with what may be regarded as the international "norms" in the case of more successful developing countries. Such an exercise would be worthwhile because it can highlight the extent to which the breakdown of the "investment - growth - savings" nexus in the LDCs has been the result of low levels of investment in the first place. In order to separate the issues of resource requirements from the issues of efficiency of resource use, it may be useful to start with a static analysis, where, to begin with, the efficiency of resource use in the LDC economy is assumed as given.

For the comparison of investment rates one can take the average investment rates in the other developing country group and compare them with the actual rates prevailing in the LDCs. For the comparison of government consumption expenditure rates one has to be more selective in choosing the comparator group, because expenditure rates normally increase with the level of development (the so-called Wagner's Law). For government consumption expenditure "norms", therefore, the average for a sample of countries with a per capita income range similar to that of the LDCs was selected. The investment and expenditure rates for the African, Asian, and Island LDCs, as compared with other developing country groups, are shown in chart 23. As can be seen, in the case of African and Asian LDCs, both the investment rates and government consumption rates fall short of the developing country "norms" throughout period 1980–1995. In the case of the island LDCs, the reverse is true, but as argued in box 1, these economies are special cases which need to be discussed separately from the other LDCs.

Despite heavy dependence on external finance, the African and Asian LDCs in no period during the past two decades managed to match the investment and government expenditure rates prevailing in other developing countries on average.

It appears, therefore, that despite heavy dependence on external finance, the African and Asian LDCs in no period during the past two decades managed to match the investment and government expenditure rates prevailing in other developing countries on average. In view of the exceptionally high gross investment requirements of the LDCs discussed in the first part of this chapter (for example, because of higher rates of environmental resource depletion, higher rates of human capital resource depletion arising from the prevalence of diseases such as AIDS, very low levels of socio-economic infrastructure, and the high degree of vulnerability to external shocks), these lower-than-average investment and government expenditure rates can in part explain the low rates of growth and development in the LDCs.

The question of external resource requirements can also be posed in relation to the requirements for finance in order to achieve certain growth and poverty alleviation objectives. For example, it would be important to form some idea of the external resource requirements of the Asian and African LDCs in order to achieve the international development targets, such as the commitment to reduce rates of poverty by half by the year 2015. On the basis of its estimates of growth elasticity of poverty in Africa, the Economic Commission for Africa (ECA) (1999) has provided estimates of necessary growth and hence investment requirements in various parts of Africa for achieving the poverty reduction targets. According to those estimates, to achieve the poverty reduction target the sub-Saharan African countries (which comprise 32 LDCs) should be able to sustain on average a GDP growth rate of over 7 per cent per annum. With the prevailing savings propensities and investment efficiency, ECA estimates that at least a doubling of investment rates, and hence a more than doubling of the inflow of external resources, are necessary for sub-Saharan Africa on average to achieve the OECD poverty reduction targets (ECA, 1999: 25–37).

Chart 23: Average gross domestic investment and general government consumption expenditure as percentage of GDP in African, Asian and Island LDCs compared to other DCs, 1980–1995

Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 2000*.

Such projections are, of course, highly sensitive to the assumptions made about investment efficiency and savings rates. However, on the basis of different assumptions regarding the marginal savings rates and investment efficiency, UNCTAD (2000b) estimates external resource requirements of between 50 and 150 per cent higher than the existing flows in the short run in sub-Saharan Africa, for escaping the low-level equilibrium trap and achieving self-sustained growth rates of 6 per cent a year. Such average projections for sub-Saharan Africa are likely to be relevant to most African and Asian LDCs that have low savings rates and are caught in the low-level equilibrium trap.

The above does not mean, of course, that there is a one-to-one relationship between external resource inflows and investment and provision of public services. Moving to a more dynamic context, we need to relax the assumption of a given amount of domestic resources available for finance. In such a dynamic context it is not difficult to conceive of a situation where even lower levels of external resources, if used more effectively, could have given rise to a better investment environment, a higher growth of investment and productivity, and a greater availability of domestic resources for finance. This seems to have been so in the other developing country average case. The efficiency of resource use, therefore, takes centre stage in a more dynamic and long-term perspective.

The efficiency of investment may have itself been adversely affected by low rates of investment.

However, to the extent that the level of investment itself affects the efficiency of resource use, the analysis of resource requirements may also be helpful in partly explaining the apparent lack of efficiency of resource use in the LDCs. This arises, for instance, in a situation where the efficiency of each investment project depends on a cluster of other complementary investment projects being implemented concomitantly. For example, the efficiency of an agricultural extension project may critically depend on an adequate level of investment in transport and irrigation projects. Another example may be where the level of investment is adequate, but the financing problems lead to an inadequate provision of complementary public services, thus adversely affecting the efficiency of investment. This can become a particularly acute problem if the requirements of finance in the public sector during periods of intense economic reform are misjudged. The fact that the average rates of investment and public expenditure in the Asian and African LDCs over the past few decades have been persistently below the average for other developing countries suggests that the efficiency of investment may have itself been seriously affected by low rates of investment.

F. Conclusions

This chapter has three major findings. First, it appears that the marginal propensity to save, and more generally the marginal propensity to raise domestic resources available for finance (DRAF), in relation to per capita income in the LDCs, are relatively high. Yet the level and the rate of increase of domestic resources available for finance are low primarily because of a low base and a slow growth of per capita income. The crisis in domestic finance in the LDCs, therefore, has arisen mainly because of those two factors rather than because of a high propensity to consume. The problem of slow economic growth in the LDCs is linked to low rates of investment as well as to the low efficiency of resource use.

Secondly, despite the extremely low levels of domestic resources available for finance, the LDCs have managed to some extent to raise their investment

levels. In doing so they have had to resort to a large amount of external financing. Nevertheless, investment and government expenditure in the African and Asian LDCs as a share of the GDP are still well below the average for non-LDC developing countries, thus indicating inadequate access to external sources of finance. In the light of the special needs of the LDCs, this has implied serious under investment in those economies. The low level of investment may itself have adversely affected the efficiency of investment.

Thirdly, the size of the external shocks in the LDC economies, in terms of income losses caused, is often many times the size of the resources that these countries can muster internally to cope with those shocks (DRAF). This has important implications for the requirement for external resources the use of those resources and the timing of external finance. It also has implications for the plausibility of the common practice of treating variables such as the budget deficit, inflation and trade openness as exogenous policy variables in the special case of the LDCs. In the LDC context, these variables are themselves likely to be the outcome of processes set in motion by external shocks much greater than the national Governments with their meagre resources can cope with.

The central accumulation and budgetary processes of the LDC economies are dominated by external sources of finance rather than domestically-generated resources.

It is clear from this chapter that the central accumulation and budgetary processes of the LDC economies are dominated by external sources of finance rather than domestically-generated resources. The high degree of LDCs' vulnerability to external shocks, combined with their high degree of dependence on external resources, can limit the scope and influence of independent government policy in the economies. For a better understanding of policy options in the latter, it is therefore important to investigate the mechanisms of external resource flow and the criteria that are likely to have affected the allocation of external funds. The problems associated with the inefficiency of investment in the LDCs also go beyond the lack of sufficient investment, discussed in this chapter. In order to gain a better understanding of these problems we need next to address the agency question, i.e. the question of control and allocation mechanisms for external finance. For this purpose, it would be helpful to consider first the sources of external finance and the form they take in the case of LDC and non-LDC developing economies. This will be taken up in the next chapter.

Annex to Chapter 1:

Determinants of savings in the LDCs: some econometric estimates

This annex, based on Hussein (2000), reports the results of estimating a domestic savings function for 18 LDCs over the period 1968-1996. The savings model is estimated by regressing the ratio of domestic saving to GDP (DS) on real GDP per capita (Y), real GDP per capita growth (g), population growth (pop), the ratio of exports to GDP (EX), inflation (π), and the ratio of private credit to GDP (CR) as a proxy for financial development. Gross domestic savings are measured as the difference between GDP and total consumption. The explanatory variables used in estimation are standard variables in the literature on savings functions in developing countries with various theoretical underpinnings (see, for example, Schmidt-Hebbel, Webb and Corsetti, 1992; Schmidt-Hebbel, Serven and Solimano, 1996; Edwards, 1996; Hussein and Thirlwall, 1999).

Before examining the results, a number of important cautionary points are in order. First, the data on savings in developing countries, and particularly the LDCs, are not very accurate. This can be easily seen by comparing the magnitude of the measurement errors in GDP (income and expenditure side differences), as reported in the World Bank data bank, with the estimated savings in the developing countries. Secondly, while economic theory is by and large about private savings, in this annex, as in most works on developing countries, the estimation is made with regard to overall savings, including government savings, because of lack of data. Thirdly, the estimated coefficients using panel data are likely to be biased because of omitted heterogeneity, particularly those related to slope and dynamic heterogeneity. Because of these problems, the results here, as in any works using cross-country panel regression, should be interpreted with due care.

To choose between a simple Ordinary Least Squares (OLS), fixed effects and random effects estimations, two tests are performed: the Breusch-Pagan test and the Hausman specification test. The Breusch-Pagan test rejects the simple OLS specification, which means that either the fixed effects model or the random effects model is superior. The Hausman specification test shows that the fixed effects model outperforms the random effects model. Results are based on the fixed - effect instrumental variables model where the model incorporates fixed country-specific effects in the intercept term. The endogeneity between domestic saving and other explanatory variables such as growth rate is taken into account by using the lagged independent variables as instruments. The following are the estimation results for 18 LDCs with available data:[a]

(1) DS = -12.86 + 0.05 Y + 0.06 g + 0.41 pop – 0.26 CR + 0.31 EX + 0.004 π
(-5.16)** (5.83)** (1.75) (1.42) (-4.22)** (5.78)** (1.65)
Adjusted R^2 = 0.56 No. of observations = 504 Standard error of regression = 6.18

Equation (1) shows that real income is an important variable to explain savings behaviour. An increase of $20 in per capita income leads to a 1 per cent increase in the ratio of domestic savings in LDCs. The same exercise was repeated using a sample of 42 other developing countries (the results are not reported here).[b] The marginal propensity to save with respect to per capita income is much higher in LDCs than in other developing countries. For 42 developing countries with an average per capita income of $1,200, an increase of $100 in per capita income leads to a 0.44 per cent increase in the domestic savings ratio.

Another important factor that affects domestic savings in LDCs is the export ratio. The estimated coefficient shows that a 1 per cent increase in the export ratio leads to 0.31 per cent increase in domestic savings rate. Although the propensity to save may be higher in the export sector than in other sectors, the strong association between domestic savings and exports is partly due to the heavy reliance of government savings on taxes on foreign trade.

Equation (1) also shows that the relationship between private credit and domestic savings is negative. A l per cent increase in the private credit ratio causes a reduction of 0.26 per cent in the domestic savings ratio.

On the other hand, inflation has no effect on domestic savings where the coefficient of the inflation rate is too small and insignificant. The two components of real GDP growth (real GDP per capita growth and population growth) also have an insignificant impact on domestic savings. Real GDP per capita is significant only in the following estimation when the inflation rate and population growth are dropped out of the model and financial development is measured by money growth (m).

(2) DS = -13.83 + 0.04 Y + 0.11g + 0.002 m + 0.31 EX
(-5.65)** (5.16)** (2.09)* (2.00)* (5.75)**
Adjusted R2 = 0.55 No. of observations = 504

To further examine the role of financial development, the money supply measure, M3, is used as proxy for financial development.

(3) DS = -11.91 + 0.04 Y + 0.10g - 0.08 M3 + 0.33 EX
(-4.73)** (4.80)** (1.90) (-1.36) (5.99)**
Adjusted R2 = 0.54 No. of observations = 504

The findings are unexpected as M3 does not have any effect on savings and its coefficient has the wrong sign. Money growth (m) is therefore the only financial indicator variable that has a (small) positive and significant effect on domestic savings. These results indicate that the formal financial system in LDCs may not be playing the role it should play in the growth process. In fact, most of the financial transactions, especially of the household sector and small and medium sized business enterprises, are carried out in the informal financial markets (curb markets). In many LDCs, a great proportion of the small firms do not have access to the formal financial markets.

a The 18 LDCs are Benin, Burkina Faso, Burundi, Central African Republic, Chad, Democratic Republic of the Congo, Gambia, Haiti, Madagascar, Malawi, Mali, Mauritania, Nepal, Niger, Rwanda, Sierra Leone, Togo and Zambia.

b The 42 countries are Algeria, Argentina, Brazil, Cameroon, Chile, Colombia, Costa Rica, Côte d'Ivoire, Democratic Republic of the Congo, Dominican Republic, Ecuador, Egypt, El Salvador, Fiji, Ghana, Guatemala, Guyana, Honduras, India, Jamaica, Kenya, Korea Republic of, Malaysia, Mauritius, Mexico, Morocco, Nicaragua, Nigeria, Pakistan, Paraguay, Peru, Philippines, Saudi Arabia, Senegal, Singapore, South Africa, Thailand, Trinidad and Tobago, Tunisia, Turkey, Uruguay and Venezuela.

Notes

1. Throughout this report (unless otherwise specified) African, Asian and island LDCs are as follows: African LDCs: Angola, Benin, Burkina Faso, Burundi, Central African Republic, Chad, Democratic Republic of the Congo, Djibouti, Equatorial Guinea, Eritrea, Ethiopia, Gambia, Guinea, Guinea-Bissau, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Niger, Rwanda, Sierra Leone, Somalia, Sudan, Togo, Uganda, United Republic of Tanzania and Zambia. Haiti is normally included in the African LDC group unless otherwise stated. Asian LDCs: Afghanistan, Bangladesh, Bhutan, Cambodia, Lao People's Democratic Republic, Myanmar, Nepal and Yemen; island LDCs: Cape Verde, Comoros, Kiribati, Maldives, Samoa, Sao Tome and Principe, Solomon Islands, Tuvalu and Vanuatu.
2. For a discussion of trends and the composition of exports from the LDCs, see *The Least Developed Countries*, *1999 Report*, part two chapter 1, pp. 79 - 91.
3. In small island economies such as Cape Verde, Kiribati, Maldives, Samoa, Sao Tome and Principe and Vanuatu, amongst the LDCs, access to telephones is much better than the group average. But even these economies are way behind the developing country average, with telephone lines per person being between 20 and 50 per cent of the developing country average.
4. See, for example, UNCTAD (1999b).
5. Eighty per cent of the 20 landlocked developing countries are in fact LDC; this makes landlockedness a predominantly LDC problem.
6. Economies of scale and indivisibilities in transportation substantially increase transportation costs for the island LDCs. For example, the cost of building a 3.4 kilometre-long causeway between two main islands (Betio and Bairiki) in Kiribati in the 1980s was about 20 per cent of the country's GNP. The same phenomenon affects the cost of other infrastructure such as electricity and telecommunications. Being highly specialized economies, they also need to import a large variety of goods over long distances in relatively small quantities. In addition to the high transport costs involved, this entails the keeping of much larger stock relative to sales.
7. According to some estimates, in most sub-Saharan African countries the freight costs for imports are 50 per cent higher than the average for other developing countries (UNCTAD, 1999b). Internal transport costs are also said to double or triple the free - on - board. cost of exportable agricultural products relative to farm-gate prices in outlying agricultural areas in most sub-Saharan African economies (Delgado, 1997:156).
8. EM-DAT (2000).
9. According to the World Health Organization (1998), by the end of 1997 the estimated percentage of the adult population living with HIV/AIDS in some LDCs was as follows: Zambia 19%, Malawi 14.9 %, Mozambique 14.1 %, Ethiopia 9.3 %, Rwanda 12.8%, Lesotho 8.3%, United Republic of Tanzania 9.4%, Uganda 9.5%, Togo 5 %, Djibouti 10.3 %, Burkina Faso 7.7 %, Burundi 8.3 %, and Central African Republic 10.8 %, these figures compare with the average sub-Saharan African rate of 7.4 per cent, and the other developing countries average rate of about 0.5 per cent.
10. The index shown in table 6 refers to the instability of real exports in terms of import purchasing power, thus including the instability resulting from both quantity shocks and terms - of - trade shocks. The instability index is measured as the standard deviation of the annual growth rates for each country over the specified period.
11. For reference to some recent studies of savings behaviour in developing countries, see the sources quoted in the annex to this chapter, p.49.
12. See the annex to this chapter.
13. Some economists have even gone so far as to include the depletion of exhaustible natural resources such as oil and minerals in the measure of net investment and savings. This, however, may be inappropriate, since the depletion of such resources does not directly the reduce productive capacities of the economy (unless it leads to sharply rising extraction costs), and only affects future foregone revenue. But with the uncertainties about future prices and the probable appearance of new technologies that can displace the resource in question, the value of the latter in future can be very uncertain.
14. With the availability of cross-country panel data sets some economists have been hasty in using the data in cross - country regression analysis without pausing to ponder whether the variables indeed measure the same thing in different countries. The conventional national accounting measures of investment in a country such as Ethiopia with widespread environmental resource degradation problems mean something totally different in terms of additions to productive capacities compared with another country with less severe environmental problems.
15. Comparative international statistics on this issue are quite revealing. According the WHO estimates (WHO, 1998: 41), in 1995 over 77 per cent of deaths in the developed market economies occurred after retirement the age of 65+. This share is projected to

increase to 85 per cent by the year 2025. In the LDCs, on the other hand, over 84 per cent of deaths in 1995 were in the below - 65 age group. If the age structure of deaths in the LDCs were in a steady state, we could not count these early deaths as a depreciation of the human capital stock. However, the accelerating number of premature deaths in most LDCs as a result of AIDS and other diseases and natural disasters means that there is a large element of human capital depreciation involved. In any event, the medical expenses associated with these premature deaths are a substantial cost to society.

16. In economies where private consumption is close to subsistence level, it would be difficult to increase DRAF without adversely affecting the productive efficiency of the workers in the short run. This is the classic case of the low equilibrium trap,where external resources may be necessary in order to increase output and productivity and hence potential savings in the domestic economy. Of course, to the extent that part of DRAF may be used for unproductive activities such as arms purchase, a re-switching of this expenditure to more productive uses can achieve the same result.
17. This is not, of course, to say that foreign aid has not been used or should not be used to support private consumption in poor economies. An important developmental role of foreign aid in poor countries which are subject to external shocks is indeed the smoothing of consumption.
18. Average annual growth rates in chart 18 are calculated for 1960-1970, 1970-1980, 1980-1990 and 1990-1997. Each country, depending on the availability of data, is hence represented by at most four observations in the graph.
19. This relationship holds even when we purge the extreme and outlying observations.
20. It should be noted that this is not, of course, a steady - state relationship, or a relationship that is likely to characterize the co-movements of private consumption and GDP in the very long run. What it signifies is that in the periods of transition or traverse from a low investment rate low growth rate situation to a high investment high growth situation, DRAF or savings will also increase commensurately.
21. The LDCs shown in chart 19 are countries for which the relevant data are available for the relevant periods. The annual income terms - of - trade loss and DRAF are both measured in dollar terms. Income terms of trade are measured as X(1/Pm – 1/Px), where X is the value of exports in dollars and Pm and Px are import and export price indices with the previous year as the base year. Dollar DRAF is measured as GNP minus private consumption, both measured in United States dollars as given in World Bank databank.
22. Two- and three-year terms - of - trade effects are measured in the same way as one-year effects, with the difference that the base years, rather than being the previous year, are set at two - and three - year lags respectively.
23. Economists who are trained in analysing industrial economies often refer to these variables as policy choices. In the industrial economies, however, the size of maximum income losses due to external shocks relative to resources available for finance is only a tiny fraction of that in the LDCs. When the size of the external shock becomes many times larger than the size of the supposed policy variable which is meant to deal with it (e.g. government revenue or expenditure) the use of such terminology becomes problematic.
24. The high correlation between savings and investment rates was first discussed in Feldstein and Horioka (1980), and later supported by findings of other studies. See, for example, Feldstein and Baccheta (1991), Dooley, Frankel and Mathieson (1987) and Summers (1988). The causes and implications of this phenomenon in terms of international capital mobility and the internal links between investment, growth and savings processes are discussed in Feldstein (1994) Mussa and Goldstein (1993) and Obstfeld (1994), amongst others.

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Aid, private capital flows and external debt: a review of trends

Chapter 2

A. Introduction

As the last chapter has shown, the central accumulation processes of the LDC economies are dominated by external sources of finance. In the long term, if economic growth can be successfully sustained, it is reasonable to expect that domestic resource mobilization will be considerably strengthened, and it is important that policy efforts seek to accelerate this process. But for the immediate future, the basic policy issue which must be addressed in relation to financing development in LDCs is whether external finance is both sufficient for, and supportive of, economic growth, poverty reduction and sustained development. In addressing this question, it is helpful first to consider the sources of external finance and the form they take. The possible sources of finance include, on the one hand, official capital flows in the form of grants or loans, provided by bilateral and multilateral aid agencies, packaged with or without technical assistance, and on the other hand, private capital flows from banks, capital markets, companies and individuals, which take the form of short- and long-term loans, acceptance of company and government bonds, and portfolio and direct investment. These capital inflows may or may not be debt-creating, and net capital outflows generated by residents may also reduce total resources available for finance, offsetting net capital inflows generated by non-residents.

This chapter describes trends in the scale and composition of long-term net capital inflows into the LDCs (section B), and examines in more detail trends in aid (section C), and in private capital inflows (section D). Section E describes trends in external debt stocks and debt service payments, whilst section F focuses on the aggregate net transfers to the LDCs, including the role of debt relief and accumulation of arrears on debt service in maintaining positive net transfers to the LDCs.

Long-term net capital inflows into LDCs as a whole have declined by about 25 per cent in nominal terms since 1990.

Each of these types of flows has different developmental implications. But the purpose of this chapter is not to address this, but rather to set the stage for the subsequent chapters. Definitions of some of the key terms used in the chapter, and data sources, are set out in box 2.[1]

B. Trends in long-term net capital inflows

1. Scale of long-term net capital inflows

Long-term net capital inflows into LDCs as a whole have declined by about 25 per cent in nominal terms since 1990. According to World Bank statistics, the level of such inflows was $10.4 billion in 1998, down from a peak of $14.2 billion was reached in 1991 (table 12). The decline is sharper in real terms. If the import price index of LDCs is used to deflate current values (i.e to express them in terms of their purchasing power over foreign goods), long-term capital inflows

Box 2: Definitions and data sources for international capital flows

Different institutions and writers use different terms to refer to different categories of international capital flows. The analysis in this chapter focuses mainly on what the World Bank in its publication *Global Development Finance* refers to as *aggregate net resource flows*. This consists of net resource flows on loans with a maturity of more than one year (loan disbursements minus principal repayment), net foreign direct investment (FDI), portfolio equity flows and official grants. Short-term debt flows are excluded from consideration. Within the text, the term *long-term net capital inflows* is used interchangeably the term with *aggregate net resource flows*. The term *aggregate net transfers* refers, again following the World Bank convention in *Global Development Finance*, to aggregate net resource flows less interest payments and profit remittances.

Data on aid flows are published by the OECD in the *DAC Development Report* and by the World Bank in *Global Development Finance*. The term *official development assistance* is used by the OECD to refer to "grants and loans to countries and territories on Part I of the DAC list of Aid Recipients (developing countries) which are: undertaken by the official sector; with the promotion of economic development and welfare as the major objective; at concessional financial terms (if a loan having a grant element of at least 25 per cent) (OECD, 2000: 262)". The grant element of loans is calculated using a discount rate of 10 per cent. The World Bank uses the term *concessional flows* to refer to grants and loans (those that are directly developmental in intent as well as those that are trade-related) with at least a 25 per cent grant element (using a discount rate of 10 per cent). This excludes technical cooperation grants, which are included in ODA. Differences in data sources, coverage and the way in which debt forgiveness is treated also lead to different estimates of official flows[1].

The present chapter uses *Global Development Finance* data to describe trends in the scale and composition of long-term net capital inflows. Trends in total aid flows and their use are examined on the basis of OECD data, but the analysis of the relative importance of official sources in long-term net capital flows and of the relative importance of different kinds of concessional flows in official capital inflows is based on World Bank sources and definitions.

Ideally, analysis of capital flows should encompass both the acquisition (and sale) of domestic assets by non-residents and the acquisition (and sale) of foreign assets by non-residents (see UNCTAD, 1999: box 5.1). Information on capital outflows is available in the IMF *Balance of Payments Statistics*. Unfortunately, the sample of LDCs with good balance-of-payments statistics makes it difficult to generalize about capital outflows.[1]

Finally, the reader should be aware that the statistical annex to this Report has been prepared from the same data sources as in past years in order to ensure that the figures in the annex are fully compatible with those of earlier Reports. Tables 19 to 29 of the statistical annex, on financial flows, net ODA and debt, are all based on OECD/DAC sources, which diverge somewhat from the World Bank figures used in the present chapter.

[1] For full discussion of these differences, see World Bank (1999: 78-80).

Table 12: LDCs: Long-term net capital inflow by type of flow, and aggregate net transfers, 1988–1998
(in million dollars)

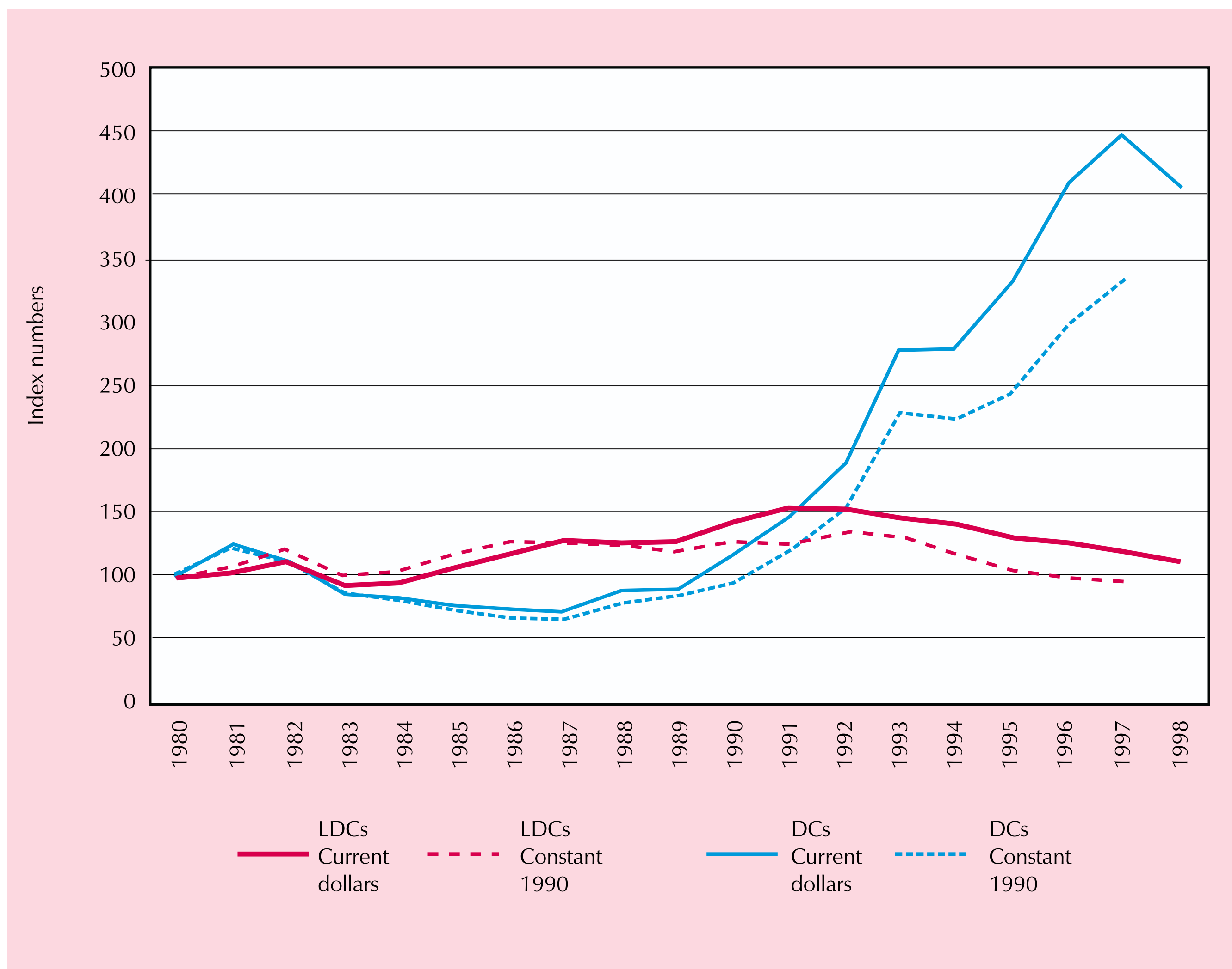
	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Aggregate net resource flows	12 100	11 978	13 388	14 214	14 157	13 563	13 124	12 253	11 760	11 145	10 403
Official net resource flows	10 850	11 025	12 607	12 283	12 290	11 285	12 138	11 193	9 969	9 078	9 054
Grants[a]	6 207	6 276	8 322	8 886	8 683	7 992	9 140	8 725	6 674	6 379	6 984
Other official flows	4 643	4 749	4 285	3 396	3 607	3 293	2 998	2 469	3 295	2 698	2 070
Private net resource flows	1 249	953	782	1 931	1 867	2 278	986	1 061	1 791	2 067	1 274
Net FDI	279	517	83	1 799	1 460	1 748	849	1 078	1 809	1 425	1 593
Portfolio equity flows	-	-	-	-	-	-	77	49	40	8	27
Net private debt flows	970	436	699	132	407	530	60	-67	-58	634	-345
Interest payments, total	1 693	1 567	1 492	1 565	1 145	1 260	1 265	1 705	1 399	1 431	1 452
Profit remittances on FDI	405	516	675	583	668	684	708	723	674	739	773
Aggregate net transfers	10 504	10 323	11 653	12 451	12 645	11 894	11 394	10 432	9 867	9 182	8 376

Source: UNCTAD secretariat estimates based on World Bank, *Global Development Finance 2000* (CD-ROM).
a Excluding technical cooperation.

into LDCs are now back to the level of 1980 (chart 24). Moreover, in per capita terms, real capital inflows were down to $17 per person in 1997. This constitutes a drop of 39 per cent since 1990.

The downward trend in the 1990s represents a reversal of the trend in the 1980s, which, after the slump associated with the debt crisis, rose between 1983 and 1991. This is in complete contrast to what has happened in other developing countries. After the debt crisis, capital inflows into such countries took much longer to recover than inflows into LDCs. Thus, by 1989, whilst capital inflows into LDCs were 40 per cent above their 1983 level in nominal terms, capital inflows into other developing countries were only 5 per cent above their 1983 level. However, between 1990 and 1997, capital inflows into other developing countries increased by 285 per cent in nominal terms and 247 per cent in real terms, whilst they declined in LDCs (chart 24). Most LDCs were less affected than other developing countries by the impact of the Asian financial crisis on capital flows. But the steady downward trend in long-term net capital inflows into LDCs has continued.

Chart 24: Long-term net capital inflows into the LDCs and other DCs, 1980–1998
(Index numbers, 1980=100)



Source: As for table 12.
Notes: 1. For definition of net capital inflows, see box 2.
2. The deflator used to estimate real aggregate net resource flows is UNCTAD's unit price of imports index.

2. Composition of long-term net capital inflows

The downward trend is the result of declining aid flows, coupled with the failure of most LDCs to attract sufficient private capital inflows to offset the decline. Other developing countries are increasingly relying on international flows of private capital as a key component of their development strategy. But whilst private capital inflows into other developing countries have, with some violent gyrations, grown exponentially in the 1990s, they have been increasing very slowly in most LDCs.

A historical perspective shows that LDCs have always been more dependent than other developing countries on official financing. This was apparent in the period from 1975 to 1982, when private capital constituted only 13 per cent of long-term capital inflows into LDCs in comparison with 55 per cent in other developing countries (chart 25). But this difference has been accentuated, particularly in the 1990s. In LDCs the share of official finance in total capital inflows increased to about 89 per cent of long-term flows in the period 1983–1989 and has remained at that level in the 1990s. At the same time, the share of official finance in total capital inflows into other developing countries has become progressively smaller. With the surge in private capital flows in the 1990s, private capital inflows have come to account for over 80 per cent of the aggregate net capital inflows into these countries in the 1990s.

The downward trend in long-term net capital inflows is the result of declining aid flows, coupled with the failure of most LDCs to attract sufficient private capital inflows to offset the decline.

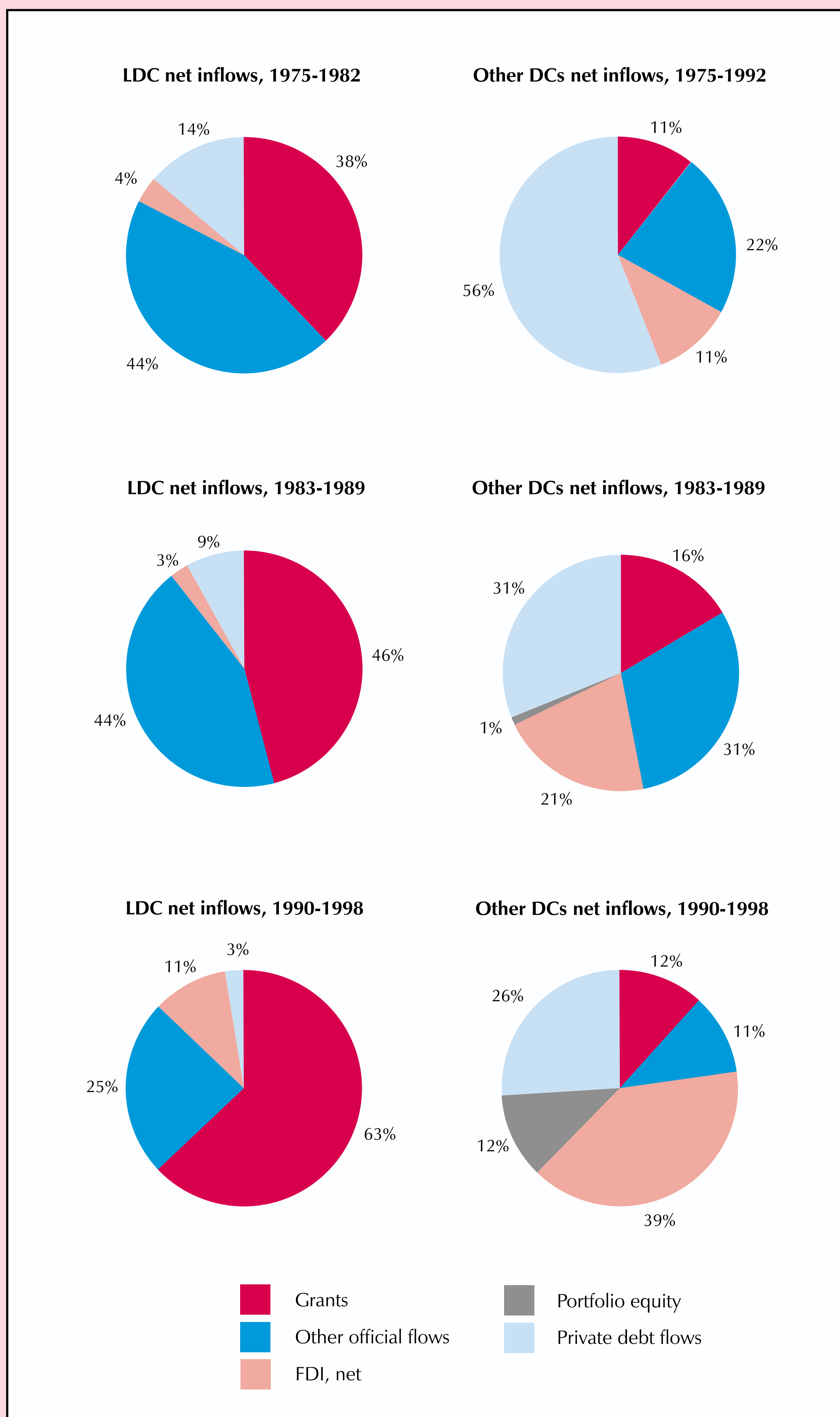
The small share of private capital in aggregate long-term capital flows to LDCs represents a general pattern. In the period 1990–1998, private flows constituted on average over 10 per cent of annual inflows into only 13 countries. Three of those countries (Angola, Equatorial Guinea, and Myanmar) are oil or gas exporters and four (Vanuatu, Solomon Islands, Maldives and Samoa) are island economies. The other six are Cambodia and the Lao People's Democratic Republic in Asia, and the Gambia, Lesotho, Liberia and Uganda in Africa (chart 26).

3. LDC share of long-term net capital inflows into developing countries

These trends in the scale and composition of capital inflows have had significant effects on the share of aggregate net resource flows, and of flows of specific types, going to LDCs. Given the reliance of LDCs on official flows, the LDC share of long-term capital inflows into developing countries actually increased in the 1980s, from 11 per cent to 18 per cent of total capital inflows into those countries. But since 1987, as private capital flows have surged and come to dominate total resource flows to developing countries and official flows have either stagnated or declined, the LDC share in aggregate flows has fallen equally dramatically. After peaking in 1987 at 18 per cent, the share has fallen to less than 4 per cent of capital inflows into developing countries (chart 27).

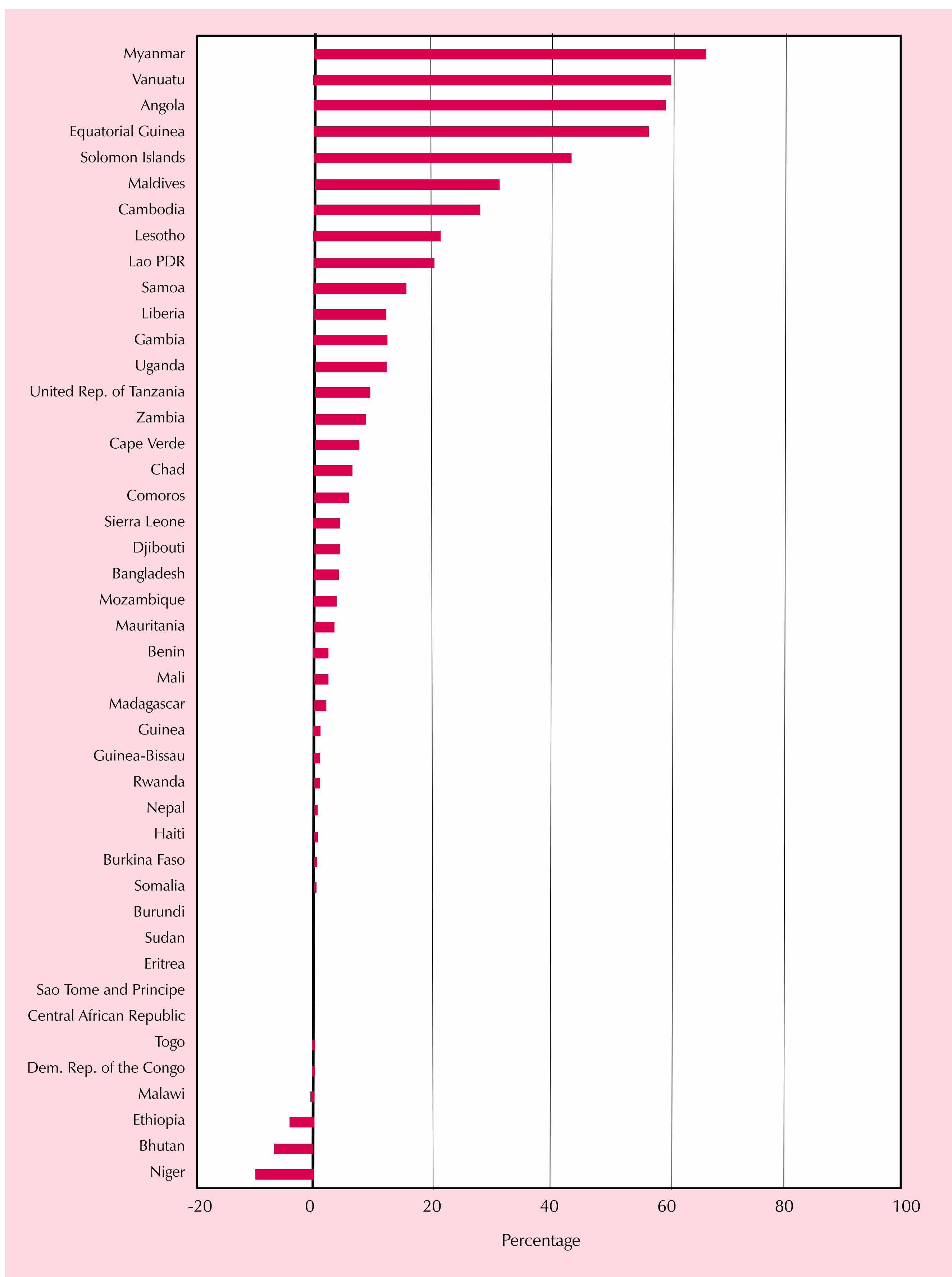
With regard to specific components of capital inflows, the share received by LDCs is highest for grants. The share of FDI received by LDCs fell from 3.6 per cent in the period 1975–1982 to 1.4 per cent in the 1990s. Moreover, LDCs are largely rationed out of portfolio equity flows and commercial loans without a government guarantee (table 13).

CHART 25: LONG-TERM NET CAPITAL INFLOW BY TYPE OF FLOW, 1975–1998: LDCs AND OTHER DCs
(Average annual percentage of aggregate net inflow)



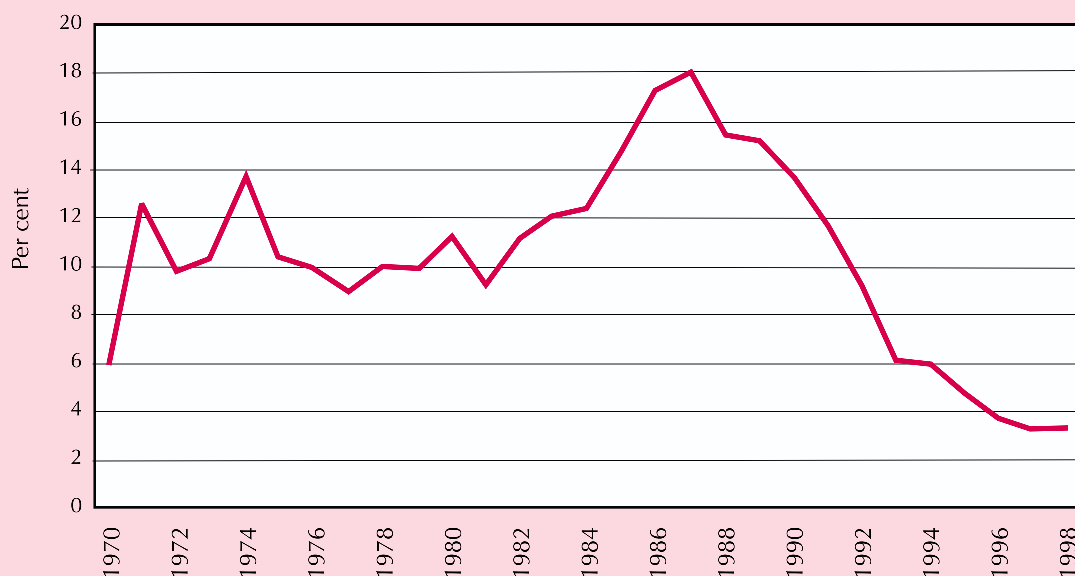
Source and definitions: See table 12.

CHART 26: LONG-TERM PRIVATE NET CAPITAL INFLOWS INTO THE LDCS, FROM PRIVATE SOURCES, BY COUNTRY, 1990–1998
(Average annual percentage of aggregate net capital inflows)



Source: As for table 12.

CHART 27: LDCS' SHARE OF LONG-TERM NET CAPITAL INFLOWS INTO ALL DCS, 1970–1998
(Percentage)



Source: As for table 12.

TABLE 13: OFFICIAL AND PRIVATE LONG-TERM NET CAPITAL INFLOWS[a] IN THE LDCS AND OTHER DCS, 1975–1998
(Annual average)

	1975–1982			*1983–1989*			*1990–1998*		
	All DCs	LDCs	LDC share	All DCs	LDCs	LDC share	All DCs	LDCs	LDC share
	$ millions		*%*	*$ millions*		*%*	*$ millions*		*%*
Official net resource flows	26 291.9	5 828.5	**21.8**	37 962.1	9 454.6	**24.8**	48 325.2	11 107.9	**23.6**
Grants, excl. technical cooperation	9 160.4	2 666.0	**28.7**	14 806.4	4 895.8	**32.9**	28 536.8	7 976.1	**27.9**
Multilateral net flows	6 736.0	1 038.1	**15.3**	12 037.4	2 272.5	**18.9**	15 133.6	2 832.3	**20.5**
Bilateral net flows	10 395.5	2 124.4	**20.1**	11 118.3	2 286.3	**20.7**	4 654.9	299.5	**3.1**
Private net resource flows	42 566.8	1 184.5	**2.9**	32 747.6	1 119.8	**3.7**	176 310.4	1 559.5	**1.2**
Foreign direct investment, net inflows	7 194.8	256.3	**4.3**	13 266.7	281.4	**2.0**	91 724.2	1 315.9	**1.8**
Portfolio equity flows	23.5	0.0	**0.0**	595.9	0.0	**0.0**	26 715.0	22.3	**0.1**
Total commercial banks net flows	26 333.5	230.5	**1.5**	10 017.4	16.0	**-2.0**	22 332.9	98.7	**-2.5**
PPG[b], commercial banks net flows	18 369.2	196.8	**1.0**	11 065.0	10.7	**-1.5**	2 382.2	114.7	**-2.3**
PNG[c], commercial banks net flows	7 964.3	33.7	**0.5**	-1 047.6	5.3	**-0.5**	19 950.7	-16.0	**-0.2**
Total bonds net flows	2 001.7	-2.2	**-0.3**	1 901.4	0.2	**0.0**	31 085.9	-0.2	**0.0**
PPG[b], bonds net flows	2 001.7	-2.2	**-0.3**	1 883.3	0.2	**0.0**	17 413.4	-0.2	**0.0**
PNG[c], bonds net flows	0.0	0.0	**..**	18.1	0.0	**0.0**	13 672.4	0.0	**0.0**
PPG[b], other private creditors net flows	7 013.2	700.0	**10.8**	6 966.1	822.2	**11.8**	4 452.4	122.7	**-2.5**

Source: See table 12.
a Net flows are disbursments minus principal repayments.
b PPG flows are public and publicly guaranteed flows.
c PNG flows are private nonguaranteed flows.

C. Trends in aid flows

1. The scale and uses of official development assistance (ODA)

Aid flows to LDCs, as measured by the share of net ODA disbursements in donors' GNP, have almost halved in the 1990s. At the start of the decade, the total ODA of DAC countries to LDCs stood at 0.09 per cent of their combined GNP, whilst in 1998 it was down to 0.05 per cent. The latter ratio was the same as in 1997, but between 1997 and 1998 ODA to LDCs contracted as a proportion of GNP in 10 out of 21 DAC countries. As chart 28 shows, in 1998 only five countries met the special targets for ODA to LDCs as a percentage of GNP which had been set in the Programme of Action for the LDCs for the 1990s – Norway (0.34 per cent), Denmark (0.32 per cent), the Netherlands (0.21 per cent), Sweden (0.20 per cent) and Luxembourg (0.17 per cent). On the positive side, Belgium, Denmark, Italy, Luxembourg and the United Kingdom all improved their performance from 1997 to 1998. Moreover, in nominal terms, Japan remained the most important donor to LDCs in 1998 (with a net ODA contribution of over $1.5 billion), followed by the United States, Germany and France, which each contributed more than $1 billion ODA to the LDCs.

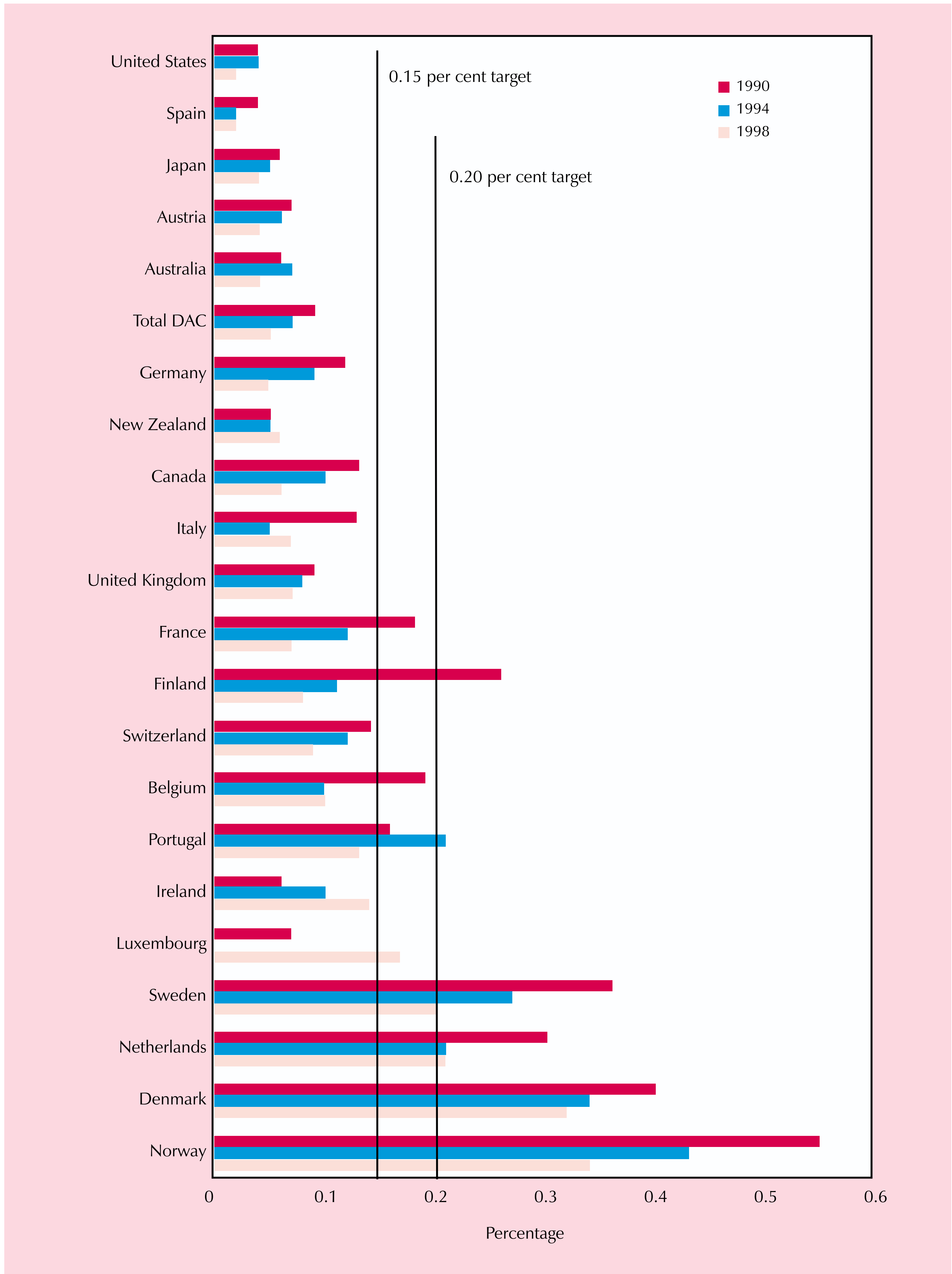
In real per capita terms, net ODA to LDCs has dropped by 45 per cent in the 1990s and is now back to the levels it was at in the early 1970s.

Annual gross ODA disbursements to LDCs in the period 1997–1998 were 23 per cent lower than during the period 1990–1995. Thirty-seven out of the 48 LDCs, including 29 of the 33 African LDCs, received lower annual gross ODA disbursements in 1997–1998 than in the period 1990–1995. Net ODA from DAC countries is estimated to have been $12.1 billion in 1998, down from $12.6 billion in 1997. The decline contrasts with the more positive developments in ODA to developing countries as a whole in 1998. Net ODA to all developing countries increased by almost $2 billion from 1997 to 1998, breaking the steady decline since 1995. For the LDCs, the decline in 1998 was the third year of uninterrupted declines, representing a reduction of more than $4.5 billion since 1995.

From a longer-term perspective, it is apparent that in nominal terms there was an increase in net ODA to LDCs in the second half of the 1980s. In fact, net ODA increased by 73 per cent in nominal terms over the period 1985–1990. The post-1995 decline reverses this trend, taking net ODA back to beneath the level it was at in nominal terms in 1987. In real per capita terms, net ODA to LDCs has dropped by 45 per cent in the 1990s and is now back to the levels it was at in the early 1970s (chart 29).

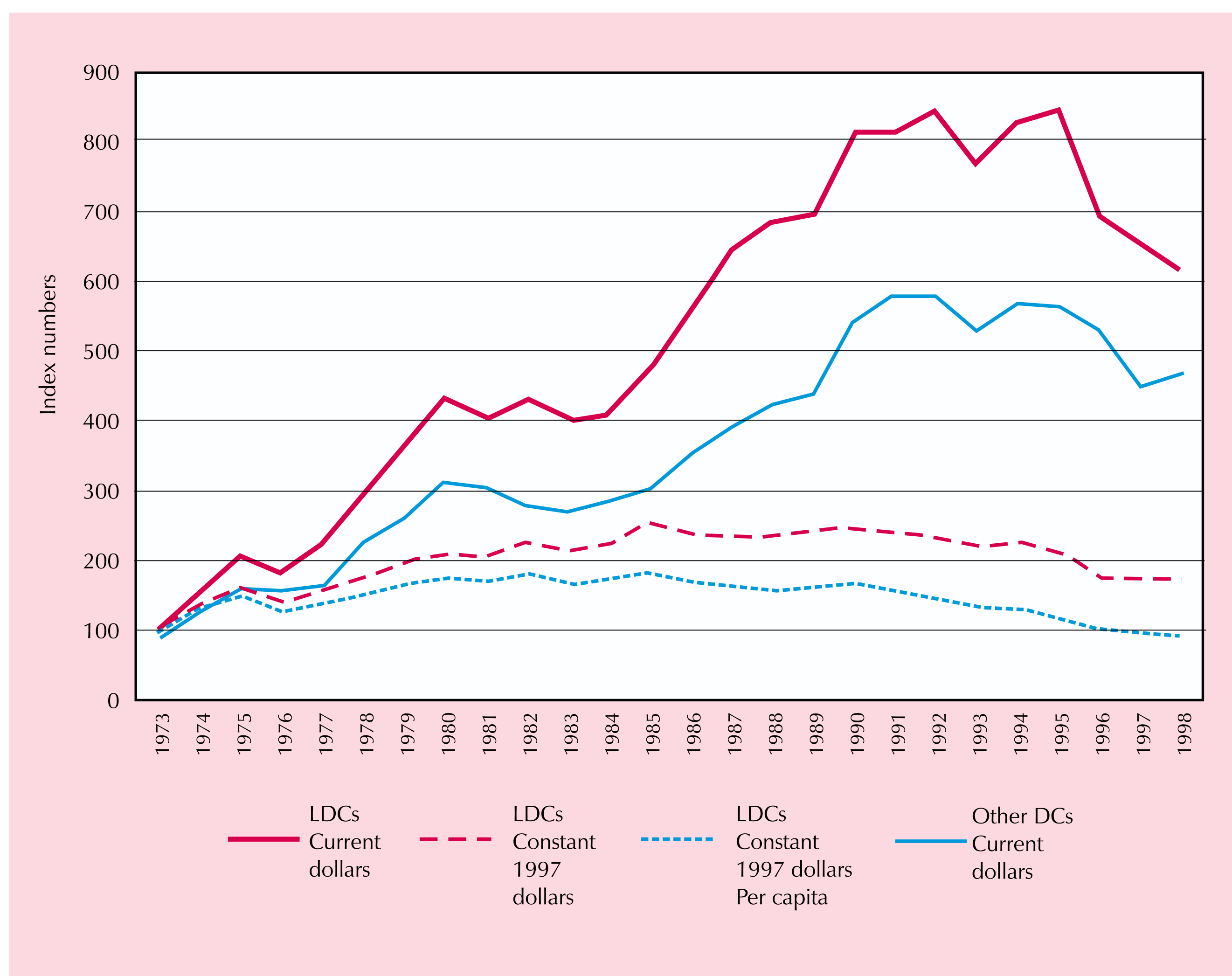
Together with the decline in ODA to LDCs in the 1990s, there has been a shift in the purposes to which ODA is committed. Table 14 gives a breakdown of net ODA commitments to LDCs by purpose since the early 1980s.[2] It shows that the proportion of ODA commitments devoted to social infrastructure and services has increased significantly, up from 14 per cent of ODA commitments in 1985–1989 to 33 per cent in 1995–1998. At the same time, commitments to economic infrastructure and services, productive infrastructure and multisectoral projects have fallen from 59 per cent to 39 per cent. The other significant feature of the 1990s is the increase in grants in the form of debt forgiveness and emergency aid. Indeed, the most rapidly growing segments of the shrinking ODA budgets during the 1990s have been emergency relief and debt forgiveness grants. In 23 of the LDCs, they accounted for 10 per cent or more of ODA grant commitments during 1995–1998, while 11 countries had levels of 25 per cent or more of their aid.

CHART 28: NET ODA TO THE LDCS FROM DAC MEMBER COUNTRIES: 1990, 1994 AND 1998
(Percentage of donor's GNP)



Source: UNCTAD secretariat estimated based on OECD/DAC data.

CHART 29: NET ODA DISBURSEMENTS FROM DAC MEMBER COUNTRIES TO THE LDCS AND OTHER DCS, 1973–1998
(Index numbers, 1973=100)



Source: See chart 28.
Note: The deflator used to calculate net ODA disbursements in constant dollars is the OECD/DAC deflator.

TABLE 14: NET ODA COMMITMENTS TO THE LDCS, BY MAJOR PURPOSES, 1980–1998
(percentage of total commitments)

	1980–1984	1985–1989	1990–1994	1995–1998
Social Infrastructure	13.0	13.8	21.8	32.8
Economic, Production Multisector	58.8	58.2	50.1	39.0
Emergency and Debt	6.7	5.9	12.9	15.9
Programme Aid[a]	10.2	14.3	11.7	9.6
Other	11.3	7.7	3.5	2.8
Total	100.0	100.0	100.0	100.0

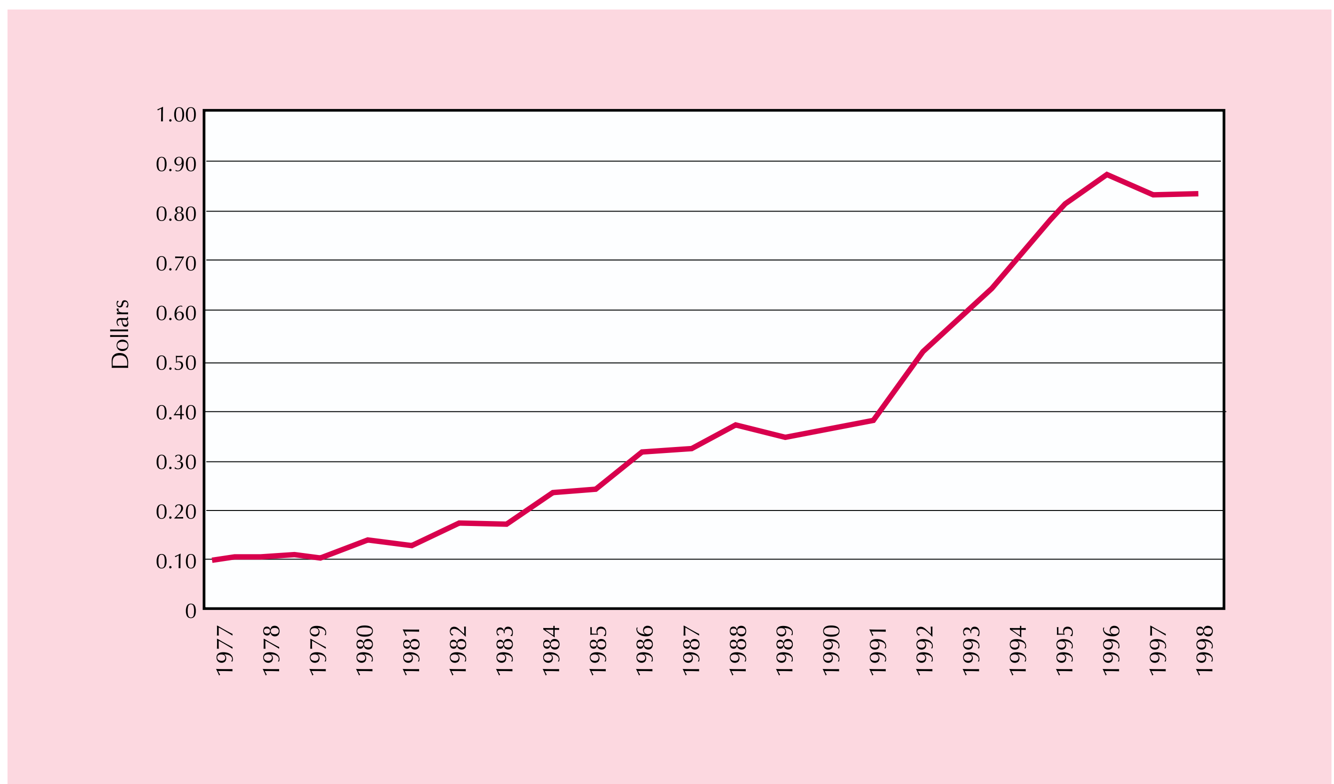
Source: See Chart 28.
a Programme aid excludes food aid.

As chart 30 shows, per capita emergency aid increased sharply in the 1990s. In some countries this was related to the eruption or acceleration of armed conflicts or external intervention. Afghanistan, Burundi, Haiti, Liberia, Rwanda, Somalia and Sudan all experienced a sharp but temporary increase in emergency relief in the early 1990s for this reason. But an increasing number of LDCs became regular recipients of emergency aid in the 1990s. Between 1993 and 1998, an average of 40 of the 48 LDCs received some form of emergency relief each year, compared with an average 32 countries between 1983 and 1992 and 25 between 1973 and 1982. In 1998, debt forgiveness and emergency relief accounted for 35 per cent of bilateral ODA grant disbursements to the LDCs.

Between 1993 and 1998, an average of 40 of the 48 LDCs received some form of emergency relief each year, compared with an average 32 countries between 1983 and 1992 and 25 between 1973 and 1982.

Programme aid, excluding food aid, has remained at around 10–15 per cent of net ODA commitments since the early 1980s. Also, although it is not identified separately in the table, technical cooperation is an important component of ODA to LDCs. It has stayed steady at around 20 per cent of net ODA to the LDCs as a group since the early 1980s, with the proportion being considerably higher for some of them.

CHART 30: PER CAPITA EMERGENCY AID COMMITMENTS TO LDCs, 1973–1998
(Dollars per year)



Source: See chart 28.
Note: The actual commitments vary dramatically from year-to-year and therefore the graph uses a 5-year trailing average. For any given year, the numbers show the average annual commitments of that year and the previous 4 years.

2. The changing composition of long-term net concessional flows

There have also been major changes in the balance between multilateral and bilateral flows and also between grants and loans. Chart 31, which uses World Bank estimates of official net resource flows and their components, shows these changes for LDCs as a whole, and also for African, Asian and island LDCs. A number of trends are evident.

First, it is apparent that during the 1990s official long-term capital flows to LDCs were overwhelmingly concessional. This situation has prevailed in Asian LDCs since the early 1970s. However, during the period from 1976 to 1983, a key moment when the debt problem emerged, between 10 and 20 per cent of long-term official flows to African LDCs were non-concessional. The subsequent difference between African and Asian LDCs in terms of their external debt burden is related to the difference in official financing.

For LDCs as a whole, the relative importance of grants has increased whilst the relative importance of loans has declined.

Secondly, for LDCs as a whole, the relative importance of grants has increased whilst the relative importance of loans has declined. Grants constituted 41 per cent of total official net resource flows in 1981 compared with 77 per cent in 1998 for all LDCs. Grants had an increasing role in both African and Asian LDCs, but this role was more marked in the former, where it rose from 39 to 82 per cent of official net resource flows, than in the latter, where it was initially higher (49 per cent of official net resource flows in 1982) and rose less – to 62 per cent. For island LDCs, grants have constituted over 60 per cent of official net resource flows in almost all years since 1975.

Thirdly, for concessional loans, the relative importance of multilateral sources has increased whilst the relative importance of bilateral sources has declined. For LDCs as whole multilateral net concessional loans (excluding IMF loans) increased from 15 per cent of official net resource flows in 1982 to 28 per cent in 1998. The increase was sharpest in Asian LDCs, where net multilateral concessional lending constituted 43 per cent of official net resource flows in 1998 as compared with 23 per cent in African LDCs. Net bilateral concessional lending fell from 35 per cent of official net resource flows in 1982 to minus 1.4 per cent in 1998. This trend is apparent in African, Asian and island LDCs.

3. The economic importance of aid

A key feature of LDCs is that the size of aid flows relative to economic activity in the recipient economies is large. Some estimates of their relative size are set out in table 15, which measures ratios of net ODA to GNP, to gross domestic investment (GDI) and to imports of goods and services, as well as aid per capita, for the period 1996–1998. Estimates are presented for individual LDCs as well as averages weighted, respectively, by GNP, GDI, imports and population.[3]

From the table it is evident that there is a stark difference between the LDCs and other developing countries in terms of the role of ODA in their economies. For 1996–1998, the average ratio of net ODA to GNP (weighted by recipient GNP) for the LDCs was 9 per cent, compared with 0.4 per cent in other developing countries. In thirty-seven LDCs, aid-to-GNP ratios were equal to or higher than 9 per cent over that period. The weighted average ratio of net ODA to GDI (weighted by GDI) was 47 per cent, compared with 1.6 per cent in other developing countries. Moreover, the weighted average of net ODA to imports of goods and services (weighted by imports) was 30.5 per cent compared with 1.7 per cent in other developing countries.

CHART 31: THE COMPOSITION OF OFFICIAL NET RESOURCE FLOWS (ONRF) INTO THE LDCS, AFRICAN LDCS, ASIAN LDCS, AND ISLAND LDCS, 1970–1998
(Percentage)

Source: See table 12.

TABLE 15: AID[a] INTENSITY INDICATORS IN THE LDCS AND OTHER DCS, 1996–1998 AVERAGES

	Aid as per cent of GNP	Aid as per cent of GDI	Aid as per cent of imports (goods and services)	Aid per capita (current $)
Angola	9.3	23.2	6.4	33.4
Benin	11.0	61.8	29.8	41.6
Burkina Faso	15.8	57.6	52.2	37.6
Burundi	9.1	90.3	48.9	12.7
Central African Republic	12.2	179.7	49.5	37.0
Chad	14.6	97.6	42.7	32.7
Dem. Rep. of the Congo	2.7	32.7	6.9	3.2
Djibouti	18.6	198.2	31.1	140.8
Equatorial Guinea	9.0	8.5	3.9	63.6
Eritrea	18.5	62.9	24.5	38.3
Ethiopia	10.9	57.4	37.8	11.4
Gambia	9.4	48.9	12.0	31.7
Guinea	9.4	43.6	34.1	50.0
Guinea-Bissau	56.5	303.1	140.3	117.2
Haiti	11.5	114.1	40.6	48.9
Lesotho	7.2	14.0	7.6	43.5
Liberia	..	..	..	37.1
Madagascar	15.6	124.7	46.8	39.6
Malawi	19.8	158.2	34.9	41.3
Mali	16.5	75.4	43.3	41.3
Mauritania	22.4	112.3	40.2	93.0
Mozambique	30.2	146.3	77.0	57.7
Niger	15.2	144.9	59.8	29.8
Rwanda	21.1	135.6	78.8	47.2
Sierra Leone	17.2	206.0	61.1	28.9
Somalia	..	..	..	9.5
Sudan	2.4	..	6.7	6.8
Tanzania	13.6	83.7	40.8	30.0
Togo	9.3	60.2	16.4	31.6
Uganda	10.4	65.2	37.5	32.3
Zambia	15.8	101.2	29.4	55.6
Afghanistan	..	..	..	7.9
Bangladesh	2.7	13.1	14.6	9.4
Bhutan	17.5	33.4	32.9	81.1
Cambodia	12.1	62.3	26.9	32.5
Lao People's Dem. Republic	20.0	73.3	43.5	64.8
Myanmar	..	..	1.7	1.0
Nepal	8.3	36.0	23.1	17.9
Yemen	6.8	27.4	8.6	18.8
Cape Verde	24.6	61.6	39.8	294.6
Comoros	16.8	84.9	39.4	65.7
Kiribati	17.6	..	23.5	181.8
Maldives	9.9	..	6.6	108.3
Samoa	17.7	..	24.3	190.2
Sao Tome and Principe	94.0	202.3	179.0	263.7
Solomon Islands	12.5	..	16.6	104.4
Vanuatu	14.4	..	20.4	184.6
LDCs	9.0	47.3	30.5	21.0
African	12.0	70.6	37.0	26.8
Asian	4.6	22.6	18.6	11.5
Island	18.4	75.4	57.5	157.9
Other DCs	0.4	1.6	1.7	5.7

Source: UNCTAD estimates based on World Bank, *World Development Indicators 2000*.

a Definition (World Bank, WDI 2000): Aid is defined as the actual international transfer by the donor of financial resources or of goods or services valued at the cost to the donor, less any repayments of loan principal during the same period.

Differences are also apparent between African, Asian and island LDCs. The aid intensity ratios are highest for island LDCs, followed by the African LDCs.

D. Trends in private capital inflows

According to data contained in the World Bank's *Global Development Finance*, there was apparently no increase in private capital flows to LDCs between 1988 and 1998 (see table 12). But the figures are deceptive. A close look at them shows that the behaviour of long-term net private capital inflows into LDCs is dominated by oil and gas development in Angola, Equatorial Guinea, Myanmar and Yemen. These four countries received 80 per cent of annual private capital flows to LDCs during the period 1990–1994. If these countries are taken out of the sample, it is apparent that long-term private capital inflows have increased from $323.1 million per annum during the period 1990–1994 to $941.9 million during the period 1995-98. Average annual inflows in the late 1990s were higher than in the early 1990s for 29 out of 45 countries for which data are available. UNCTAD data also indicate higher net FDI inflows into the LDCs, and it may be that more accurate national monitoring of FDI and the proper classification of some current transfers as capital flows would show that private capital flows are even higher.[4]

Average annual private capital inflows in the late 1990s were higher than in the early 1990s for 29 out of 45 countries ...

However, although these trends are positive, large increases in private long-term capital inflows into LDCs are concentrated in just a few countries. In fact, about three fifths of the increase in private capital inflows between the early and late 1990s noted in the last paragraph have been concentrated in four countries – Cambodia, Lao People's Democratic Republic, Uganda, and the United Republic of Tanzania. Private capital generally accounts for such a small proportion of total capital inflows that even where private capital inflows have been increasing, they have been unable to offset the decline in official finance in most LDCs. As table 16 shows, there are only three LDCs in which the increase in net private capital inflows was sufficient to offset declining net official finance. Also, it is apparent that the LDCs are failing to attract certain types of private capital. In the early 1980s, long-term international bank finance to LDCs collapsed and it has failed to recover. These countries have also been bypassed by portfolio equity flows, with all the swings they generate, and by bond issues.

... Large increases in private long-term capital inflows into LDCs are concentrated in just a few countries.

Almost all the increase in long-term private capital inflows into LDCs has been driven by FDI inflows. A feature of FDI inflows into LDCs is their geographical concentration and it is this that underlies the geographical concentration of private capital flows to LDCs. This concentration of FDI flows lessened somewhat between the early and late 1990s, but not by much. Whereas about 75 per cent of net FDI inflows into LDCs was absorbed by four countries (Angola, Myanmar, Yemen and Zambia) during the period 1990–1994, the same proportion was absorbed by just eight during 1995–1998 (Angola, Bangladesh, Cambodia, Equatorial Guinea, Myanmar, Lao People's Democratic Republic, Uganda, and United Republic of Tanzania).

The economic significance of the private capital inflows into LDCs can be put in better perspective by expressing these flows as a percentage of GNP. If the oil economies are disregarded, private capital inflows constitute less than 1 per cent of LDCs' GNP over the 1990s (chart 32), compared with around 4 per cent for developing countries in general (see UNCTAD, 1999: table 5.1). Private capital inflows constitute more than 2 per cent of GNP in just a few economies. During the period 1990–1994, the only countries in which private capital inflows were more than 2 per cent of GNP were four small island economies (Maldives,

TABLE 16: DIRECTION OF CHANGE IN OFFICIAL, PRIVATE AND AGGREGATE NET RESOURCE FLOWS TO THE LDCS, BY COUNTRY, 1990 TO 1998

		Changes in official capital inflows		
		Increase	*Decrease*	
Changes in private capital inflows	*Increase*	**Bhutan**	Bangladesh	Lesotho
		Burkina Faso	Benin	Madagascar
		Cambodia	Burundi	Mali
		Cape Verde	Central African Rep.	Mozambique
		Lao PDR	Chad	Myanmar
		Liberia	Comoros	Nepal
		Malawi	Dem. Rep. of the Congo	Sao Tome and Principe
		Maldives	Djibouti	Togo
		Solomon Islands	Equatorial Guinea	**Uganda**
			Ethiopia	**United Rep. of Tanzania**
			Gambia	**Vanuatu**
	Decrease	**Eritrea**	Angola	Somalia
		Guinea	Guinea-Bissau	Sudan
		Haiti	Mauritania	Yemen
		Rwanda	Niger	Zambia
		Sierra Leone	Samoa	LDCs aggregate

Source: As in table 12.

Note: Countries which experienced positive change in aggregate net resource flows between 1990 and 1998 are highlighted in bold.

Samoa, Solomon Islands and Vanuatu), plus Zambia and the oil economies. In 1995–1998, 12 countries passed this threshold. These were the four small island economies, plus Angola and Equatorial Guinea, in all of which inflows remained above 2 per cent of GNP, together with Cambodia, Cape Verde, Lesotho, Lao People's Democratic Republic, Uganda, and the United Republic of Tanzania. Private capital inflows remained at below 1 per cent of GNP in 24 out of 40 countries.

Finally, the significance of long-term private capital inflows for LDCs can be put in perspective by comparing their scale with private current transfers, the main component of which is workers' remittances.[5] The developmental impact of these transfers is more uncertain than that of long-term capital inflows. Although they can make an important positive contribution to the current account of the balance of payments, they may be more oriented to consumption and housing investment than developing productive capacities, and they are subject to uncontrollable volatility, associated with the policies in the countries to which migrant workers have moved. But in the period 1995–1998, in spite of the increasing long-term private capital flows during the 1990s, annual inflows in the form of private current transfers exceeded long-term private capital inflows in two thirds (17) out of 25 LDCs for which data are available. Moreover, they constituted over 2 per cent of GNP in almost half of these countries.

E. Trends in external debt

External indebtedness began to be a problem in LDCs in the late 1970s, and following the second oil price shock, rising interest rates and economic recession in industrial countries in the early 1980s, the problem escalated. In 1976, only 2 out of 28 LDCs for which data are available had external debt-to-GDP ratios of

CHART 32: TRENDS IN PRIVATE CAPITAL INFLOWS INTO THE LDCS, AFRICAN LDCS, ASIAN LDCS, AND ISLAND LDCS, 1980–1998
(Percentage of GNP)

Source: See table 12. a Excluding Afghanistan, Angola, Equatorial Guinea, Eritrea, Kiribati, Liberia, Myanmar, Sao Tome and Principe, Somalia, Tuvalu and Yemen. *Note:* LT flows refer to long-term flows.

over 50 per cent and external debt-to-export ratios higher than 200 per cent, but by 1982 over half of the LDCs were in this situation, and by 1987 two thirds of the LDCs for which data were available had levels of indebtedness beyond these thresholds.[6] In that year, 19 LDCs had been to the Paris Club to reschedule their debts. Most of those experiencing debt problems were African LDCs, a fact which is related to patterns of external financing (box 3).

The debt problem has continued to linger on in the 1990s (tables 17 and 18). For LDCs as a whole, the nominal value of the total external debt stock rose from $121.2 billion in 1990 to $150.4 billion in 1998, according to World Bank statistics. This corresponded to an estimated 101 per cent of their combined GNP, up from 92 per cent in 1990. Half of this debt stock was concentrated in just six countries – Angola, Bangladesh, the Democratic Republic of the Congo, Ethiopia, Mozambique and Sudan – and in 23 out of the 45 countries for which

Box 3: Contrasting trends in external financing and external indebtedness in African and Asian LDCs

There is an important contrast between African LDCs and Asian LDCs in terms of the pattern of external financing, particularly during the critical initial period (1976-1982) when the external debt built up. Loans to African LDCs increased much more sharply than those to Asian LDCs in the 1970s; African LDCs were also more reliant than Asian LDCs on private loans; and the concessionality of official finance to African LDCs was lower than that to Asian LDCs. For every year between 1978 and 1991 (excepting 1984), the average interest rate on new official loans to African LDCs was double or more that on loans extended to Asian LDCs (see the chart below). Moreover, during every year of the critical period in which indebtedness grew in Africa (1979–1985) the interest rates on new official loans were more than 3 per cent, whereas (with the exception of one country, Yemen, in one year) they never exceeded this level in Asia.

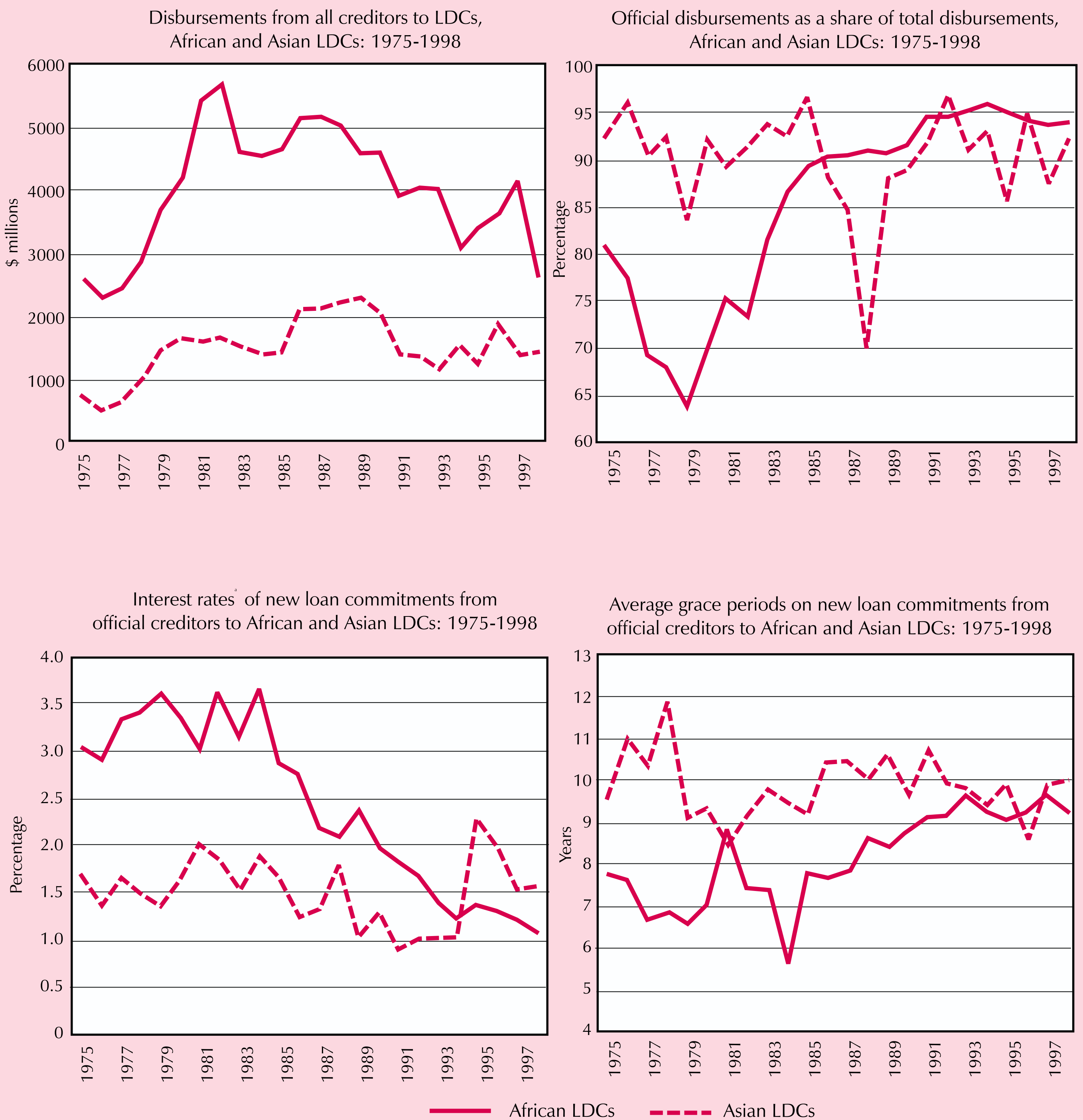
Export credits played a major role in the build-up of the debt in African LDCs, increasing by 27 per cent a year in African LDCs between 1975 and 1979 (Krumm, 1985: table 5). Ambitious infrastructure projects were often externally financed on terms much shorter than the profile of returns, and many projects in productive sectors were ill-conceived and proved to be economically unviable. The role of ECAs in the build-up of the debt problem in low-income countries has recently been described as follows:

> From the creditor government perspective, the motivation for much of the commercial lending or guaranteeing of loans to LICs [low-income countries] during the 1970s and 1980s was the stimulation of their own exports, and the associated economic and industrial benefits of protecting or creating domestic employment, as well as the benefits of cementing diplomatic relations with the trading partners concerned. This was sometimes known as “national interest” lending. It was, by definition, a highly risky business, with a real possibility that eventually much of the debt would not be repaid. Industrial country governments were, however, willing to accept these risks. Most of the LICs were also aid recipients, and many official creditor governments saw the provision of commercially-priced export credit guarantees (a contingent liability, but not usually an immediate cost to the national budget) as a complement to direct grants and concessional Official Development Assistance (ODA) loans in their overall development cooperation policy (Daseking and Powell, 1999: 4).

When non-oil commodity prices declined and the concomitant terms-of-trade shock was magnified by the second oil price shock, debt-servicing capacity was seriously impaired. Debt management capabilities of LDCs were very low, and the domestic policy response to adjust to the new external economic circumstances was often slow. In many cases, this was encouraged by an assumption that commodity prices would recover. International commodity price forecasts in the early 1980s, which provided the basis for the expectations of Governments, donors and lenders, were excessively optimistic, being based on the impression that the debt problem was a transitory liquidity problem. For example, Zambia negotiated an Extended Fund Facility with the IMF in 1983 which assumed a 45 per cent increase in copper prices over four years. In the event, copper prices fell by about 12 per cent, leaving Zambia with a considerably higher level of mainly non-concessional debt and a lower than expected payments capacity (Brooks et al., 1998: 8).

The difference in provision of concessional finance to Asian and African LDCs was critical to their subsequent growth-and-debt trajectories. Most of the LDCs that began experiencing serious debt problems were African LDCs. With exception of Cambodia and the Lao People’s Democratic Republic, and later Yemen, Asian LDCs have never experienced the level of debt distress of the African LDCs. In the 1990s, within the framework of policy reforms, the difference between African and Asian LDCs in terms of the concessionality of official finance has disappeared.

Box 3 (continued)



Source: See table 12.

a Weighted by value of new loan commitments from official creditors.

TABLE 17: SCALE AND COMPOSITION OF THE LDCS' EXTERNAL DEBT, 1990 AND 1998

	Debt stocks						*Principal and interest arrears[b]*			
	Total debt stocks $ millions		Share of official[a] (incl.IMF) per cent		Share of multilateral[a] (incl.IMF) per cent		Share of total debt per cent		Share of official arrears per cent	
	1990	*1998*	*1990*	*1998*	*1990*	*1998*	*1990*	*1998*	*1990*	*1998*
Angola	8 593.8	12 172.8	21.4	26.5	0.7	2.3	8.1	22.2	19.6	25.8
Bangladesh	12 768.5	16 375.6	96.7	98.5	56.0	67.3	0.1	0.1	96.1	100.0
Benin	1 291.8	1 646.8	94.4	94.7	42.9	62.3	7.6	4.8	88.5	94.2
Bhutan	83.5	119.6	74.0	100.0	50.2	67.9	2.2	-	100.0	-
Burkina Faso	834.0	1 399.3	85.4	95.5	67.8	86.2	10.2	3.1	56.5	86.4
Burundi	907.4	1 118.7	97.5	98.1	77.5	84.1	0.0	5.0	100.0	99.5
Cambodia	1 854.4	2 209.7	92.5	98.0	1.5	15.5	26.9	43.4	99.9	100.0
Cape Verde	135.3	243.7	94.7	92.9	64.3	73.8	9.9	9.8	91.8	90.4
Central African Republic	698.5	921.3	91.5	90.8	70.5	69.6	5.5	16.7	85.6	92.5
Chad	524.1	1 091.4	92.7	96.3	69.2	80.4	4.2	4.3	79.5	95.5
Comoros	184.9	203.1	93.3	93.9	61.6	80.4	20.4	22.1	100.0	100.0
Dem. Rep. of the Congo	10 270.2	12 929.2	84.1	65.9	23.9	20.8	12.8	64.0	41.1	86.1
Djibouti	205.3	287.8	75.6	94.8	41.9	53.3	0.6	9.3	100.0	100.0
Equatorial Guinea	241.1	306.1	81.8	69.4	30.4	35.5	20.0	44.7	86.7	85.5
Eritrea	..	149.3	..	96.5	..	51.0	..	0.0	..	..
Ethiopia	8 634.3	10 351.8	91.6	90.6	14.8	26.4	3.2	56.0	84.3	95.7
Gambia	369.1	477.0	90.8	96.8	67.2	76.8	0.4	0.0	100.0	100.0
Guinea	2 476.4	3 545.9	88.7	90.9	29.5	51.2	9.9	16.0	87.3	96.7
Guinea-Bissau	692.1	964.4	87.1	92.0	40.3	44.0	20.6	25.7	94.3	99.8
Haiti	888.9	1047.5	83.4	97.2	59.3	82.9	7.5	0.3	41.1	100.0
Lao People's Dem. Rep.	1 768.0	2 436.7	99.9	99.9	15.5	41.7	0.1	0.0	100.0	100.0
Lesotho	395.6	692.1	90.8	90.9	77.4	75.4	1.1	1.8	56.8	44.4
Liberia	1 849.0	2 102.9	67.4	57.6	40.9	35.0	58.2	78.3	72.5	78.8
Madagascar	3 701.3	4 394.1	90.2	93.8	37.1	41.9	10.5	17.1	92.1	95.6
Malawi	1 558.2	2 444.0	91.1	97.9	77.2	85.6	1.6	2.1	63.7	75.0
Maldives	78.0	179.9	77.2	81.9	41.7	62.9	0.0	0.0	..	..
Mali	2 466.9	3 201.5	96.9	94.1	39.1	55.0	2.9	22.1	99.6	100.0
Mauritania	2 096.1	2 588.6	84.1	88.9	34.5	42.7	9.8	19.4	86.3	100.0
Mozambique	4 652.8	8 208.3	78.2	71.2	11.6	25.6	20.0	19.0	48.2	96.9
Myanmar	4 694.8	5 680.4	89.8	79.6	26.3	21.1	12.3	35.8	79.7	84.9
Nepal	1 640.0	2 645.7	91.8	97.5	80.0	85.3	0.6	0.4	100.0	58.4
Niger	1 725.5	1 659.4	69.5	91.9	45.6	62.6	6.4	5.7	49.0	100.0
Rwanda	711.7	1 225.9	92.9	95.8	76.2	82.8	1.4	6.2	100.0	97.9
Samoa	92.0	180.1	98.3	85.7	89.0	80.2	0.0	0.0	..	..
Sao Tome and Principe	150.0	245.8	88.5	95.0	49.1	65.6	19.3	13.5	95.9	100.0
Sierra Leone	1 151.1	1 243.1	53.2	90.8	25.2	57.4	30.7	3.7	71.8	90.2
Solomon Islands	120.5	152.4	74.5	68.6	51.6	60.1	0.2	5.4	100.0	49.4
Somalia	2 370.3	2 635.0	86.4	76.2	38.5	34.1	39.2	67.9	96.4	97.1
Sudan	14 762.0	16 843.0	57.3	50.1	18.1	16.8	63.7	80.2	75.9	77.6
Togo	1 274.7	1 448.4	87.1	96.4	50.7	61.7	0.3	1.9	65.0	100.0
Uganda	2 582.9	3 935.2	81.6	94.7	60.1	71.9	11.5	7.4	42.0	75.3
Utd. Rep. of Tanzania	6438.2	7 602.6	84.5	84.8	33.0	44.8	18.8	23.9	74.9	82.5
Vanuatu	40.2	63.2	72.4	85.8	39.6	70.1	0.0	0.0	..	..
Yemen	6 344.8	4 138.0	55.1	90.6	16.2	44.9	16.2	17.9	49.2	75.5
Zambia	6 916.2	6 865.3	73.1	93.1	34.0	50.0	32.3	12.9	92.3	91.2

Source: UNCTAD secretariat estimates, based on World Bank, *Global Development Finance 2000*, and *World Development Indicators 2000*.

a on long-term debt, including IMF.

b on long-term debt, excluding IMF.

TABLE 18: EXTERNAL DEBT BURDEN INDICATORS FOR THE LDCS, 1990 AND 1998
(Percentage)

	Debt stocks to GDP		Debt stocks to exports		Debt service paid to exports		Present value of debt to exports
	1990	*1998*	*1990*	*1998*	*1990*	*1998*	*1998*
Angola	83.7	162.9	214.7	309.8	8.1	34.4	291.9
Bangladesh	42.8	38.3	365.6	182.4	22.6	7.6	134.6
Benin	70.0	71.4	233.3	288.6	6.9	10.6	183.0
Bhutan	29.3	30.0	88.0	76.4	5.5	5.9	50.0
Burkina Faso	30.2	54.2	129.1	343.2	5.3	13.0	166.9
Burundi	80.2	126.4	928.8	1819.0	43.4	49.1	828.7
Cambodia	166.4	77.0	..	259.0	..	1.5	207.6
Cape Verde	39.9	49.2	77.2	91.8	3.3	7.2	79.1
Central African Republic	47.0	87.2	316.9	633.2	13.2	20.9	393.8
Chad	30.1	64.4	191.1	326.9	4.4	10.6	188.8
Comoros	74.0	103.5	318.8	590.4	1.9	18.0	289.4
Dem. Rep. of the Congo	109.9	185.6	397.5	777.2	13.5	1.2	731.5
Djibouti	48.3	..	..	..	..	..	..
Equatorial Guinea	182.5	67.1	570.0	73.3	12.1	1.4	59.9
Eritrea	..	23.0	..	39.2	..	1.0	34.1
Ethiopia	126.2	158.2	1276.3	983.5	34.9	11.3	829.7
Gambia	116.5	114.7	217.5	177.7	22.2	9.7	100.4
Guinea	87.9	98.5	294.4	431.6	20.0	19.4	307.4
Guinea-Bissau	283.7	468.9	2463.0	3131.2	29.9	25.6	2253.2
Haiti	29.8	27.1	273.6	218.5	10.1	8.2	125.0
Lao PDR	204.5	193.3	1690.2	493.3	8.7	6.3	227.0
Lesotho	63.6	87.3	71.3	114.0	4.2	8.4	81.6
Liberia	..	..	..	..	.	..	..
Madagascar	120.1	117.2	748.6	514.7	45.0	14.7	383.3
Malawi	86.4	144.8	344.4	430.1	29.3	14.7	241.2
Maldives	53.5	48.9	42.4	41.4	4.8	3.1	27.3
Mali	101.9	118.8	375.9	492.2	10.2	12.6	335.5
Mauritania	184.7	261.6	417.6	648.0	29.1	27.6	358.2
Mozambique	185.2	210.8	1552.0	1413.5	26.2	18.0	470.3
Myanmar	..	..	703.2	325.5	9.0	5.3	278.9
Nepal	45.2	55.3	312.9	192.8	13.6	6.4	119.0
Niger	69.6	81.0	297.8	492.3	17.0	18.4	330.5
Rwanda	27.5	60.6	472.6	981.5	13.9	16.6	555.6
Samoa	63.1	102.6	67.3	106.7	4.0	3.0	83.1
Sao Tome and Principe	299.8	602.1	1807.2	2119.0	33.7	31.9	1245.0
Sierra Leone	128.4	192.2	547.4	1108.9	10.1	18.2	735.4
Solomon Islands	57.1	50.7	123.2	76.6	11.9	3.3	32.7
Somalia	258.5	..	3362.1	..	15.2	..	..
Sudan	112.1	162.5	1848.7	2694.4	6.2	9.8	2537.7
Togo	78.3	95.9	170.1	205.1	11.4	5.7	142.3
Uganda	60.0	58.1	1051.2	581.9	60.0	23.6	350.6
United Rep. of Tanzania	152.6	94.8	1182.8	644.6	32.9	20.8	481.7
Vanuatu	26.3	26.2	33.6	32.7	2.0	0.9	20.1
Yemen	134.3	95.8	138.6	217.1	3.7	6.5	105.4
Zambia	210.3	204.8	507.8	600.8	14.9	17.7	482.8

Source: UNCTAD Secretariat estimates, based on World Bank, *Global Development Finance 2000*, and *World Development Indicators 2000*.
Note: Exports are defined as exports of goods and services and workers remittances' receipts

data is available, external debt stocks in nominal terms were less than $2 billion. Yet using the criteria which the international community has recently adopted under the enhanced HIPC Initiative to judge debt sustainability, it is apparent that in 1998 the external debt was unsustainable in two thirds (28) of the 45 LDCs for which data are available.

There were certainly some improvements in external indebtedness indicators in the period 1994–1997. However, the debt-servicing capacity of the LDCs deteriorated critically in 1998, as their earnings from exports of goods and services declined by about 8 per cent (or $2.6 billion), according to World Bank figures, from $34 billion in 1997 to $31.4 billion in 1998. Twenty-seven out of the 45 LDCs for which data are available were unable to acquit themselves of their debt service obligations in 1998.

The debt-servicing capacity of the LDCs deteriorated critically in 1998, as their earnings from exports of goods and services declined by about 8 per cent.

Total debt service paid by LDCs as a whole amounted to $4.4 billion in 1998, compared with $3.9 billion in 1990. The ratio of debt service to exports declined from 14 per cent in the latter year to 12 per cent in 1998. But the relatively low average debt service ratio reflects payments actually made, not payments due. In 1990, arrears constituted 19 per cent of the total debt stock, whilst by 1998 this was as high as 30.4 per cent.

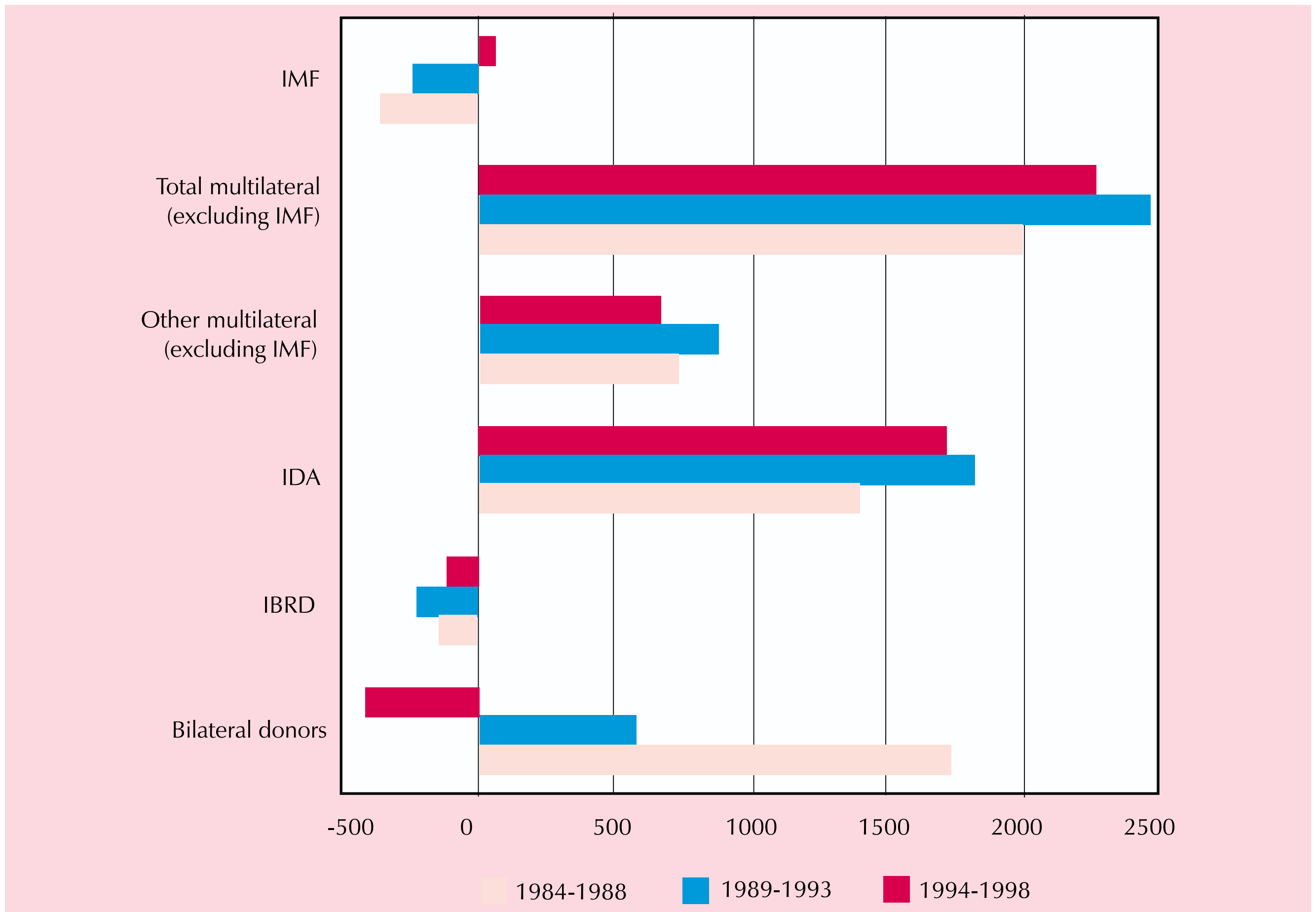
Analysis of the pattern of arrears shows that they are particularly high in LDCs which have experienced protracted armed conflict and/or which have been cut off from international assistance, notably Angola, Cambodia, the Democratic Republic of the Congo, Ethiopia, Liberia, Myanmar, Somalia and Sudan.[7] However, the inability to pay debt service is a widespread problem. As well as in these eight countries, arrears constituted over 15 per cent of the debt stock in 1998 in the Central African Republic, Comoros, Guinea, Guinea-Bissau, Madagascar, Mali, Mauritania, Mozambique, the United Republic of Tanzania, and Yemen.

F. Aggregate net transfers and exceptional financing

After the outbreak of the debt crisis in the early 1980s, aggregate net transfers to middle-income countries actually became negative as capital inflows fell and interest payments rose. For the least developed countries, the increased concessional inflows during the 1980s helped to ensure that this did not occur. Net transfers by the international creditor/donor community has been positive mainly because of the scale of bilateral grants, and loans through IDA and multilateral organizations other than the IBRD and IMF. During the period 1988–1993, annual aggregate net transfers on loans to the IBRD and IMF for LDCs as a whole were in each case negative (i.e more money was being taken out than put in), and during 1994–1998, although net transfers on debt to the IMF became positive, they remained negative for the IBRD and became negative for bilateral loans (chart 33).

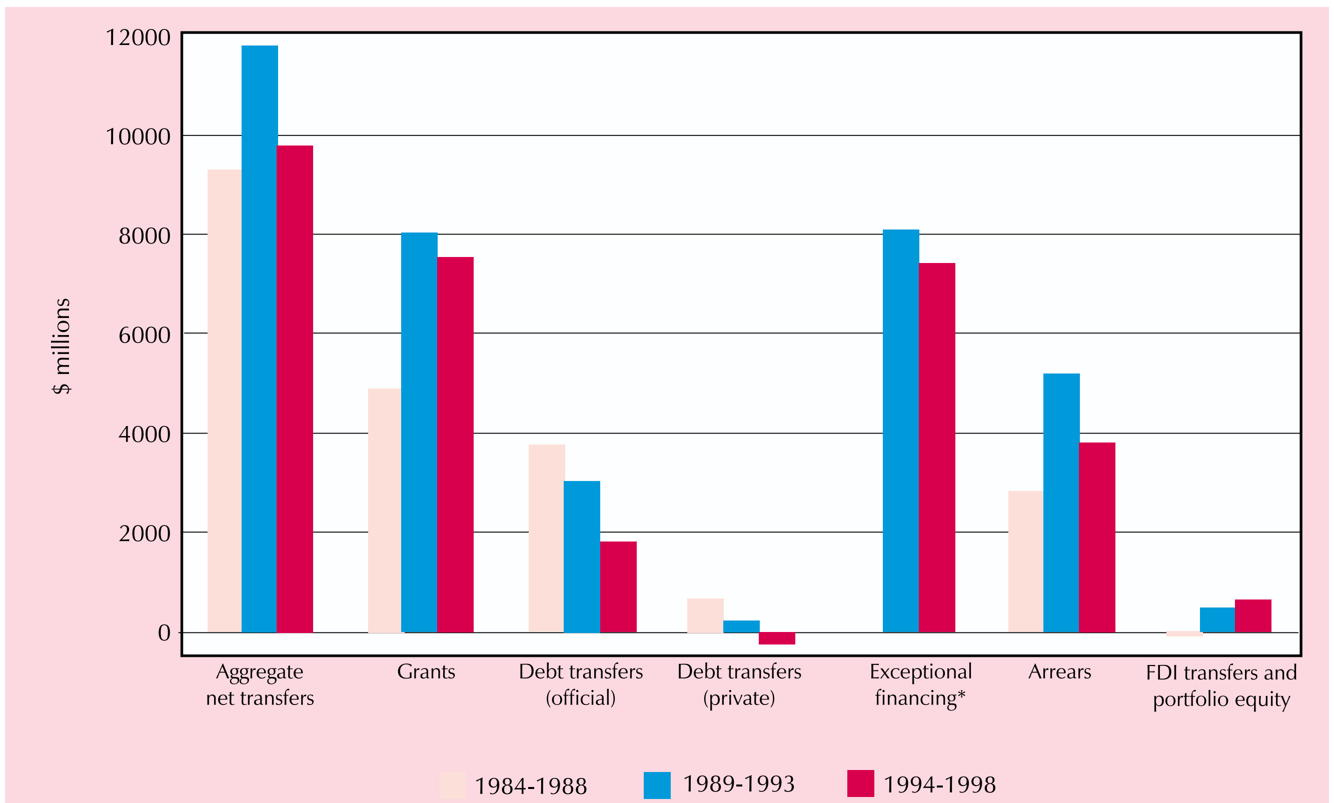
Sustaining positive aggregate net transfers to the least developed countries has also become dependent on debt rescheduling, debt forgiveness and the accumulation of arrears to external creditors, which together reduce the actual levels of debt service outflows. Chart 34 provides some estimates of levels of such exceptional financing for the least developed countries during the period 1984–1998. Exceptional financing is defined here as the difference between debt service which were contractually due and debt service which were actually

CHART 33: NET OFFICIAL TRANSFERS ON DEBT TO THE LDCS BY CATEGORY OF CREDITORS, 1984–1998
(Average annual net transfers, $ millions)



Source: As in table 12.
Note: Net official transfers on debt are loan disbursements minus debt service (principal repayments and interest payments).

CHART 34: ANNUAL AVERAGE NET TRANSFERS AND EXCEPTIONAL FINANCING TO THE LDCS, 1984–1998
($ millions)



Source: As in table 12. *Note:* FDI transfers are net FDI minus profit remittances.
* Data on exceptional financing are not available for 1984–1988.

paid.[8] It should be stressed that the numbers are best estimates, since there are difficulties in calculating with precision what debt service was due. However, it is clear that LDCs as a whole are highly dependent on these "virtual financial flows", which come either through formally negotiated debt relief on debt service payments or through disorderly accumulation of arrears. If these "virtual financial flows" were not supplementing the actual flows, aggregate net transfers would have been just 31 per cent of their actual level during 1989–1993 and only 25 per cent of their actual level in 1994–1998.

As noted above, arrears accumulation has been particularly important in countries that are experiencing conflict or have been excluded from official inflows. However, as table 19 shows, exceptional financing has been critically important for a wide range of countries. Indeed, during 1989–1993, it constituted more than 2 per cent of GNP in more than two thirds (25) out of the 38 countries for which data are available, and during 1994–1998, it constituted over 2 per cent in more than half of the countries for which data are available (23 out of 41). For many severely indebted LDCs, "virtual financial flows" have become the main source of external finance after ODA.[9]

For many severely indebted LDCs, "virtual financial flows" have become the main source of external finance after ODA.

As will be argued in later chapters, it is not helpful to treat exceptional financing as a form of development finance. But in practice, debt relief is functioning as such, which is making it natural for debt relief and ODA to be treated as analogous forms of assistance, and for ODA to be diverted into debt relief.

G. Conclusions

The evidence of this chapter highlights seven important features of trends in the volume and sources of external finance available to the least developed countries.

First, long-term capital flows have declined by about 25 per cent in nominal terms during the 1990s, and in real per capita terms capital inflows have fallen by about 40 per cent.

Second, the main source of long-term capital inflows into LDCs is ODA. The degree of reliance on official rather than private sources of external finance is a major difference between LDC and non-LDC economies. This contrast was apparent in the 1970s, but it became clearer after 1982 and has become particularly marked in the 1990s. ODA grants are particularly important for many LDCs, and especially important to African LDCs.

Third, the declining trend in long-term net capital inflows into LDCs as a whole is the result of declining aid flows coupled with the failure of most LDCs to attract sufficient private capital inflows to offset that decline. Other developing countries are increasingly relying on international flows of private capital as a key component of their development strategy. But only a few LDCs have been able to attract significant private capital inflows.

Fourth, the declining aid flows to the LDCs reflect the failure of the international community to implement commitments made as an outcome of the Second United Nations Conference on the Least Developed Countries held at Paris in 1990. In the Paris Declaration and Programme of Action for the Least Developed Countries for the 1990s, the international community, particularly the developed countries, committed itself to a "significant and substantial

TABLE 19: EXCEPTIONAL FINANCING[a] AS A PERCENTAGE OF GNP, 1989–1993 AND 1994–1998
(Annual averages)

	1989–1993	1994–1998
Angola	19.2	48.1
Bangladesh	0.2	0.0
Benin	5.6	1.8
Bhutan	0.3	0.0
Burkina Faso	2.5	1.6
Burundi	2.5	1.5
Cambodia	..	5.3
Cape Verde	1.3	0.5
Central African Republic	4.0	4.0
Chad	2.1	1.8
Comoros	5.8	3.9
Democratic Republic of the Congo	11.8	14.2
Djibouti	..	1.2
Equatorial Guinea	14.4	7.3
Eritrea	..	..
Ethiopia	9.6	12.7
Gambia	0.3	0.1
Guinea	7.7	2.9
GuineaBissau	24.7	26.9
Haiti	2.0	1.5
Lao People's Democratic Republic	0.6	0.0
Lesotho	0.4	0.1
Liberia	..	..
Madagascar	13.6	10.1
Malawi	1.0	0.6
Maldives	0.0	0.0
Mali	3.4	9.2
Mauritania	13.6	9.3
Mozambique	16.8	16.4
Myanmar	..	..
Nepal	0.1	0.0
Niger	5.5	5.4
Rwanda	0.8	1.5
Samoa	0.1	0.0
Sao Tome and Principe	17.4	22.5
Sierra Leone	13.4	10.4
Solomon Islands	0.1	2.0
Somalia	..	..
Sudan	11.1	7.0
Togo	7.2	7.8
Uganda	3.0	2.4
United Republic of Tanzania	10.3	7.5
Vanuatu	0.6	0.0
Yemen	9.0	17.4
Zambia	18.8	5.0

Source: UNCTAD secretariat estimates, based on World Bank, *Global Development Finance 2000*.
a For definition of exceptional financing, see text.

increase in the aggregate level of external support" to the LDCs. In order to reach a flow of concessional resources commensurate with the increase called for, donor countries agreed to seek to implement the following targets:

- Donor countries already providing more than 0.20 per cent of their GNP as ODA to LDCs: continue to do so and increase their efforts;
- Other donor countries which have met the 0.15 per cent target [set by the Substantial New Programme of Action for the Least Developed Countries for the 1980s]: undertake to reach 0.20 per cent by the year 2000;
- All other donor countries which have committed themselves to the 0.15 per cent target: reaffirm their commitment and undertake either to achieve the target within the next five years or to make their best efforts to accelerate their endeavours to reach the target;
- During the period of the Programme of Action, the other donor countries: exercise their best efforts individually to increase their ODA to LDCs so that collectively their assistance to LDCs will significantly increase (UNCTAD, 1992: 26).

National and international policy efforts to promote economic growth, poverty reduction and sustainable development in the LDCs must start from the reality that not only are the central accumulation and budgetary processes of the LDCs dominated by external rather than domestically generated resources, but also long-term net capital inflows are dominated by aid.

In practice, the share of aid to LDCs in DAC donors' GNP fell from 0.09 per cent in 1990 to 0.05 per cent in 1998, and in that year only five DAC members met the 0.15 per cent target of the Programme of Action, namely Denmark, Luxembourg, the Netherlands, Norway and Sweden.

Fifth, ODA commitments to LDCs are increasingly being devoted to social infrastructure and services, as well as to debt forgiveness and emergency aid.

Sixth, many LDCs, particularly in Africa, have serious external debt problems. Some progress towards lessening the debt burden was made in the mid-1990s, but levels of external indebtedness are now higher than in 1990. According to international criteria of debt sustainability, which many regard as conservative, the external debt is unsustainable in two thirds of the least developed countries.

Seventh, in spite of growing debt stocks and interest payments, the LDCs have continued to receive positive net resource transfers. This was achieved during the 1980s and up to 1992 through increased commitment of resources on concessional terms by official creditor-donors. But exceptional financing in the form of debt forgiveness, debt rescheduling and the accumulation of arrears, all of which reduce actual debt service to below levels that were contractually due, has also become important, particularly since 1988. Such "virtual financial flows" are particularly significant for highly indebted LDCs.

It is apparent that national and international policy efforts to promote economic growth, poverty reduction and sustainable development in the LDCs must start from the reality that not only are the central accumulation and budgetary processes of the LDCs dominated by external rather than domestically generated resources, but also long-term net capital inflows are dominated by aid. The next chapter focuses on the reasons why most LDCs have not been able to attract as much private capital as other developing countries, and on the potential for changing this situation. The last three chapters deal with the conditions that govern access to concessional finance and debt relief, the

question of who controls the uses to which aid is put, and the consequences for the LDCs of the domination of their central accumulation and resource allocation processes by multiple aid donors.

Notes

1. For another review of trends in capital flows to poor countries, as well as discussion of related development issues, see Griffith-Jones and Ocampo (1999).
2. It should be noted that these data are estimates, since not all ODA commitments are classified.
3. These numbers are sometimes referred to as "aid dependency ratios", but following O'Connell and Soludo (forthcoming), they are referred to here as "aid intensity ratios".
4. This point is persuasively discussed in Bhinda et al. (1999: chapter 1).
5. This category can also include inward movement of capital by foreign investors, the return of money which previously exited the country as flight capital, and private gifts for humanitarian emergencies, or simply misrecording of items. In East Africa in particular, it is suggested that private capital inflows are misclassified as current transfers (see Kasakende, Kitabire and Martin, 1999).
6. These threshold levels are those beyond which it has been found that there is over a 60:40 chance of needing to reschedule (Cohen, 2000).
7. For a discussion of the interaction between external indebtedness, growth and investment in conflict and post-conflict African economies, see Elbadawi and Ndung'u (2000).
8. The term "exceptional financing" is widely used in the context of evaluations of the IMF's Enhanced Structural Adjustment Facility (ESAF), where it often refers to accumulation of arrears to external creditors, rescheduling of interest and/or principal repayments, and debt cancellation, as well as to balance-of-payments support from multilateral organizations. In the present context, it is used to refer to the difference between debt service contractually due and debt service actually paid. This has been calculated by adding up principal and interest rescheduled, principal and interest forgiven and an estimate of unpaid arrears during the year. This last figure, it must be stressed, is a best estimate. When the change in the year-end stock of arrears is positive, the change has been included since it is reasonable to assume that these arrears resulted from amounts due and not paid in the current year. However, when the change in the stock of arrears is negative, it has been ignored in the calculations since it is impossible to identify how the arrears were cleared. If the reduction is due to rescheduling of arrears, it relates to payments due in prior years. If it is a result of clearance by payment, it measures actual payments made and, ideally, if this is the case, we should deduct this payment from the calculation (since, again, it does not relate to amounts due in the current year). It is likely that when this occurs in LDCs, the chances are that the arrears were rescheduled. Thus, it is likely that this assumption is reasonable.
9. For estimates of the importance of debt re-scheduling, debt cancellation and arrears accumulation in ESAF countries, see IMF (1997: table 5).

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The private capital-flow problem

Chapter 3

A. Introduction

The private capital-flow problem of developing countries in general has been starkly described as one in which "there is either too much capital or too little, and it is mostly hot rather than cold" (Dornbusch, 1998: 197). Although there is some evidence of increasing instability in short-term capital flows in the LDCs in the 1990s (UNCTAD, 2000: chart 5), the LDCs have not experienced the kind of hot surges and sudden withdrawals of external finance that have characterized emerging markets in Latin America and East Asia during this period. Instead, for almost all LDCs, the private capital-flow problem is that the international community of investors and lenders, which includes a small stratum of residents of the LDCs themselves as well as non-residents, places very little of its funds in LDCs.

This pattern presents an important challenge to national policy-makers and also international agencies seeking to promote development in LDCs. The 1990s has seen major policy efforts in LDCs and in other developing countries to reduce barriers to the free flow of private capital. These efforts have been premised on the assumption that international capital markets can, and will, allocate capital efficiently once governmental obstacles to free market operations are removed. The task has thus been to create an environment in which capital can flow to its highest return, in terms both of its use and of its location.

For almost all LDCs, the private capital-flow problem is that the international community of investors and lenders, which includes a small stratum of residents of the LDCs themselves as well as non-residents, places very little of its funds in LDCs.

It has also been assumed that all countries can benefit from the increasing global efficiency in resource allocation which is expected to result. Much hangs on this assumption. In short, it provides the implicit rationale for the two-speed development of a liberal international economic order – one in which policies to facilitate the free movement of goods and capital are vigorously promoted whilst equivalent measures to facilitate the free movement of labour are eschewed. Such an asymmetrical pattern of liberalization would condemn the populations of certain countries to poverty and immiserization if their territories were rationed out of international capital flows and unable to develop internationally competitive economic activities, whilst at the same time their populations were constrained from legally moving to find remunerative decent work in other territories where capital booms were under way. Two-speed liberalization would in such circumstances leave most citizens of such territories with a stark choice between poverty at home, and social exclusion abroad, as illegal, or quasi-legal, international migrant workers in other countries.

The low levels of private capital flows to LDCs may arise for three fundamental reasons, each with its own policy implications.

First, international capital markets are capable of allocating capital efficiently, but the LDCs have not pursued the requisite policies to facilitate private capital flows. This is likely to be a particular problem if LDCs are failing to liberalize as fast as other countries. According to neoclassical investment theory, capital should move to countries where the level of capital stock is relatively low and where, therefore, other things being equal, the marginal productivity of capital (the rate of return) is highest. The policy implication is that the LDCs should

redouble their efforts to create a liberal environment in which capital markets will behave as they should.

Secondly, it could be that international capital markets allocate capital efficiently and LDCs have undertaken the necessary policy action to ensure free movement of capital, but that those countries receive only a small amount of private capital inflows because relative risk-adjusted returns are lower than in other locations. Liberalization is delivering increasing global efficiency, but some countries do not benefit from this process. The implications of this situation are that policy efforts should be directed to improving the national enabling environment in ways which increase the returns on private capital investment and reduce risks that are deterring private capital.

Thirdly, it is possible that international capital markets do not allocate capital efficiently since there are various types of market failure. These include inadequate information, misperception of risks, large externalities owing to the interdependence of investment decisions, and market segmentation. As a result of these deficiencies, good investment opportunities in LDCs, with high risk-adjusted rates of return, are not realized. Market failures may exist at both national and international levels, and addressing them therefore entails national and international policies. The existence of market failures does not necessarily mean that Governments should invariably substitute for the market mechanism, as there may be other markets or intermediaries to deal with the problem. But in the absence of market alternatives, public intervention, including through the provision of global and regional public goods, may be justified to the extent that it is effective.

The policy problem is not simply to increase private capital inflows into LDCs as such, but also to ensure that they have a positive developmental impact.

The present chapter assesses the importance of various factors which make it difficult for LDCs to access international capital markets and attract FDI. Section B sets out some of the national factors which limit private capital inflows into LDCs, assessing the importance of the national policy environment, risks and returns, and domestic market failure. Section C examines the importance of international market failure and the negative influence of the external debt overhang on private capital flows. Section D draws some lessons from a recent international policy initiative designed to promote private investment in frontier markets, including LDCs, namely the International Finance Corporation's "Extending IFC's Reach" (EIR) programme. Section E sets out conclusions and policy implications.

The chapter draws in particular on Fitzgerald (2000) and Tourtellotte (2000), which are background studies commissioned for the present Report, and on the research for the UNCTAD/UNIDO pilot seminar on the mobilization of the private sector in order to encourage foreign investment flows to the least developed countries, held in Geneva in June 1997 (UNCTAD, 1997, 1998a). A general analysis of determinants of patterns of FDI flows can be found in UNCTAD (1998b), whilst a broad synopsis of new financing mechanisms for non-FDI foreign equity investment, and a comprehensive discussion of the role of official agencies in enhancing private flows to LDCs, are contained in *The Least Developed Countries 1998 Report* (part one, chapter 2).

Finally, it must be stressed at the outset that although the focus of the chapter is on the potential for attracting private capital flows, the policy problem is not simply to increase private capital inflows into LDCs as such, but also to ensure that they have a positive developmental impact. This is most likely to be achieved if FDI is seen by national Governments as a complement to domestic investment and efforts are made to integrate private capital inflows into a

national development strategy which seeks to promote increasing domestic investment, savings and exports, and the development of domestic productive capacities and international competitiveness.

B. Limits to private capital inflows: (1) national factors

1. The national policy environment

The policy environment for private sector activity in a country can be a critical factor which deters private capital flows. In the past, restrictions on foreign investment, free enterprise and profit remittance certainly reduced private capital flows to LDCs. However, the importance of government restrictions as a constraint on private capital flows to LDCs has been diminishing for the simple reason that many LDCs have been undertaking extensive economic reform programmes. The nature and the extent of this process are described in more detail in the next chapter. However, it may be stated here that there has been a significant shift in many LDCs towards a more liberal policy environment for private investment and lending. In Africa, for example, when transnational corporations were recently asked which factors would have a negative influence on their investment, under 10 per cent identified the regulatory and legal framework as a problem (UNCTAD, 1999a).

Unfortunately, however, the liberalization of the policy regime has not catalysed private capital flows into most LDCs to the degree expected. The privatization of large, State-owned utility, telecommunication and other infrastructure services has attracted new foreign investors, and associated transaction promoters and facilitators who have provided fee-based services. But the evidence of the next chapter shows that economic reforms in LDCs have not served to catalyse FDI inflows; rather, what they catalyse is ODA inflows.

As more and more developing countries remove restrictions on private capital, the choices available to foreign firms regarding where to invest as well as where to lend money, increase, and basic economic factors become more and more important.

The reason why economic liberalization does not automatically lead to much larger private capital inflows is simple. Removing restrictions on foreign investors may be a necessary condition for attracting private capital flows, but it is not a sufficient condition. As more and more developing countries remove restrictions on private capital, the choices available to foreign firms regarding where to invest and locate each of their activities, as well as where to lend money, increase, and basic economic factors become more and more important. Economic reforms can certainly act as a device signalling that the Government is establishing a business-friendly environment. But the empirical finding in Africa, that "though [foreign] investors see the existence of a programme with the IMF or World Bank as a sign of stability and intent to reform, they do not rank this as an important factor in investment decisions" (Bhinda et al., 1999: 55), can be expected to apply to LDCs generally. What matters are not merely symbols and signals, but actual risks and actual returns compared with those of other potential locations for investments and loans.

In this regard, the reform programmes can even have contrary results. For example, the incentive for some of the earlier FDI inflows into LDCs was based on the existence of protected markets, and thus trade liberalization has in some cases prompted a process of disinvestment. Devaluation has also sometimes acted as a disincentive for foreign investment, for even though projects might be highly profitable in local currency terms, foreign exchange profits have

considerably diminished (Bennell, 1995). This applies with particular force to investments oriented to domestic markets. Another crucial area which business people mention is the availability and quality of infrastructure services, which have often declined with reduction in public expenditure (UNCTAD, 1999b). Finally, commodity traders and those engaged in the provision of pre-finance for export crops have sometimes noted a fall in the quality of produce with the dismantling of marketing boards.

With the weak response of foreign private capital to reforms in many countries, some now argue that the critical problem is a lack of credible commitment to reform, and slippage in the implementation of reform programmes is identified as a key risk factor which is preventing a positive response to the reform process. The credibility of reforms is certainly a risk factor which influences investment decisions. However, as will be discussed in the next chapter, to the extent that there is an issue of credibility, it is as much a result of weaknesses in policy design, the inflexibility of programmes to cope with shocks, and underfunding, as it is a consequence of any weakness in national policy commitment. Moreover, it is fallacious to assume that the risks which are deterring investors can be reduced to risks associated with the credibility of reform. The riskiness of investing and lending in LDCs is more deeply rooted in the overall vulnerability of LDC economies.

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As LDCs reform their legal and regulatory framework governing FDI, as well as the tax regime and trade policy, attention is now turning to other aspects of the national policy environment which might be regarded as constraining capital flows. These are the level of corruption and bribery, and the way in which the implementation of the new regulatory regime is affecting transaction costs of doing business. With regard to corruption, in spite of its economic and moral costs, there is no evidence that this is a more severe problem in LDCs than elsewhere.[1] With regard to the administrative costs of doing business, it is clear that these are important in a competitive world. Governments in LDCs can certainly do more to reduce them by improving bureaucratic interfaces with business in the areas of investment and trade regulations, labour market regulations, entry and exit rules, location and environmental regulations, tax systems and legal systems. But in the final analysis, the main limits to private capital flows are more fundamental than this.

2. Risks and returns

Private investors and lenders, whether residents or non-residents of the LDCs themselves, make their investment and lending decisions by comparing the risk and return profiles of different economic opportunities in different markets. For lenders, the perceived risks in LDC environments often weigh so heavily in risk-return calculations that offers of money are normally non-existent or, if they are made, they are too expensive and not economically viable for the borrower. For market-seeking FDI, whose profitability is rooted in the size of the national market or access to regional markets, LDCs are often simply economically unattractive in terms of the magnitude of profits. For efficiency-seeking FDI and resource-seeking FDI, perceived risks often deter investment in spite of low wage costs and the availability of valuable natural resources.

Available evidence on rates of return in LDC environments is limited. Data on rates of return on United States FDI in LDCs in recent years indicate that these rates are on average lower than the rates of return achieved on average in other developing countries in the same region. Notable exceptions are Angola,

the Democratic Republic of the Congo, Haiti, the Lao People's Democratic Republic, Mozambique, and Yemen, in particular years (table 20).

Perceived risks are also high. According to *Institutional Investor*, which only included 21 LDCs in its listing in 1999, only two – Bangladesh and Nepal – achieved a risk rating of over 25 (on a scale of 0 to 100, in which 100 is the least risky), which is far below the ratings achieved by countries receiving major capital inflows and also by transitional economies. A number of countries in which there are major conflicts and instability – namely, Afghanistan, Angola, the Democratic Republic of the Congo, Liberia, Sierra Leone and Sudan – are stuck with ratings below 15. Anglophone African countries, which have persistently pursued reforms in the 1990s, have seen an increase in their ratings from the levels of the conflict countries. But their rating generally remain below 20, i.e. not much higher than the worst conflict economies. Similarly, the ratings of francophone African countries, which generally entered the listings only at a later date, are stuck in the 15–20 range (chart 35).

TABLE 20: RATES OF RETURN ON UNITED STATES DIRECT INVESTMENT ABROAD IN SELECTED LDCS, 1995–1998[a]
(per cent)

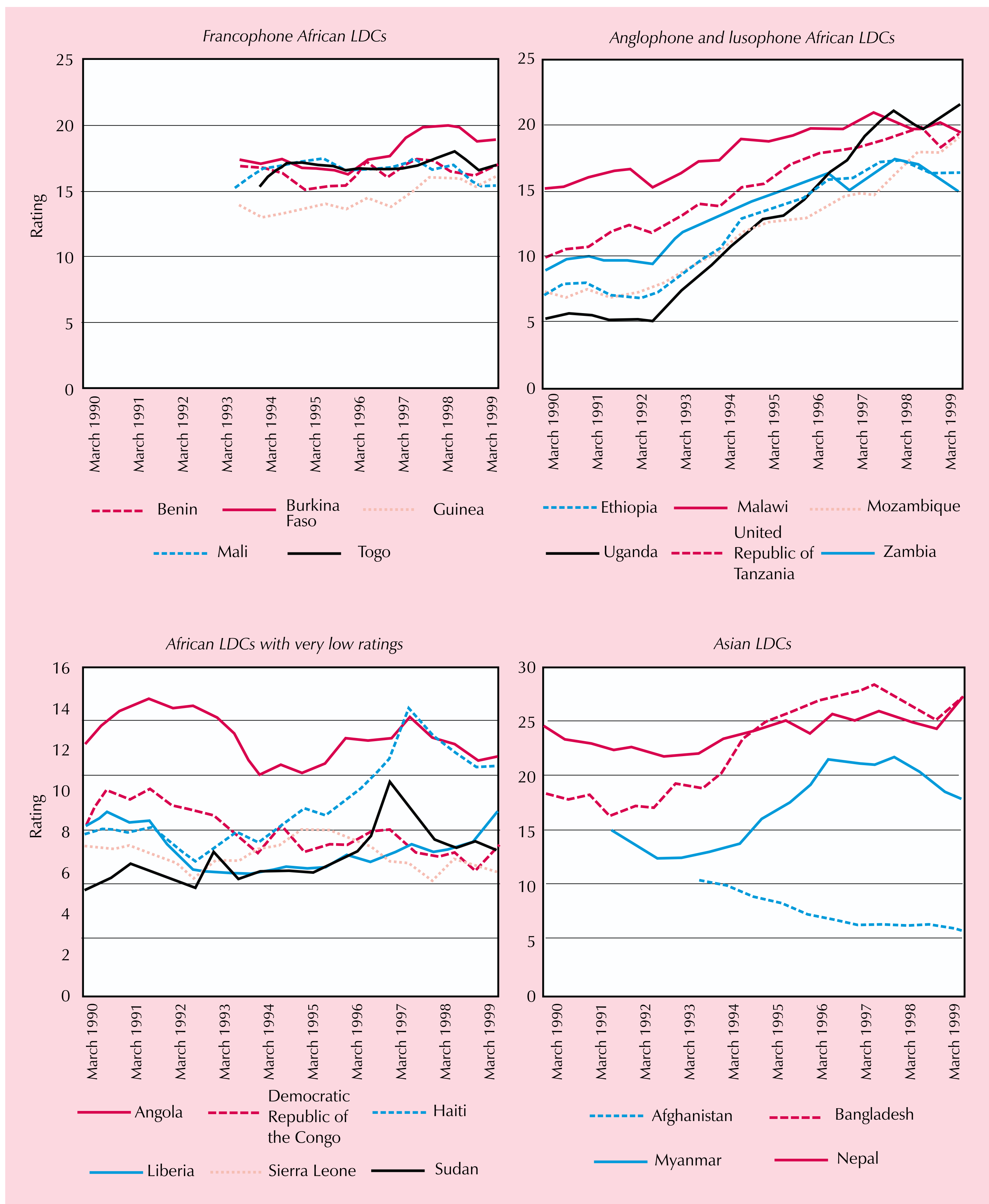
	1995	1996	1997	1998
Africa (excluding South Africa)[b]	31	25	20	14
Angola	..	..	26	13
Burkina Faso	..	..	..	50
Chad	..	-11	-9	..
Democratic Republic of the Congo	-13	14	25	2
Ethiopia	..	4	12	14
Guinea	..	264	..	..
Liberia	9	7	1	3
Malawi	8	..	..	..
Mali	..	16	11	10
Mozambique	68	40	29	22
Niger	..	-114	300	73
Sierra Leone	..	..	..	33
Togo	..	13	12	11
United Republic of Tanzania	-19	-157	-3	-24
Zambia	23	16	12	6
Asia-Pacific[b]	16	14	14	8
Bangladesh	11	11	-28	-13
Cambodia	..	..	..	200
Lao People's Democratic Republic	..	..	67	40
Myanmar	..	3	..	..
Solomon Islands	40		40	50
Yemen	185	26	22	16
Latin America and other Western Hemisphere[b]	13	12	13	9
Haiti	38	21	21	21

Source: UNCTAD secretariat estimates, based on United States, Department of Commerce (1999).

a The rate of return is calculated as the net income of United States foreign affiliates in a given year divided by the average of beginning-of-year and end-of-year FDI stock. The FDI stock data are valued at historical costs, resulting in an under-valuation of investment undertaken recently as compared to investments of an older date.

b Regional averages for all developing countries.

CHART 35: INSTITUTIONAL INVESTOR COUNTRY CREDIT RATING OF LDCs, 1990–1999



Source: Institutional Investor, various issues.

There are various sources of risk in LDC market environments, and some are specific to landlocked and island LDCs. But the LDCs in general suffer from considerably greater external sector volatility than low-income countries as a whole or middle-income countries (Fitzgerald, 2000: table 3). In particular, exports, reserves and debt levels exhibit far more variability. External sector volatility makes it much harder to achieve fiscal and monetary stability since in many cases, tax revenues are related directly or indirectly to raw material exports and their prices, and government expenditure is reliant on aid flows and conditioned by debt service requirements. Moreover, as indicated in Part Two, chapter 1, LDCs have few resources for dealing with shocks. As a consequence, exogenous shocks which can be absorbed by middle- or high-income countries may bring about large changes in the average level of income or its distribution among regions and groups, or in the economic capacity of the State to provide public goods, in LDCs. The vulnerability of LDCs is also apparent in their low capacity to protect their economies and people from catastrophic natural events. Moreover, LDCs are prone to levels of social stress which can lead to armed conflict and thus to the breakdown of functioning domestic economies. These conflicts pose particular problems of both market and sovereign risk and tend to have a considerable influence on international investors, as well as real and perceived regional spillover effects.

An important point about the riskiness of LDC market environments is that it does not lead to the total exclusion of LDCs from international private capital flows, but rather to their integration in particular ways. Long-term international bank finance and bond issues for the national Government and firms tend to be unavailable in LDCs owing to the risks involved, and commercial credit tends to be limited to very short-term facilities at high interest rates secured against traded goods. But multinational firms in energy and mining, and, to a lesser extent, agricultural plantations, will negotiate natural resource concessions which result in very high levels of returns in order to counteract risk. They may also invest in their own infrastructure and even their own security forces. As their projects are often strategically vital, they can gain access to inside information and influence political developments, and they are rarely obliged to pull out in times of conflict and instability (Bhinda et al., 1999). Foreign investors are less interested in domestic market supply of manufactures and services, although some privatization offerings have attracted inflows. Most programmes have begun with large utilities (telecommunications, water, electricity, transport) where monopoly profits can be guaranteed, or with smaller guaranteed profit-makers such as cigarettes, breweries or cement, which in some cases are sold very cheaply.

An important point about the riskiness of LDC market environments is that it does not lead to the total exclusion of LDCs from international private capital flows, but rather to their integration in particular ways.

Investors cope with high levels of risk in LDC environments in ways which circumscribe the developmental impact of foreign investment. Many foreign investors concentrate on projects in which returns are quick as well as high, and to secure their investment they may borrow from local financial institutions, using the real assets as security, and repatriate their initial investment immediately. Perceived risks are also such that the basic rule of foreign investors often becomes “Get the money back as soon as possible or don’t do it”. This contributes greatly to the short-term and opportunistic nature of many of these markets and to the negative social and political implications that can arise when markets are dominated by chronic opportunism and by local and foreign opportunists (Tourtellotte, 2000).

An example of this is the way in which, on a small but increasingly important scale, foreign entrepreneurs (often from neighbouring countries) are attracted to conflict economies because of the opportunities for the predatory exploitation

of projects such as gems, mining and logging, which do not require large infrastructural investments. These investors generally operate outside the law; indeed, they may set up private armies of their own. They can have a disintegrative effect on both the State and civil society, and may have an interest in perpetuating a conflict situation. The experience of Angola, the Democratic Republic of the Congo, Liberia and Sierra Leone gives particular cause for concern in this context (see Nafziger, Stewart and Vyrynen, 2000).

3. Domestic market failures

The negative effects of low risk-adjusted rates of return on private capital inflows are compounded and intensified by various types of domestic market failure. These exist when investment or lending does not take place even when risk-adjusted returns could justify it. Such market failures can arise in all contexts, but they are particularly important in LDCs. This is because in economies at low levels of development, the efficiency of markets is hampered by poor integration and weak competition, institutions which arise to deal with market failures are absent or underdeveloped, and complementary inputs and necessary public goods are unavailable.

In economies at low levels of development, the efficiency of markets is hampered by poor integration and weak competition, institutions which arise to deal with market failures are absent or underdeveloped, and complementary inputs and necessary public goods are unavailable.

Four types of domestic market failure are worth underlining as critical features which must be addressed if the national enabling environment for private investment is to be improved.

First, a critical characteristic of LDC markets, from the perspective of international investors and lenders, is a lack of readily marketable assets or products to buy or sell. Potentially interesting assets can and do exist, but an investment principal is deterred by the costs and related risks required to give them marketable status. What could be made available in the future is regarded by business people as too risky, expensive and time-consuming to develop.

Second, the financial systems of most LDCs are weak. As *The Least Developed Countries 1996 Report*, which treated this issue extensively, including discussion of the impact of financial liberalization, put it:

> Although the financial systems of LDCs display considerable heterogeneity, certain characteristics are widespread and are common to most countries. Financial systems are still largely undeveloped in terms of both depth (i.e. volume of financial assets in relation to the size of the economy) and diversity of FIs [financial institutions] and assets. Competition within financial markets is usually weak and FIs are often inefficient. The financial position of many FIs, especially those in the public sector, is fragile. Services provided by formal-sector FIs are often poor, excluding large sectors of the public, and, as a consequence, significant levels of intermediation take place in informal financial markets (p. 89).

The weakness of the financial system has important negative effects on private capital inflows since foreign investors and lenders use the financial system as a source of current information on macroeconomic conditions and company performance. Insofar as local banks cannot provide this information effectively, foreign investors and lenders stay away from a country (Bhinda et al., 1999: 89–90). The World Bank's Foreign Investment Advisory Service (FIAS) has also found that the availability of domestic financing is a key factor in attracting FDI (Pfeffermann, 1997: 205).

Third, an important source of market failure in LDC economies is the fact that the profitability and risks of individual projects depend on investments in other projects. A critical problem for all activities is the high cost and general lack of efficient business services that are necessary for competitive pricing and quality standards, especially for export markets. This is a particularly acute problem for landlocked LDCs, as they often require business services from neighbouring territories. The systemic competitiveness of a cluster of linked activities is also vital for the development of natural resource complexes (Ramos, 1998; Ocampo, 1999).

Fourth, there is underinvestment in all kinds of goods which are necessary for a thriving private sector. Inadequate physical infrastructure, particularly in transport, communications and information technology, is a central problem which is having adverse effects on international competitiveness. Other difficulties in the LDC environment which arise through underprovision of public goods or underdeveloped markets include:

- Highly imperfect or non-existent fundamental data and research information;
- Non-standard and inadequate accounting practices and disclosure of information;
- Underdeveloped or non-existent company law;
- Legal systems that do not protect investors, foreign or local;
- Crime and physical danger for persons and property;
- Disease and inadequate health care;
- Low skills of the labour force.

C. Limits to private capital inflows: (2) international factors

1. International market failures

Market failures affecting LDCs are not simply due to LDC characteristics, but are also a feature of international markets.

Efforts to encourage foreign investment in LDCs have mainly focused on changing the domestic conditions for foreign investors. But market failures affecting LDCs are not simply due to LDC characteristics, but are also a feature of international markets.

As LDCs have so little access to private flows other than FDI, it is difficult to assess the importance of international market failures. Ideally, it would be necessary to have data on the *ex-ante* plans of both borrowers and lenders as well as on *ex-post* outcomes. But a comparison of private lending to low-income countries (LICs) and middle-income countries (MICs) suggests that a process of credit rationing is taking place that is not reflected in the price of credit. The MICs receive twice as much private lending as LICs, relative their economic size. But for new loan commitments they actually pay a lower rate of interest. The market regards poor countries as much more risky, but is unable to price this risk in the form of interest rate premiums (Fitzgerald, 2000). It is reasonable to assume that this is also the case in those LDCs that are a subset of LICs.

Important sources of international market failure are (i) information and perception problems, and (ii) market segmentation and marginalization owing to small markets and transaction sizes.

Business information services and risk-rating agencies have increased their coverage of emerging markets in recent years because of market demand for this service. However, coverage of most LDCs remains very thin. Moreover, within individual countries, there is no readily available information on the health of companies and on the creditworthiness of local partners. Even where there is coverage of countries, there is often a gap between conditions in the country and perceptions. For example, Uganda's credit rating started rising sharply only after eight years of adjustment and ten years of political stability.

Mainstream global businesses and investment institutions with high levels of resources are potentially important in developing LDC resources. However, the volume and size of most potential business opportunities in LDC markets are viewed as too small to be of interest.

With poor information, investment and lending decisions do not follow standard practices for assessing risks and returns, but are much more reliant on quantitative rationing based on subjective perceptions. A survey of investment fund managers with portfolios in Sub-Saharan Africa (SSA) found, for example, that they "do not use textbook, mean-variance based, evaluation techniques when evaluating the 'frontier' or 'pre-emerging' markets of SSA...because of the absence of reliable, agreed data... [W]ith regard to such markets investment managers have greater autonomy. In sum, the paucity of information means that investors do not have a common information set and their judgement is based on subjective evaluation of returns with an unquantified and subjective estimate of downside risk" (Aybar, Harris and Smith, 1997: 7).

The small size of potential business opportunities is a significant deterrent to foreign investors. Given the levels of risk and asset development costs in LDC environments, mainstream global businesses and investment institutions with high levels of resources are potentially important in developing LDC resources. However, the volume and size of most potential business opportunities in LDC markets are viewed as too small to be of interest. This leads to a market segmentation in which the small markets are left to regional investors, who in any case are likely to be better informed of risks and profits, and also informal international capital. The small scale of transactions can lead to an investment catch-22 situation in which those who could be able to make the investment, will not, and those who would like to make it, cannot (box 4).

Box 4. The LDC investment catch-22: those who could invest, won't; those who would invest, can't

A good illustration of the difficulty that LDCs face in finding suitable investors is the fact that they attract relatively little interest from the large global trading companies as regards commodity export projects. Global trading organizations possess the levels of resources necessary for developing LDC commodity export business for the longer term, but they generally pass over these markets because the exportable quantities available of a given commodity are deemed too small to warrant the time and trouble involved, even if they are profitable. This is particularly the case for new, less traditional export commodity projects, but it often also applies to more traditional local commodity markets that have been damaged, destroyed or just neglected because of war or economic stagnation.

The absolute profits that are possible from smaller transactions, even if profit margins are good, are too small for a large global company with bigger and more interesting options elsewhere. Also, the upfront investment needed to restart former export businesses, and securing the necessary quantity and quality of an agricultural commodity, represent most often a longer-term commitment of significant resources.

Large commodity companies will sometimes consider buying smaller quantities of a product from an LDC exporter who is able to offer an exportable quantity, but the exporter will have had to cover all the upfront market development costs, and then assume the local transaction performance risks vis-à-vis the global buyer. For a small to medium-size trader, the local performance risk alone on a single transaction with a large global player can mean bankruptcy. The performance risk in LDC transactions is normally high. This is risky business that is not easily sustainable for a smaller company alone.

This illustrates a classic constraint in identifying foreign trade and investment counterparties in LDC market environments: *Those who could invest, won't, and those who would invest, can't.*

Source: Tourtelotte, 2000.

2. The impact of the external debt

The international policy environment can also act as a critical constraint on private capital flows to LDCs. This can occur through international policy towards: (i) market access in industrialized economies for agricultural commodities and traditional low-technology manufactures where LDCs might be able quickly to develop a competitive advantage; (ii) the volume, purposes and effectiveness of ODA; and (iii) the external debt of LDCs to official creditor-donors (which is the issue taken up in this section).

The lingering external debt of many LDCs is an international policy problem since most of it is owed to official creditors. It is apparent that where commercial debt is a small proportion of total debt, commercial debt reduction has marginal effects on country creditworthiness (Bhinda et al., 1999: 92). There is also now clear evidence that high levels of external debt deter private capital inflows. Econometric analysis for a sample of 31 SSA countries, including 11 LDCs, over the period 1980–1995, shows that "a large external debt relative to GDP adversely affects inward movements of capital" (Bhattacharya, Montiel and Sharma, 1997: 225). Moreover, the ratio of external debt to GDP, together with the domestic investment ratio, are "the pivotal factors for obtaining private loans" (p. 229). Chart 32 (in the previous chapter) indicates how private loans to LDCs as a whole collapsed after the debt crisis of the early 1980s.

There is also now clear evidence that high levels of external debt deter private capital inflows.

However, not only do LDCs with severe debt problems lose access to world financial markets, but also the external debt depresses private investment, both domestic and foreign. An important channel for this has been the crowding-out effects of debt service payments on government expenditure. But investment is also discouraged because there is considerable uncertainty about what fraction of scheduled debt payments will be serviced from the country's own resources. This amount is, as indicated in the section of the last chapter on exceptional financing, quite important for the external viability of indebted LDCs. But it is the subject of constant negotiations between the authorities in the indebted country and various categories of creditor, and entails both formal rescheduling and debt forgiveness as well as the informal and disorderly accumulation of arrears. The outcome of these negotiations is only loosely rule-based and depends on complex factors, including changes in foreign aid budgets in creditor countries, political developments, and perceptions of the commitment to reforms. It is axiomatic that a basic condition for a flourishing private sector is a policy environment in which there are simple rules as well as safeguards against frequent and predictable alteration of the rules. But this is far from the case with regard to the negotiation of debt service which must be paid. The uncertainty associated with this process inevitably discourages investors, who rank external debt high as a key risk factor in LDC market environments.[2]

D. The IFC's "Extending IFC's Reach" programme

One new international initiative of the 1990s, which seeks to promote private investment, including the facilitation of private capital inflows, in difficult market environments is the International Finance Corporation's (IFC) "Extending IFC's Reach" (EIR) programme. This programme, which was introduced in 1996, is not specifically targeted at LDCs. However, it includes LDCs and initial experience with it underlines the difficulties which even official international financial institutions face in financing private sector development in these countries.

1. The EIR Programme

The IFC, a member of the World Bank Group, is the largest official multilateral source of loan and equity finance for private sector enterprises in developing countries. Its mainstream operations fall into three areas: (i) project financing, through such products as long-term loans, equity investments and guarantees, and stand-by financing; (ii) resource mobilization, either through joint ventures or raising additional investment from commercial banks and institutional investors through its syndications, or B-loan programme; and (iii) advisory services and technical assistance. In general, its traditional market role has been limited to that of a complementary player, following the core principle that the financing needed by developing countries is to come first from direct investors and from the market place, whenever such capital is available on reasonable terms. The IFC's special contribution is seen as adding value, financial or otherwise, above and beyond what private market institutions are able or prepared to provide, and playing a catalytic role in stimulating the flow of private capital to developing countries by encouraging and persuading other investors to invest in projects where the IFC is itself investing.

Historically, the IFC's operations have not been oriented to poorer countries. Cumulative gross country commitments to LDCs (at 30 June 1999) accounted for 1.1 per cent of all IFC global commitments in terms of number of enterprises. The IFC's direct financing in LDCs was 3.9 per cent of the IFC total, and LDC syndications represented 1.0 per cent of all syndications mobilized. Total IFC commitments in LDCs (IFC plus syndications) were 2.7 per cent of IFC totals.

Because of the limited scope of local private enterprise and the lack of viable financial institutions in some EIR countries, private sector promotion placed a strong emphasis on the development of small and medium sized enterprises and technical assistance.

In September 1996 the IFC launched the "Extending IFC's Reach" (EIR) programme, a three-year global pilot programme designed to try to extend the development impact of private capital to poor countries that were not sharing in the growth of private capital flows to other developing countries during the 1990s. The programme had two central objectives: to establish a local presence, and to pioneer the promotion of private sector investment in countries where the IFC had had little or no previous activity because of "difficult country environments". The cornerstone of EIR implementation was the setting up of local field offices for the IFC to develop an understanding of each new country, establish relationships with the local business, financial and legal communities, and with the government, and promote and market the IFC. Drawing on a special administrative budget of $18 million, field offices were established in all target countries or clusters during the three-year life of the programme. Sixteen countries and country clusters were initially targeted. Early operational results were encouraging and in late 1998 the IFC expanded the list of target countries. By the time of programme completion in December 1999, EIR covered a total of 41 countries, 18 of which were LDCs.

Private sector promotion in EIR countries had both quantitative and qualitative objectives. Through the direct financing of local projects, where possible, and through technical assistance aimed at institution- and market-building efforts, it was hoped that the beginnings of a quantitative, measurable market development impact could be achieved. The qualitative goal was to create a "demonstrator" impact. By demonstrating to the markets, through its own successful investments, that it is possible to do business in EIR countries, the IFC hoped to catalyse additional private market interest and investment in those countries.

Because of the limited scope of local private enterprise and the lack of viable financial institutions in some EIR countries, private sector promotion placed a

strong emphasis on the development of small and medium sized enterprises (SMEs) and technical assistance. In September 1997, a Small Enterprise Fund (SEF), which initially totalled $40 million and later rose to $100 million, was created to finance projects costing from $0.5 million to $2.5 million. To help expedite the approval process for small investments, authority for project approvals was delegated from the IFC's Board of Directors to regional department directors. In addition, the IFC was allowed to finance up to 50 per cent of small projects instead of the maximum of 25 per cent limit normally prescribed under IFC investment guidelines.

Donor-supported technical assistance programmes played a particularly prominent role in the formulation and execution of the entire EIR programme, providing direct support in investment projects, and working on broader market development issues such as legal and policy framework reform, sector reviews, and capacity-strengthening and training. EIR strove to maximize the development impact of technical assistance efforts by tying assignments as closely as possible to an active, working business context, often at the enterprise level.

The total number of EIR project approvals between 1996 and 1999 represented approximately 20 per cent of all IFC investments approved worldwide over the same three-year period. This was up from 4 per cent for EIR countries between 1991 and 1996. During the programme's first year and a half alone, EIR financing approvals exceeded all IFC investments in these frontier countries during the five years preceding the initiative's launch in 1996.

Although LDCs were not expressly targeted by the programme, nearly half the EIR countries were LDCs (18 of 41 countries). Of the 181 projects approved as part of the EIR programme, 28 per cent (50) were in LDCs. These 50 LDC investments represent approximately 6 per cent of the number of IFC projects approved for all countries between 1996 and 1999. In terms of project size, LDC investment reached $1.8 billion, or 25 per cent of all EIR projects, and approximately 4 per cent of all project approvals concluded by the IFC worldwide during this three-year period. IFC direct financing in LDCs was $238 million, or 21 per cent of all EIR dollar investments approved by the IFC for its own account, and 2.3 per cent of all IFC investments globally.

A total of 75 SEF investment approvals were approved under EIR, with 25 projects (33 per cent) going to 10 LDCs for a total project size of $64 million, or 27 per cent of all SEF dollar financing. In terms of project count, 50 per cent of all LDC investments approved under the entire EIR programme were in the form of small investments through SEF. Of the 25 EIR investments in LDCs that were not funded through SEF, 21 were IFC investments of less than $10 million. Four LDC investments of over $10 million were approved: two in Mozambique, and one each in Mauritania (financial markets) and Cambodia (infrastructure).

Programme activity in LDCs was overwhelmingly concentrated in sub-Saharan Africa (Table 21). Of the 18 LDCs included in the EIR initiative, 13 were in sub-Saharan Africa and 9 of these countries received a total of 44 investment approvals: Cape Verde (1), Eritrea (1), Ethiopia (1), Gambia (2), Guinea (4), Guinea-Bissau (3), Mali (13), Mauritania (5) and Mozambique (14). In terms of project count, these 44 LDC projects represented 88 per cent of all EIR investments made in LDCs. In Asia the two LDCs receiving financing under the programme were Cambodia and the Lao People's Democratic Republic. Haiti was included as an EIR country but has had no investment approvals under the programme.

TABLE 21: "EXTENDING IFC'S REACH" (EIR) PILOT PROGRAM RESULTS:
LDC FINANCING APPROVALS SEPTEMBER 1996–DECEMBER 1999
($ millions)

EIR LDC	No. of project count	Project size $ millions	IFC investment $ millions	Participants [a] $ millions
Sub-Saharan Africa				
Angola	-	-	-	-
Cape Verde	1	6.4	1.5	-
Central African Republic	-	-	-	-
Chad	-	-	-	-
Equatorial Guinea	-	-	-	-
Eritrea	1	1.9	0.9	-
Ethiopia	1	36.5	8.6	-
Gambia	2	1.0	0.5	-
Guinea	4	6.4	1.9	-
Guinea-Bissau	3	4.5	0.8	-
Mali	13	129.2	22.8	25.0
Mauritania	5	25.7	22.6	-
Mozambique	14	1 458.5	148.5	-
Total Sub-Saharan Africa	**44**	**1 670.1**	**208.1**	**25.0**
Asia				
Cambodia	3	125.3	28.0	47.4
Lao People's Dem. Republic	3	6.1	2.3	-
Maldives	-	-	-	-
Nepal	-	-	-	-
Total Asia	**6**	**131.4**	**30.3**	**47.4**
Latin America				
Haiti	-	-	-	-
Total Latin America	**-**	**-**	**-**	**-**
EIR LDCs	**50**	**1 801.5**	**238.4**	**72.4**
All EIR	**181**	**7 268.8**	**1 154.7**	**504.6**
EIR LDCs as % all EIR	**27.6%**	**24.8%**	**20.6%**	**14.4%**

Source: Tourtellotte (2000), based on IFC data.
a Participants includes both Participant Loan and IFC Equity Underwriting.

2. LESSONS FROM THE EIR PROGRAMME

With the implementation of the EIR programme, the reach of the IFC's official financing activities has been extended. This is reflected in its current investment portfolio holdings. Although total financing amounts in LDCs were still only 3.9 per cent of the worldwide total (as of 30 June 1999),[3] in terms of the number of projects, LDCs as a group have 11.5 per cent of the IFC's global current investment portfolio, which is larger than the share of cumulative commitments. But the IFC current investment portfolio remains quite concentrated. Mozambique accounted for 35 per cent of all current investment portfolio holdings in sub-Saharan African LDCs, and Mozambique, Uganda, Zambia, and the United Republic of Tanzania, the last three of which were not EIR programme countries, together accounted for approximately 60 per cent of all sub-Saharan African LDC activity. The following 13 of the 33 Sub-Saharan Africa LDCs held no investments: Burundi, Central African Republic, Chad, Comoros, Djibouti, Equatorial Guinea, Ethiopia,[4] Lesotho, Niger, Rwanda, Sao Tomé and Principe, Somalia and Sudan. Within the Asia-Pacific region, LDC investment was concentrated in two countries – Nepal and Bangladesh. There were also no IFC investment projects in Afghanistan, Bhutan, Haiti, Kiribati, Myanmar, Solomon Islands or Tuvalu.

Despite the unevenness of the outcome, the extension of IFC activities is encouraging. The IFC has concluded from the three-year pilot programme that it can do business in difficult and highly risky business environments if it has the necessary resources and field capacity, that technical assistance is extremely important in severely underdeveloped markets, and that its efforts have helped local entrepreneurs, especially in the areas of financial engineering and corporate governance. But the experience also highlights some of the problems of promoting private investment in LDCs and also the limitations which an official development agency such as the IFC faces in this task.

By helping business pioneers survive and thrive, the IFC tries to prompt and lead even further market movement by showcasing successful operations.

The traditional way in which the IFC has helped to stimulate market forces is by providing a market kick-start through letting it be known that it will help business pioneers by sharing a part, but not the majority part, of the risks. By helping these pioneers survive and thrive, the IFC tries to prompt and lead even further market movement by showcasing successful operations. In the past, this arrangement worked best in regions that were generally closest and better known (best information), the most readily accessible and largest (most developed, efficient, least expensive and most suited to economies of scale), wealthiest (best returns) and safest (lowest risks). But whether it can work in less developed markets, without some modification, is unclear.

The market development problem in LDCs can be better visualized if the market structure is seen as comprising three strata. In the top stratum– stratum A – there are commercially viable assets, formal market structures and local linkages to global markets. Foreign market interest in poor countries has predominantly been in this market stratum, particularly in metal and mineral resource extraction, and to a lesser extent, agricultural commodities, and recently some newcomers have been attracted by the sale of State assets that were developed enough for investing and trade. But this stratum is very thin and the developed assets that exist are already claimed. There is simply not much business to do for most global investors, and this is the principal reason for the lack of global market motivation in LDC-type markets. Moreover, even the stratum A assets that could be of foreign market interest exist in a local risk environment that does not greatly stimulate investor interest either in bidding up their prices or in making large longer-term investments.

Despite the unevenness of the outcome, the extension of IFC activities is encouraging.

Stratum B often contains assets with appreciable levels of local comparative advantage and development, and domestic entrepreneurs often try to develop these assets. But because of problems of risk, poor business support services and weak infrastructure, private enterprises in market stratum B are not commercially bankable, in the sense that it is difficult to finance their development on purely commercial terms. But it is finance which they need in order to create market-based solutions to those problems.

Finally, stratum C is the least developed, least formal, and most often the poorest. With rare exceptions, foreign businesses have so far had little or nothing to do here. Assets exist, but they are most often undeveloped and largely inaccessible to outside markets. In a number of LDCs, the most promising potential in stratum C lies in agricultural production for both domestic consumption and export.

Under these circumstances, a key to broad market development in LDCs involves enterprise and asset development in stratum B. First, the most effective way to increase business interest in LDC-type markets in the short and medium term is to deepen asset availability in stratum A. The way to do this is by developing and elevating assets from stratum B to stratum A. Secondly, the

ability to realize the potential of stratum C in the near term depends on developments in stratum B. Market demand from stratum B stimulates more productive activity in stratum C, and creates increased market accessibility for stratum C assets through more formal upward domestic market linkages, and outward global market linkages. Microenterprise finance efforts to assist microentrepreneurs such as local farmers are of great potential importance in this regard in helping to stimulate and improve local production to meet an increased demand for local products from stratum B. In short, enterprise and asset development in stratum B is necessary in order to deepen market stratum A, and to stimulate and boost local demand, production and greater upward and outward market linkages for stratum C.

In extending its reach, the problem for the IFC is not simply to reach LDCs but also to reach stratum B within the market structure of LDC economies. The IFC is trying to focus much of its new SME development efforts there, and this could elevate stratum B assets to stratum A to increase the depth of LDC-type markets and attract greater international market interest. However, the restrictions to which the IFC is subject, defined largely by its traditional market role, make it a more natural and effective market actor in stratum A-type environments. Achieving meaningful results in stratum B-type environments in the poorest countries presents an enormous new challenge for the institution.

In extending its reach, the problem for the IFC is not simply to reach LDCs but also to reach promising domestic enterprises without access to private finance.

Advisory services and technical assistance programmes alone cannot simultaneously achieve the objectives of creating investment-enabling market conditions *and* "bankable" local business enterprises. It is simply too much to expect that both these objectives can be achieved in LDC-type markets through passive, market-facilitating means, especially coming from an outside, foreign institution. Policy needs to encourage local private sector interests themselves to take a more active and direct role in improving the local market conditions that define LDC market risk. But for this to be achieved, technical assistance needs to be complemented by more much direct and active business development support, namely direct financing support for stratum B enterprises.

However, the IFC has restricted ability to provide direct project financing to stratum B enterprises, precisely because for these enterprises conventional market standards of commercial viability are not yet there. These enterprises are not "bankable". However, 80 per cent of the IFC's lending resources are borrowed from the private capital markets with a triple-A credit rating. One advantage of that rating is that the IFC has lower borrowing costs which can be passed on to developing country clients. But the IFC must be extremely careful about how much risk it takes, and not stray too far, if at all, from conventional market practices. It quite literally cannot afford to do so.

In this situation the IFC is making the development of a commercially viable financial sector its principal near-term objective in these types of markets. But although a healthy financial sector does facilitate business, a healthy business sector also facilitates the conditions for a healthy financial sector, especially in commercial bank lending. The two sectors are complementary and interdependent. One feeds the growth of the other. In LDC markets, where both the financial and corporate sectors are most often severely underdeveloped, decisions that focus on the development of one sector and not the other are strategically questionable. These two sectors are forced to grow together, and at a rate that is more or less the same.

Indeed, it is difficult to make a convincing argument that a healthy, profitable financial sector can be created in a business environment where the corporate

sector is languishing, unless the financial sector intends to survive on activities other than commercial lending to local businesses. This is *already* the case, however, for the banking sector in many LDCs and the continuation of this situation is exactly what must be avoided. Yet it remains unclear why local banks will begin to lend to local businesses at some point in the future, when they will not do so now. Commercial banks live on lending to healthy business clients, and the present near-term outlook in LDCs for an increase in viable, "bankable" business clients is poor. The development of both these sectors is blocked and it will be hard, and possibly fruitless, to try moving one away from stasis, without actively trying to move the other at the same time.

The most obvious and immediate constraint on the growth and development of the LDC corporate sector is the lack of investment resources available to local private enterprises.[5] This is the result of what might be called a "private enterprise gap" – the gap which exists because official development institutions are unable to provide the investment resources needed for business development to stratum B domestic companies which private financial institutions are unwilling to support (Tourtellotte, 2000). To the extent that the IFC cannot bridge that gap, the best it can probably do is to continue to reach out to more countries, using donor-supported funds for technical assistance market development programmes and, where possible, financing the limited number of "bankable" SMEs it can find in the short and medium term in order to create a market "demonstrator" effect. Market demonstration appears to be the most achievable near-term objective of the IFC's direct SME financing efforts in the poorest countries. But this is unlikely to have a major impact. Successful private sector development, and the complementary private capital inflows which would follow from asset and market development led by a healthy domestic corporate business sector, need a more direct approach to financing business development and a more comprehensive approach to creating the ingredients for an enabling environment for business.

The most obvious and immediate constraint on the growth and development of the LDC corporate sector is the lack of investment resources available to local private enterprises.

E. Conclusions and policy implications

This chapter has argued that with increasing economic liberalization and the removal of restrictions on capital repatriation and remittances of dividends and profits, purely commercial considerations and market failures have become the major constraints on private capital flows to LDCs. Costs of asset development, risks which are rooted in the vulnerability of LDCs to shocks, lack of business support services, weak physical, social and administrative infrastructure, and the small scale of most projects all deter foreign investment and lending in the LDCs. International capital markets are also characterized by imperfections which limit LDC access to private finance even when projects are economically viable.

Increasing the inflows of forms of private capital which support the longer-term development goals of export growth, technology transfer and employment creation should be a central objective of both the LDCs and their development partners.

Increasing the inflows of forms of private capital which support the longer-term development goals of export growth, technology transfer and employment creation should be a central objective of both the LDCs and their development partners. Policy efforts at the national level have so far focused on reducing national government restrictions which can impede the free international movement of capital, and more recently, on developing financial institutions. Experience, however, suggests that private capital inflows increase as national economic growth occurs, and tend to follow on from asset and market development led by a healthy domestic corporate business sector. Countries which have successfully addressed market failures at the national level and harnessed the energies of the private sector in the interests of national

development have done so through performance-related and time-bound positive incentives which offset the risks of asset development and raise the “animal spirits” of entrepreneurs. They have also sought to supply the necessary ingredients for business development, particularly through ensuring adequate access to credit and technical assistance to build firm-level capabilities (UNCTAD, 1994: part 2, chapter 1). The types of measures necessary for developing domestic productive capacities are set out in the *Least Developed Countries 1999 Report* (part two, chapter 3). As argued there, special attention should be paid to stratum B domestic companies, described in that context as the “missing middle” in the LDC enterprise sector (p. 135). Attracting forms of foreign capital which support business development in this stratum, as well as promoting developmental linkages between foreign and domestic business in this stratum, should be important policy goals.

International policies are as important as national efforts in promoting private capital inflows. Overcoming international market failures which limit access to global finance should be seen as a major challenge for international development cooperation. It is clear that an agency such as the IFC can, by itself, play only a limited role through reassuring investors by partially financing private businesses, and by providing advice and technical assistance. Official agencies also need to step up their activities in LDCs in the field of investment insurance. To increase demand for cover in these countries, the Multilateral Investment Guarantee Agency (MIGA) and national agencies need to establish special outreach programmes for potential investors through a more targeted approach. Investment guides also provide a way of loosening the information constraint and weakening unfounded prejudices. UNCTAD’s work in this area is exemplary.[6] Also it is likely that a large return can be achieved if concerted efforts are made to improve the international and timely availability, as well as reliability, of economic statistics on the LDCs. Moreover, international official agencies can have a role to play in kick-starting venture capital funds in pre-emerging markets. This may be one mechanism through which finance can be injected into stratum B firms.

Overcoming international market failures which limit access to global finance should be seen as a major challenge for international development cooperation.

Special attention should be paid to the role which international financial institutions (IFIs) can play for the LDCs as intermediaries in international capital markets. The IFIs raise funds on OECD capital markets at very low rates and then lend them on to developing countries after adding a small margin to cover administrative costs. For those middle-income countries and large low-income countries (such as China and India) which have access to international markets, multilateral funds are cheaper since no risk premium has to be paid. But for the LDCs whose Governments have no direct access to international bond markets, this intermediation is of even greater value since it overcomes the international credit constraint. Ways in which this financial intermediation function can be made more effective in the LDCs have unfortunately gone out of fashion as increasing attention has focused on adjustment lending and poverty lending. It is essential that the continued relevance and utility of this traditional function of multilateral IFIs be reasserted for the LDCs.

Policies to address the external debt problem which is affecting many LDCs should also be re-examined in the light of their effects on private capital flows. There is clear evidence that the debt burden is having detrimental effects on private capital inflows, and policies of debt relief should be geared to give a positive shock to private sector expectations. If successful, this will support long-run poverty reduction. The current approach to debt relief, which will be discussed in detail in chapter V, is far from what is required.

In the long run, if economic growth occurs in LDCs, it is possible to envisage private capital flows playing an increasing role in meeting the development finance needs of the LDCs. But policy-makers in the LDCs should not have false expectations that FDI can lead the development process, and donors should not see the signs of rising private capital inflows into a number of LDCs as an opportunity for reducing ODA. For the immediate future, given the constraints on private capital inflows, most LDCs must rely on ODA as their major source of external finance.[7] The large investment requirements of the LDCs, outlined in chapter 1, also imply that a successful transition to increased reliance on domestic resources and private capital inflows will require more, rather than less, ODA.

The large investment requirements of the LDCs imply that a successful transition to increased reliance on domestic resources and private capital inflows will require more, rather than less, ODA.

A decrease in development aid by the donor community, on the assumption that all developing countries now find themselves in an era of global private capital flows, is not likely to lead to the substitution of long-term private capital inflows, in the form of FDI or bank loans through established channels, for aid. Rather, it is more likely to promote the substitution of private current transfers from international migrant workers for aid. More LDCs will become more deeply integrated into an international informal economy in which largely unrecorded private capital flows support "grey" economic activities such as the smuggling of gems, illegal logging and narcotics, and the donor community will face increasing financial outlays for peacekeeping and humanitarian emergencies.

Notes

1. Estimates of business perceptions of corruption are published in Transparency International's Corruption Perceptions Index. This index actually only includes 6 LDCs out of a total of 99 countries, and what the index actually measures must be treated with some caution. But in comparative terms the level of corruption in Malawi is perceived to be at around the same level as in Poland and Brazil, and Mozambique and Zambia are perceived to be at around the same level as the Republic of Korea and Turkey. The two LDCs in the sample which have the highest levels of perceived corruption, Uganda and the United Republic of Tanzania, are actually two of the top performers amongst LDCs in terms of their attraction of new FDI inflows.
2. A business-sector perspective on principal bottlenecks to trade development in the LDCs is contained in WTO (1997). Interestingly, trade finance comes out as the most serious obstacle.
3. Tourtellotte (2000: table 6). Investment commitments for the IFC's own account, disbursed and outstanding, and undisbursed. This does not include loan syndications or participation by other investors.
4. One investment for Ethiopia was approved in FY99, but has not yet appeared in the "committed" portfolio figures. This was the IFC's first investment in Ethiopia since 1967.
5. For a discussion of a Japanese approach to addressing this constraint, which may be relevant in the LDCs, see Okuda (1993).
6. An investment guide on Ethiopia has already been prepared, and investment guides on Bangladesh, Mali, Mozambique and Uganda will be published in the next six months. The guide on Ethiopia is available at http://www.ipanet/unctad/investmentguide/guide/ethiopia.htm.
7. For an econometric analysis for a data set covering many low-income and highly indebted countries which reaches the same conclusion, see Lensink and White (1998).

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Structural adjustment, economic growth and the aid-debt service system

Chapter 4

A. Introduction

During the 1990s there were profound changes in the national policy environment in many LDCs. These changes were mainly brought about within the framework of structural adjustment programmes guided by the IMF and World Bank. The process began in the early 1980s with World Bank structural adjustment loans, but in general, LDCs were not in the vanguard of this movement.[1] However, this situation changed radically following the introduction by the IMF of the Structural Adjustment Facility (SAF) in March 1986 and its extension in September 1987 into the Enhanced Structural Adjustment Facility (ESAF). Indeed, the ubiquity and scope of economic reforms undertaken in ESAF-supported programmes can be said to have been the main new feature of the LDC national policy environment in the 1990s.

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The SAF/ESAF was a lending facility under which low-income countries were provided with highly concessional assistance from the IMF which was conditional on the implementation of an agreed three-year programme of policy change, consisting of three annual programmes with an agreed timetable which was monitored. The importance of ESAF loans stemmed less from the amount of resources provided than from the access which an IMF agreement provided to other official resources. Without an IMF ESAF agreement, it was impossible to have debt rescheduling through the Paris Club. Moreover, an ESAF programme was often a precondition for grants and loans by bilateral donors, and financing from other international financial institutions in low-income countries. ESAF-supported programmes thus shaped policy change in LDCs, and also acted as the framework for obtaining concessional finance and debt relief in the 1990s.

In November 1999 the ESAF was transformed into the Poverty Reduction and Growth Facility (PRGF), which will now shape policy change and condition access to official finance and debt relief in most LDCs. But in order to assess the implications of the new facility for LDCs, it is necessary to have a clear understanding of how the ESAF worked and draw appropriate policy lessons from this experience. The present chapter thus examines the working of ESAF programmes in LDCs, whilst the next chapter will focus more closely on the nature and potential effects of the transformation of the ESAF into the PRGF.

The present chapter addresses five major questions:

1. What were the objectives and strategy of SAF/ESAF-supported programmes? (Section B)
2. What was the extent of policy reform in LDCs under SAF/ESAF programmes? (Section C)
3. What were the outcomes of SAF/ESAF policy reforms in LDCs? (Section D)
4. What mechanisms underlie the performance of SAF/ESAF policy reforms? (Sections E and F)
5. What are the policy implications? (Section G)

The analysis of the policy reforms draws, in particular, on the results of three evaluations made by, or for, the IMF – an early evaluation of effects (Schadler et al., 1993); an internal evaluation after 10 years (IMF, 1997), generally known as "the internal evaluation"; and a specially commissioned "external evaluation", which focuses on social effects, progress to external viability and ownership (IMF, 1998) – as well as on the background studies for the internal evaluation, which provide the most complete empirical evidence on the effects of SAF/ESAF-supported programmes (Bredenkamp and Schadler, 1999).[2]

B. The objectives and strategy of SAF/ESAF-supported programmes

The two basic objectives of the SAF/ESAF-supported programmes were (i) to promote sustained higher growth, with an improvement in living standards; and (ii) to promote progress towards external viability, which was understood as meaning that external current account deficits could be financed by "normal" and "sustainable" capital flows. Most of the countries, including the LDCs, which used the facility had low savings, investment and growth, and government and external accounts were in chronic imbalance. A number of LDC SAF/ESAF users had already undertaken stabilization under IMF Stand-by Arrangements or the Extended Fund Facility. Nearly all had high and often increasing debt and debt service ratios,[3] and all were resorting to "abnormal", "exceptional" financing in some form, either accumulating arrears to external creditors, rescheduling interest and/or principal repayments, or receiving balance-of-payments support from multilateral organizations (Schadler et al., 1993: 22–23). Sustaining multilateral debt service was becoming a particular problem by the mid-1980s. IMF debt service increased from 12 per cent of total debt service of LDCs in 1977 to 30 per cent in 1986, and in that year, multilateral debt service constituted almost half of total LDC debt service.

The two basic objectives of the SAF/ESAF-supported programmes were (i) to promote sustained higher growth, with an improvement in living standards; and (ii) to promote progress towards external viability.

The adjustment strategy under SAF/ESAF arrangements was two-pronged. The first prong was policy reform, which entailed measures to control aggregate demand as well as supply-side measures to address the structural problems which were leading to low savings, investment and efficiency. The second prong was the mobilization of external resources to ease temporarily the external financing constraint and help move economies towards a higher growth path and external viability.

The policy reforms were based on the view that the structural problems were by and large the legacy of protectionist, inward-oriented and dirigiste development strategies with extensive public sector involvement and regulation of the economy. They sought to reduce the institutional rigidities and structural distortions which rendered the supply side of the economy inefficient and unresponsive to market signals. Central policy changes were: exchange rate adjustment and public expenditure reduction as central elements of stabilization; trade liberalization; the reduction of the role of the State in production and distribution, in controlling prices, and intervening in exchange and product markets; liberalization of the financial sector; and the restructuring of government expenditure through privatization and civil service reform. These measures were expected to support higher growth and external viability by reducing inflation, augmenting savings, increasing the efficiency of resource allocation and rationalizing government expenditure.

The mobilization of external resources was complementary to policy reforms, and had two elements. On the one hand, efforts were made to increase the

volume and concessionality of official finance provided to low-income countries undertaking programmes. On the other hand, efforts were made to reduce the scale or timing of debt service payments through either increasing the concessionality of debt rescheduling agreements with Paris Club creditors (from Toronto to London to Naples terms), or, if absolutely necessary, tolerating the build-up of arrears to creditors. The shift to increasing concessionality was particularly important in African LDCs, where the growth of the external debt burden can be related to the terms of official lending in the late 1970s and early 1980s (see chapter 3, box 3). The process of resource mobilization was also supported by the Special Programme of Assistance for Africa (SPA), which was initiated in 1987 (World Bank, 1998).

Thirty-three out of the 48 LDCs have engaged in SAF or ESAF programmes since 1988.

C. The scope of SAF and ESAF policy reforms

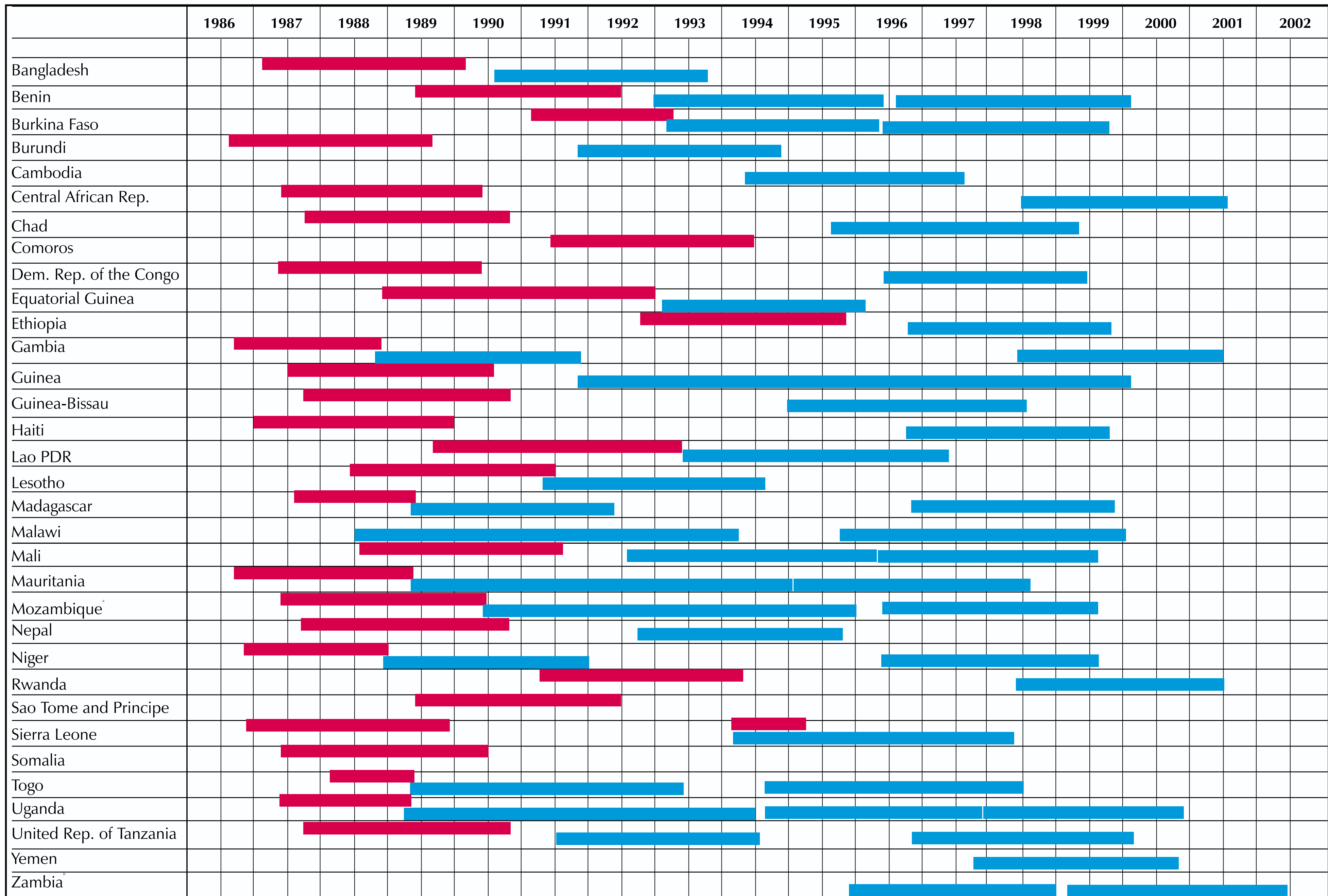
Thirty-three out of the 48 LDCs have engaged in SAF or ESAF programmes since 1988, including 27 African LDCs, 5 Asian LDCs (including Yemen), and Haiti. Of those 33 countries, one third have been under IMF-supported programmes for over half the total number of months between the beginning of 1988 and the end of 1999, and 27 countries have been engaged in implementing agreed policies for three years or more in that 12-year period (chart 36). The LDCs that have not engaged in this process are seven island LDCs (Cape Verde, Kiribati, Maldives, Samoa, Solomon Islands, Tuvalu and Vanuatu), some of which were ineligible for the facility because of their higher income levels; some States experiencing severe civil conflict or sanctions by the international community (Afghanistan, Angola, Liberia, Myanmar and Sudan); and Bhutan, Djibouti and Eritrea.

In spite of interruptions, and also policy slippages (which have generally been due to problems of meeting fiscal targets), profound policy changes have occurred in countries undertaking SAF/ESAF programmes.

There have been intermittent interruptions in many programmes (see section E below), some countries have gone further than others, and all policy conditionalities have not been equally met. Four LDCs – Comoros, the Democratic Republic of the Congo, Sao Tome and Principe, and Somalia – are also not identified in IMF evaluations as “ESAF-programme countries”, as they only undertook SAF programmes (or, in the case of the Democratic Republic of the Congo, undertook a SAF programme and an ESAF in the late 1990s).[4] But, in spite of interruptions, and also policy slippages (which have generally been due to problems of meeting fiscal targets), profound policy changes have occurred in countries undertaking SAF/ESAF programmes. The most extensive structural reforms have occurred in the deregulation of pricing and marketing, particularly in the important markets for agricultural products and inputs; the easing of trade barriers, particularly curtailing quantitative restrictions; reform of foreign exchange regimes; and liberalization of interest rates. But less progress has been made with financial sector reforms and privatization. Moreover, fiscal targets have been difficult to meet.

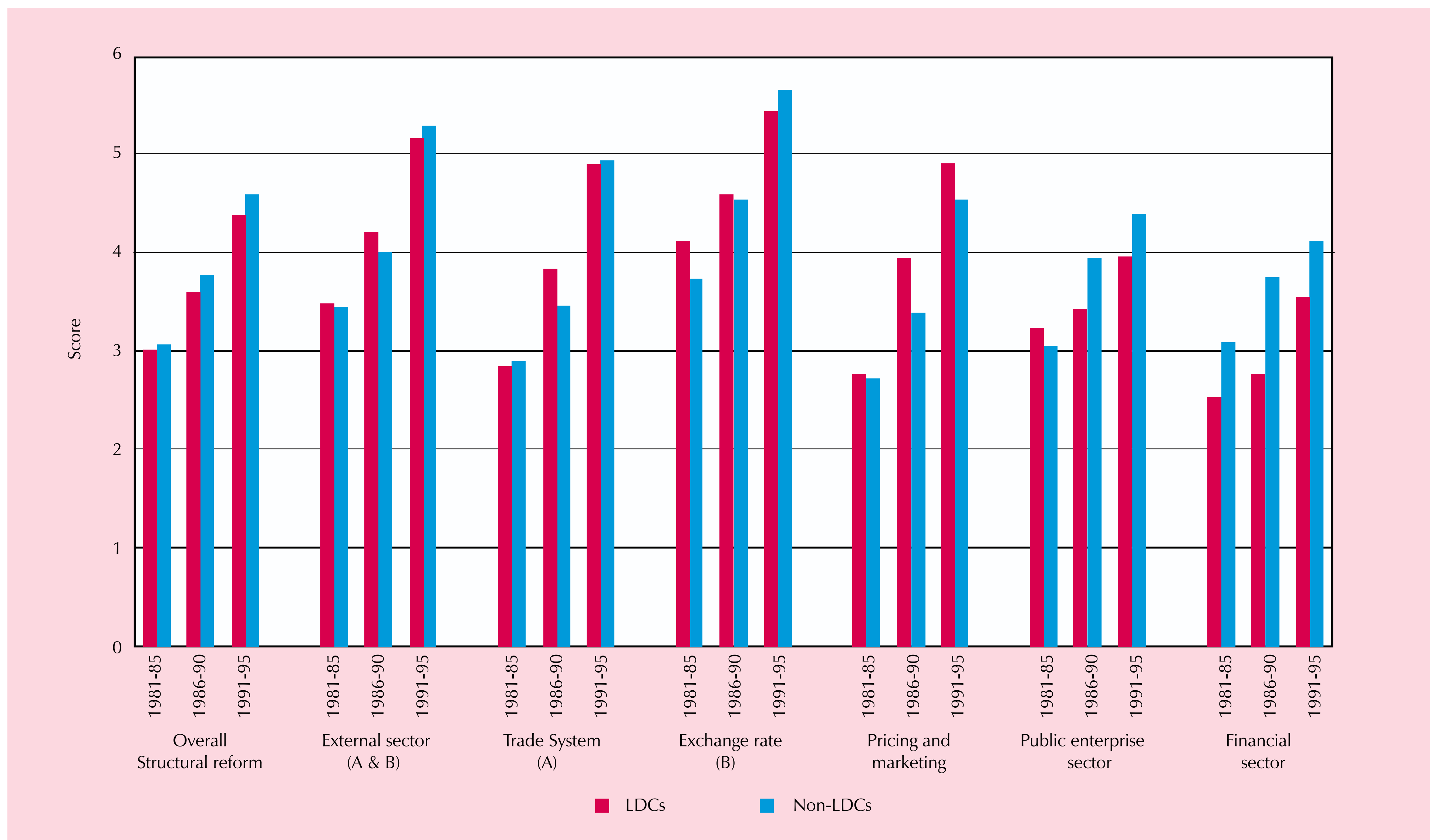
Evidence for the status of structural reforms in 30 ESAF programme countries, including 19 out of the 29 LDCs which the IMF identifies as ESAF programme countries, during the period 1991–1995, and for the pace of change between 1981–1985 and 1991–1995, is provided in one of the background studies for the IMF internal evaluation (Dicks-Mireaux et al., 1999). This shows that the LDCs have kept up with other developing countries in the sample in all areas except financial sector reform and the reform of public enterprise sector, and that they had gone further than the other developing countries in the area of pricing and marketing reforms (chart 37). The extent of reform is classified as low (score 1–2), moderate (3–4) or high (5–6) relative to a specified notion of “best

CHART 36: THE TIMING OF SAF AND ESAF ARRANGEMENTS IN THE LDCS, BY COUNTRY



Source: IMF, Annual Reports (various issues). *Notes:* 15 LDCs are not using IMF facilities: Afghanistan, Angola, Bhutan, Cape Verde, Djibouti, Eritrea, Kiribati, Liberia, Maldives, Myanmar, Samoa, Solomon Islands, Sudan, Tuvalu and Vanuatu. *a* ESAF date of expiration extended to June 1995 and amount increased to 130.1 million SDRs. *b* SAF undisbursed amount of 182 million SDRs in 1995 was arranged under a one-year arrangement in 1996. In 1998/1999, the amount of 254 million SDRs was approved under an ESAF arrangement for the period of March 1999 to 2002.

CHART 37: STATUS OF STRUCTURAL REFORMS IN ESAF-PROGRAMME COUNTRIES, 1981–1995: LDCS AND OTHER DCS



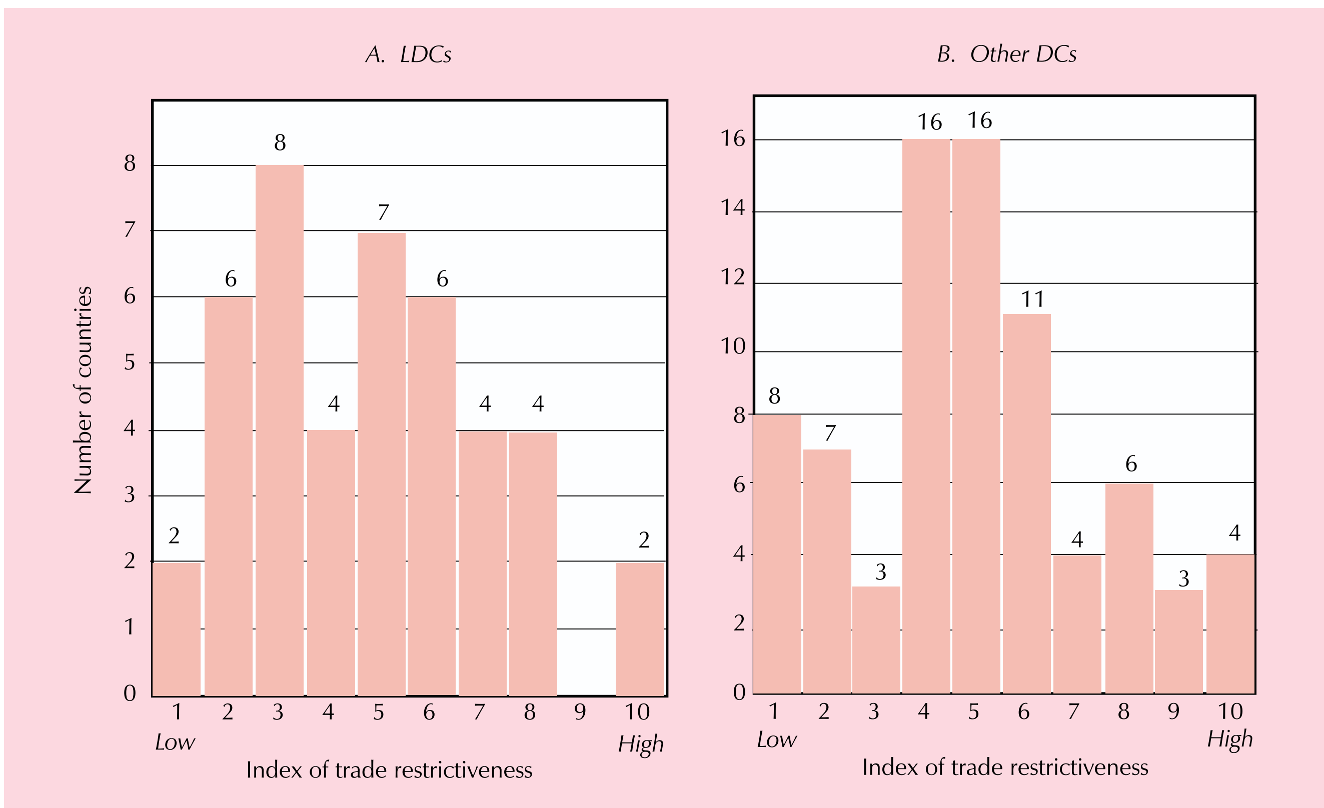
Source: UNCTAD secretariat calculations, based on Dicks-Mireaux et al., 1999.
Note: The extent of reform is classified as low (score 1–2), moderate (3–4) or high (5–6) relative to a specified notion of "best practices" (5–6) or to an average for all DCs (3–4).

practices" (score of 5–6) or to an average for all developing countries (3–4). More than half of the LDCs in the sample are in the high group for structural reforms with regard to pricing and marketing, exchange systems and trade regime.

LDCs have actually gone further than other developing countries in dismantling trade barriers.

This data set has not been continued. But recent evidence on the trade regime – using the IMF index of trade restrictiveness – shows that LDCs have actually gone further than other developing countries in dismantling trade barriers. In 1999, for 43 LDCs for which data are available, 37 per cent had no or minor non-tariff barriers coupled with average import tariff rates of below 20 per cent, while among the 78 other developing countries recorded only 23 per cent were in this category. Sixty per cent of the LDCs in this sample had average import tariff rates which were below 20 per cent and non-tariff barriers were

CHART 38: TRADE RESTRICTIVENESS FOR THE LDCS AND OTHER DCS, 1999
(Index)



Source: IMF estimates, based on the following classification scheme:

Tariffs	*Open*	*Moderate*	*Restrictive*
Open	1	4	7
Relatively open	2	5	8
Moderate	3	6	9
Relative restrictive	4	7	10
Restrictive	5	8	10

Tariffs are classified as follows:

Open, average tariff range 0≤t<10 per cent. Relatively open, average tariff range 10≤t<15 per cent. Moderate, average tariff range 15≤t<20 per cent. Relatively restrictive, average tariff range 20≤t<25 per cent. Restrictive, average tariff range 25 per cent or over.

Non-tariff barriers are classified as follows:

Open, NTBs are either absent or minor. Less than 1 per cent of production or trade is subject to NTBs. Moderate, NTBs are significant covering at least one important sector of the economy but not pervasive. Between 1 per cent and 25 per cent of production or trade is subject to NTBs. Restrictive many sectors or entire stages of production are covered by NTBs. More than 25 per cent of production or trade is subject to NTBs.

moderate in the sense that they are not pervasive, covering less than 25 per cent of production or trade (chart 38).[5]

With regard to financial openness, evidence from African LDCs indicates that broad changes have been made (Gelbard and Leite, 1999). For 24 LDCs for which there are data, 19 were identified as either closed or minimally open in 1987, but by 1997 only 6 were in this category, and whereas none were classified as largely open in 1987, 9 (over one third) were so classified in 1997. Twenty-three out of the 24 countries were identified as financially repressed in 1987, but in 1997 only 4 countries were in that category, and although none were identified as largely liberalized, 14 were somewhat liberalized (table 22).

TABLE 22: STATUS OF FINANCIAL LIBERALIZATION AND FINANCIAL OPENNESS: AFRICAN LDCS

Country	Financial openness[a]				Financial liberalisation[b]			
	1987		1997		1987		1997	
	Index[c]	Quartile	Index[c]	Quartile	Index[c]	Quartile	Index[c]	Quartile
Angola	15	Closed	23	Closed	0	Repressed	23	Repressed
Benin	38	Minimally open	77	Largely open	20	Repressed	43	Minimally liberalized
Burkina Faso	38	Minimally open	69	Somewhat open	20	Repressed	73	Somewhat liberalized
Cape Verde	38	Minimally open	62	Somewhat open	0	Repressed	47	Minimally liberalized
Comoros	38	Minimally open	62	Somewhat open	20	Repressed	27	Minimally liberalized
Central African Rep.	31	Minimally open	46	Minimally open	20	Repressed	23	Repressed
Dem. Rep. of the Congo	23	Closed	46	Minimally open	20	Repressed	50	Somewhat liberalized
Equatorial Guinea	31	Minimally open	62	Somewhat open	20	Repressed	69	Somewhat liberalized
Eritrea	31	Minimally open	54	Somewhat open	0	Repressed	3	Repressed
Ethiopia	15	Closed	23	Closed	0	Repressed	7	Repressed
Gambia	62	Somewhat open	85	Largely open	44	Minimally liberalized	69	Somewhat liberalized
Guinea	31	Minimally open	54	Somewhat open	20	Repressed	63	Somewhat liberalized
Guinea-Bissau	54	Somewhat open	92	Largely open	20	Repressed	30	Minimally liberalized
Lesotho	23	Closed	46	Minimally open	20	Repressed	52	Somewhat liberalized
Madagascar	54	Somewhat open	69	Somewhat open	20	Repressed	61	Somewhat liberalized
Malawi	31	Minimally open	46	Minimally open	20	Repressed	43	Minimally liberalized
Mali	31	Minimally open	77	Largely open	20	Repressed	68	Somewhat liberalized
Mozambique	38	Minimally open	62	Somewhat open	0	Repressed	63	Somewhat liberalized
Niger	54	Somewhat open	85	Largely open	20	Repressed	67	Somewhat liberalized
Sao Tome & Principe	38	Minimally open	54	Somewhat open	20	Repressed	40	Minimally liberalized
Togo	46	Minimally open	77	Largely open	20	Repressed	68	Somewhat liberalized
Uganda	46	Minimally open	92	Largely open	20	Repressed	67	Somewhat liberalized
United Rep. of Tanzania	46	Minimally open	85	Largely open	20	Repressed	68	Somewhat liberalized
Zambia	62	Somewhat open	85	Largely open	20	Repressed	67	Somewhat liberalized

Source: Gelbard and Leite (1999).

a The financial openness index combines features that reveal the degree of openness of the financial system and its integration into the world market:
Are there significant restrictions on the purchase of domestic financial assets by non-residents? On the purchase of foreign exchange or foreign financial assets by residents?
Is there a parallel market for foreign exchange? In such a case, is the exchange differential vis-à-vis the official rate normally lower than 10 per cent?
Is there a multiple exchange rate system? A forward exchange market? An exchange tax?
Are there controls on interest payments? On profit/dividend payments? On liquidation of direct investment?
Are there repatriation requirements for service earnings?
Has the country commited itself to avoid imposing restrictions on payments and transfers for current transactions and adopting discriminatory currency arrangements and/or multiple currency practices related to current transactions?

b The financial liberalization index measures the absence of financial repression by taking into account whether credit controls are used and whether interest rates are market-determined and positive in real terms:
Are interest rates liberalized?
How many years have real lending interest rates and real deposit rates been positive?
Is an informal financial sector significant?
Are selective credit controls absent?

c These indices are measured on a 0–100 scale. The higher the value of the index, the higher the degree of financial openness or liberalization. Countries have been grouped into four broad categories, depending on the quartile in which their overall index falls.

Finally, most LDCs now have liberal or relatively liberal FDI regimes, in terms of remittances of dividends and profits and capital repatriation. In a sample of 45 LDCs for which data are available, only 9 maintain strict controls on such capital transfers. Twenty-seven countries have adopted a free regime, guaranteeing transfers; and 9 countries have a relatively free regime, either by controlling capital repatriation (while allowing free remittances of dividends and profits) or by requiring the Government's prior authorization of transfers (UNCTAD, 1997).

The degree of policy change which has occurred in the LDCs is often underestimated.

The degree of policy change which has occurred in the LDCs is often underestimated. But it should not be surprising. On the one hand, the prospect, held out by economic theory, that the poorest countries could reap the greatest benefits from globalization by pursuing vigorous liberalization offered a strong incentive for domestic policy-makers concerned to accelerate economic growth and improve living conditions within their countries. On the other hand, lack of access to alternative sources of foreign capital together with tight conditionality forced the pace and shape of reform. It is telling in this regard that empirical research has found that "there is a clear inverse relationship between the use of conditionality and the recipient government's access to alternative sources of capital" (Killick, 1998: 12). Moreover, the ways in which new conditionalities have been entering into the agendas of the World Bank and the IMF have been through the periodic replenishments of their concessional windows, including in particular IDA and ESAF (Kapur, 1997; see also Kapur and Webb, 2000).

D. Outcomes: economic growth and progress to external viability

Although the overall growth performance of LDCs undertaking SAF/ESAF-funded programmes improved after they undertook economic reforms, the improvement was slight for the six years after programmes were initiated. Focusing on ESAF-programme countries for which data are available, and excluding the extreme positive and negative cases (Equatorial Guinea on the one hand, and Guinea Bissau, Rwanda, and Sierra Leone on the other hand), the average real GDP per capita was declining by 1.4 per annum in the three years before the programmes were initiated, was stagnant in the three years after and then declined by 1.1 per cent in the next three years (table 23). The dispersion

TABLE 23: ECONOMIC PERFORMANCE OF THE LDCS, BEFORE AND AFTER THE ADOPTION OF SAF/ESAF PROGRAMMES

	3 years before	1st 3 years after	2nd 3 years after	1996–1998
Average annual growth rates (%)				
Real GDP per capita (%)	-1.4	0.0	-1.1	1.9
Exports of goods and services (constant 1995 $)	1.1	5.2	4.5	9.8
Gross domestic investment (constant 1995 $)	0.8	1.2	0.7	6.3
Average annual ratio (as % of GDP)				
Gross domestic investment	16.3	19.3	19.3	19.7
Gross domestic savings	-0.8	1.0	-0.1	2.8

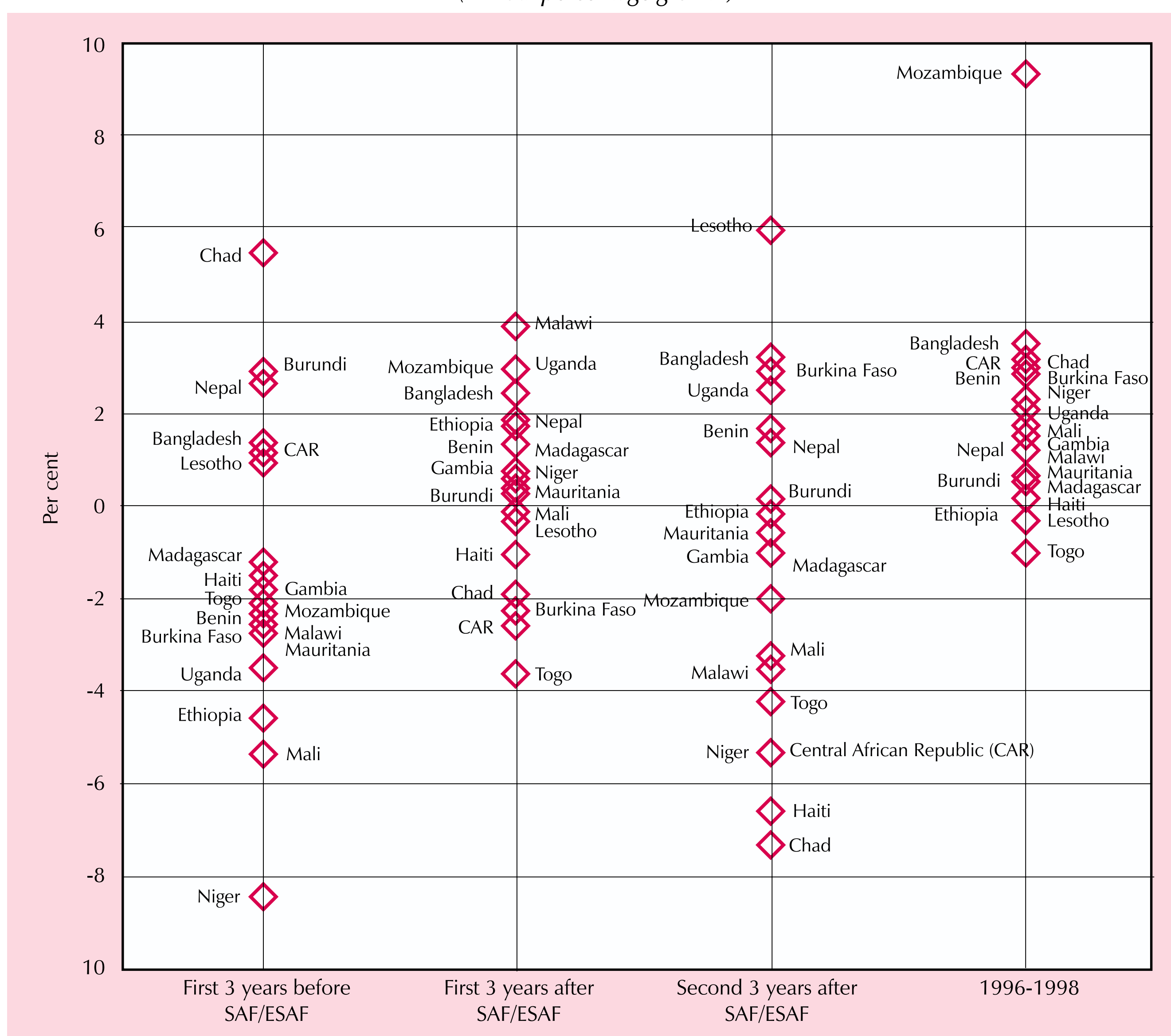
Source: UNCTAD secretariat estimates, based on World Bank, *World Development Indicators 2000* and *Global Development Finance* 2000.

Note: The sample includes all LDCs for which data are available and which are identified by the IMF as ESAF-programme countries, except Equatorial Guinea, Guinea-Bissau, Rwanda and Sierra Leone, which are outliers. The countries are: Bangladesh, Benin, Burkina Faso, Burundi, Central African Republic, Chad, Ethiopia, Gambia, Guinea, Haiti, Lesotho, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nepal, Niger, Togo and Uganda.

in growth rates decreased markedly in the first three years after SAF/ESAF-funded programmes, and then increased again in the next three years (chart 39). There is an acceleration of export growth in the first three years after initiating ESAF reforms, and gross domestic investment increases as a proportion of GDP. During 1996–1998, real GDP per capita growth picked up to 1.9 per cent per annum, and there is a further acceleration of export growth and gross domestic investment. But domestic savings, though they improved, remain very low.

Regarding progress to external viability, it is apparent that in 1998, the latest date for which data are available, 25 of the 33 LDCs which initiated SAF or ESAF programmes had levels of indebtedness which were unsustainable according to the criteria which the international community has recently adopted under the enhanced HIPC Initiative to judge debt sustainability. What is particularly troubling is that the situation was apparently worse in 1998 than at the start of the decade. The ratio of the total debt stocks to GDP increased in 18 out of the 29 ESAF programme LDCs and the ratio of total debt stocks to exports of goods and services plus workers' remittances increased in 17 out of 29 ESAF – programme countries.[6] One positive aspect of the situation is that rates of indebtedness began to decline more generally in ESAF-programme LDCs in the

Chart 39: Real per capita GDP growth rate in the LDCs initiating SAF/ESAF programmes during 1987–1992
(Annual percentage growth)



Source: UNCTAD secretariat estimates, based on World Bank, *World Development Indicators 2000.*

period 1994-1998. But this pattern applies to all LDCs, and not simply those that have engaged in reforms.

E. Mechanisms: differential performance under ESAF economic reforms

The extent to which these outcomes can be attributed to domestic policy changes, the external economic environment, and uncontrollable events such as the weather, is a highly controversial issue. The central methodological problem in evaluating effects of the reforms is determining a counterfactual, which specifies what policies would have been adopted and what outcomes would have occurred in the absence of ESAF support, against which to compare actual outcomes. The most widely applied methodology entails comparisons between countries which did and countries which did not adopt ESAF-supported programmes, on the assumption that countries which did not receive support provide an appropriate counterfactual for those which did.

Using this methodology, IMF studies show that ESAF programmes have been successful (IMF, 1999a; IMF, 1999b). The latest published work evaluating the programmes (undertaken by IMF staff) confirms the main conclusions of the internal evaluation finding that "for output growth and the debt/service ratio, sizeable beneficial effects that are statistically significantly different from zero are identified", whilst "the effects on inflation are not significantly different from zero" (Dicks-Mireaux et al., 2000: 521). However, this study also conducts diagnostic tests of the validity of the assumption that the policy reaction function for countries which do not receive support describes the counterfactual for countries that do receive support. These diagnostic tests indicate that this assumption is unreliable and thus the differences in performance cannot reliably be attributed to the ESAF programmes. The results, it is argued, raise questions about the validity of other evaluations of the programmes which use this methodology, and it is concluded that "on the basis of this study, it cannot be ruled out that the inherent limitations of panel data covering countries facing highly diverse circumstances render it impossible to obtain reliable estimates of the independent effects of IMF-supported lending" (p. 522).

This is a sobering conclusion. It implies that the efficacy of the economic reforms, on which so many lives and livelihoods now hang, is, and must remain, an act of faith. However, rather than trying to answer the question whether economic reforms work by comparing differential outcomes between ESAF and non-ESAF countries, it is now more important to understand the mechanisms through which programmes do, and do not, work. This shifts emphasis away from comparisons between those who undertake and those who do not undertake reforms towards the differential performance amongst countries pursuing the programmes, and in the same country over time. The question becomes why have these had more positive outcomes in some countries than others, and at some times rather than others; and if positive outcomes have occurred, how sustainable are they.

1. The role of external finance and global market developments

The basic mechanism through which ESAF-funded programmes boost economic growth in LDCs is by increasing their access to concessional financing.

In countries which are rationed out of international capital markets and with severe balance-of-payments constraints, such access is fundamental to growth prospects. It is particularly important if an ESAF loan is a precondition for other official finance on concessional terms.

As the IMF's External Evaluation points out, ESAF loans, reinforced by increased concessional finance from other donors, expand consumption and production possibilities (IMF, 1998: 37–39). Typically, the increased supplies of foreign exchange associated with the initiation of an ESAF programme have enabled the rehabilitation and full utilization of existing capital stock rather than the creation of new capital. But expanded official flows in import-strangled economies can also render many more potential investments remunerative (Helleiner, 1992: 780–781), and the cheapening of the price of wage goods has often led to the flourishing of informal sector activities (Wuyts, 1998).

These reforms acted as a gatekeeper for official finance rather than opening up access to private finance.

Table 24 provides evidence of the changes in official financing associated with the initiation of ESAF-funded reform programmes. The most striking feature is that a comparison of the five years before and the five years after the start of such a programme reveals that average annual grants per head increased by over 100 per cent in real terms in 20 out of 29 cases and by over 68 per cent in a further 6 cases. The average interest rate on new official loan commitments was 1 percentage point lower in 16 cases and the average grant element in official loans was 10 percentage points higher in 16 out of the 29 cases.[7]

As chart 40 shows, these reforms acted as a gatekeeper for official finance rather than opening up access to private finance. In almost half of the cases, the average annual ratio of net ODA to GNP increased by over five percentage points between the five years before and after the initiation of reforms. But the ratio of net FDI to GNP declined in almost half of the cases, increasing by over 1 per cent in just five cases.[8]

The positive effects of enhanced access to concessional finance have been reinforced in some countries by positive global market developments. The importance of this is underlined in the early internal evaluation of SAF and ESAF programmes conducted by the IMF. Comparing countries making more or less progress to external viability, the study found that "the striking difference between the two groups is in external developments. The deterioration in the terms of trade in the countries with weaker performance was a large multiple of that in the countries with stronger performances" (Schadler et al., 1993: 38). For LDCs undertaking ESAF programmes, the importance of terms-of-trade movements is apparent in the difference between economic performance in the early 1990s and 1994–1998. Moreover, during the latter period, whether debt-to-export ratios were rising, declining or more or less stable is closely related to export price developments. Export value growth exceeded export volume growth in 13 out of the 15 SAF/ESAF-programme LDCs in which the debt/export ratios were falling by more than 2 per cent per annum, whereas export volume growth exceeded export value growth in 12 out of the 16 countries where debt-to-export ratios were rising, stagnant or falling very slowly (table 25).

In those countries in which external indebtedness declines, it is possible to discern the beginnings of a virtuous circle in which decreasing external debt is associated with increasing domestic investment, which is associated with increasing exports, which in turn contributes to a further lessening of the external debt burden.

In those countries in which external indebtedness declines, it is possible to discern the beginnings of a virtuous circle in which decreasing external debt is associated with increasing domestic investment, which is associated with increasing exports, which in turn contributes to a further lessening of the external debt burden. This is apparent in that not only is there a strong relationship between reduction in debt-to-export ratios and export growth (as indicated above), but also there appears to be a relationship between rates of

TABLE 24: GRANTS AND CONCESSIONALITY OF NEW OFFICIAL LOANS CONTRACTED BEFORE AND AFTER THE INITIATION OF SAF/ESAF PROGRAMMES

		5-year average Real grants per capita ($)			5-year average official interest rate (%)			5-year average official grant element (%)		
	Initiation year	Pre-SAF/ESAF	Post-SAF/ESAF	% change	Pre-SAF/ESAF	Post-SAF/ESAF	difference	Pre-SAF/ESAF	Post-SAF/ESAF	difference
Bangladesh	1987	3.3	6.7	104.6	1.4	1.2	-0.2	72.9	74.2	1.3
Benin	1989	7.4	25.0	239.1	3.1	1.1	-2.0	55.4	74.2	18.7
Burkina Faso	1991	11.9	23.6	98.4	2.3	1.0	-1.3	59.7	75.9	16.2
Burundi	1986	5.3	13.2	147.8	2.8	1.2	-1.6	55.6	73.5	17.9
Cambodia	1994	6.9	20.3[a]	194.8	0.2	1.7[a]	1.5	15.9	71.6[a]	55.7
Central African Rep.	1987	9.0	24.8	175.5	2.6	1.7	-1.0	58.6	69.1	10.5
Chad	1987	9.5	20.0	110.3	2.3	1.8	-0.4	43.5	68.4	24.9
Equatorial Guinea	1988	22.4	60.1	168.5	1.7	1.3	-0.4	66.7	69.8	3.0
Ethiopia	1992	9.3	8.8	-4.6	2.7	1.2	-1.6	50.7	73.9	23.2
Gambia	1986	18.7	44.3	136.9	3.6	1.2	-2.4	48.1	68.3	20.2
Guinea	1987	4.2	20.8	389.1	3.1	2.2	-0.8	51.2	61.3	10.0
Guinea-Bissau	1987	20.3	42.6	110.2	2.9	1.2	-1.6	50.4	68.2	17.7
Haiti	1986	4.4	13.5	208.4	2.2	1.2	-1.1	66.4	58.7	-7.7
Lao PDR	1989	4.4	14.7	230.9	0.2	0.8	0.6	88.0	80.0	-8.0
Lesotho	1988	18.3	30.7	68.3	2.2	2.9	0.7	63.6	55.8	-7.8
Madagascar	1987	2.9	16.7	467.3	4.6	1.8	-2.8	42.8	68.6	25.8
Malawi	1988	5.4	25.4	368.8	2.5	1.4	-1.1	64.3	73.7	9.5
Mali	1988	11.1	20.8	87.5	1.8	1.3	-0.5	64.9	68.8	3.9
Mauritania	1986	24.5	42.5	73.3	2.7	2.2	-0.5	52.9	61.4	8.6
Mozambique	1987	6.7	43.9	553.9	3.4	1.5	-1.9	42.0	71.2	29.1
Nepal	1987	2.7	7.3	174.2	1.2	1.0	-0.2	76.1	78.4	2.3
Niger	1986	9.0	21.4	136.4	3.7	1.7	-2.0	49.1	66.9	17.8
Rwanda	1991	11.8	60.1	409.3	1.5	0.6	-0.8	71.5	63.5	-8.0
Sierra Leone	1986	4.5	8.3	83.7	1.3	1.7	0.4	67.8	68.8	1.0
Togo	1988	11.4	22.2	94.6	2.4	0.8	-1.7	63.7	62.3	-1.3
Uganda	1987	2.6	14.0	439.3	3.1	1.7	-1.4	57.2	67.5	10.4
UR of Tanzania	1987	8.4	22.5	168.0	2.6	1.6	-1.0	54.7	70.7	16.0
Yemen	1997	6.8	7.4[b]	8.3	2.1	0.5[b]	-1.6	59.8	81.7[b]	21.9
Zambia	1995	59.9	28.3[c]	-52.8	2.0	1.1[c]	-0.9	66.5	75.6[c]	9.1

Source: UNCTAD Secretariat estimates, based on World Bank, *Global Development Finance 2000*, and on OECD-DAC database.

a 1995–1998 average.
b 1998 figure.
c 1996–1998 average.

decline in debt-to-GDP ratios and rates of growth of domestic investment (chart 41). This may be a purely accounting relationship, but how policy can best catalyse and sustain virtuous relationships between reduced external indebtedness, investment and export growth merits closer study. It would appear that one channel for this is through increased concessional finance enabling increased imports which are necessary for higher investment, which in turn facilitates export growth, thus reinforcing the initial catalytic effect of increased concessional finance. The role of official finance in this process is spelt out in one of the background studies for the internal ESAF evaluation, which demonstrates that the countries which made progress towards external viability "maintained larger current account deficits than those that made no progress. These larger deficits were financed by higher levels of official transfers" (Tsikata, 1999: 154).

However, the sustainability of this process depends critically on continued access to concessional finance plus favourable global market developments. This

CHART 40: NET ODA AND NET FDI INFLOWS BEFORE AND AFTER THE INITIATION OF SAF/ESAF PROGRAMMES
(Changes in average annual inflows as percentage of GNP[a])

Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators 2000.*
a 5 years before and 5 years after, in percentage points.

TABLE 25: TRADE PERFORMANCE AND DEBT–EXPORT RATIOS , 1994–1998

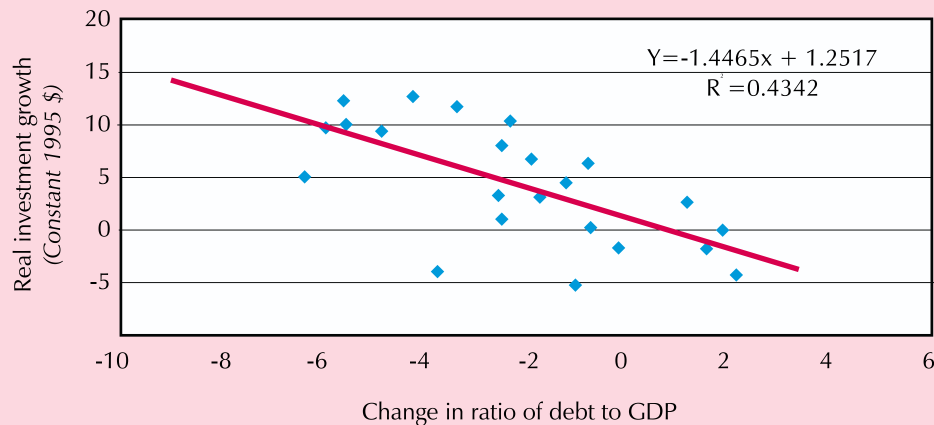
	EDT%XGS[a]	Growth rates (%) Exports of goods and services In value (A)	In volume (B)	(A) > (B)
LDCs with decreasing debt-export ratio		**17.2**	**14.3**	
Equatorial Guinea	-40.4	73.1	84.4	no
Haiti	-30.2	26.6	26.2	yes
Rwanda	-18.8	27.8	22.2	yes
Ethiopia	-13.7	19.1	14.9	yes
Bangladesh	-12.0	16.4	15.4	yes
Uganda	-11.3	17.1	18.3	no
Togo	-10.7	12.7	8.1	yes
Malawi	-7.6	12.1	9.3	yes
Mozambique	-6.7	9.6	4.8	yes
Angola	-5.4	6.3	-2.0	yes
Madagascar	-4.0	4.1	-3.7	yes
Gambia	-3.9	3.9	1.4	yes
United Republic of Tanzania	-3.0	13.6	2.1	yes
Nepal	-2.7	4.8	4.5	yes
Chad	-2.6	10.3	9.3	yes
LDCs with stable or increasing debt-export ratio		**4.9**	**6.4**	
Sao Tome and Principe	-1.4	1.7	2.5	no
Guinea	-0.9	4.0	10.0	no
Lesotho	-0.8	15.6	18.1	no
Niger	-0.7	4.5	3.3	yes
Guinea-Bissau	0.1	1.7	5.0	no
Yemen	1.6	35.4	-2.1	yes
Mali	2.2	11.8	14.1	no
Zambia	2.4	-3.9	3.2	no
Cape Verde	3.7	19.3	20.9	no
Central African Republic	5.9	-5.3	6.9	no
Mauritania	6.5	-3.0	-1.2	no
Benin	7.4	5.3	4.1	yes
Burkina Faso	7.5	6.4	8.1	no
Burundi	13.7	-8.3	5.0	no
Comoros	27.2	-6.7	5.8	no
Eritrea	50.9	-0.6	-1.4	yes

Source: UNCTAD secretariat estimates, based on World Bank, *Global Development Finance 2000* and *World Development Indicators 2000*.

a External debt stock as a percentage of exports of goods, services and remittances (annual average).

is particularly highlighted by the IMF's External Evaluation, which underlines that in those countries where faster growth has occurred following the adoption of ESAF programmes, the sustainability of that growth is questionable. The reason is that investment rates remain low and the scope for financing increased investment through domestic savings is limited because of low incomes.[9] To sustain initial gains, enhanced private and public capital inflows will be needed until domestic savings rise. But given the weak private flows response to reforms, this implies that there is a continued need for enhanced official capital inflows. To the extent that official credit-donors reduce concessional flows once the major policy reforms are in place and the economy is apparently "on track", the process can be quickly derailed.

CHART 41: REAL INVESTMENT GROWTH AND CHANGES IN EXTERNAL INDEBTEDNESS IN ESAF PROGRAMME LDCS, 1994–1998
(Annual percentage growth)



Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators 2000* and *Global Development Finance 2000.*

2. CAUSES AND CONSEQUENCES OF PROGRAMME INTERRUPTIONS

An important background study for the IMF Internal Evaluation makes it clear that the outcomes of programmes depend on whether they are interrupted or not. For low-income countries as a whole, cumulative capital formation and per capita growth in interrupted programmes were significantly slower than during uninterrupted programmes (Mecagni, 1999: table 9.1). The recent World Bank Report on Africa also shows that on-track countries have been doing better than countries where reforms are interrupted.

These findings are important, but they reflect the consequences of interruptions for access to concessional finance as much as the effect of interruptions on the change in the policy environment. This is because interruptions entail a discontinuity in the disbursement of IMF funds. It is quite possible for such a delay to engender what has been called “a self-fulfilling collapse of fiscal resources” (Sachs et al., 1999: 7). This can happen if a fiscal target is not met, causing the IMF to delay payments. As Sachs et al. put it, “The IMF decision in turn blocks the disbursement of funds by other major creditors, including the World Bank and bilateral donors. The absence of such funds then dramatically worsens the budget situation, proving that the IMF was right to suspend the program. A long period of default, followed by difficult negotiations to restart lending, transpires”(p.7).

As interruptions are important for outcomes, an important issue for understanding the mechanism by which policy reforms work is to understand the causes of policy interruptions. Using the data set gathered for the

background studies for the internal evaluation, which covers SAF/ESAF arrangements approved during the period from 1986 to the end of 1994, it is possible to identify 34 interruptions, which occurred in 17 LDCs adopting these programmes. This is obviously not a complete sample, but it is the best available source for examining an issue discussion of which tends to be based on beliefs rather than facts. Interruptions in this data set are identified by discontinuities in the disbursement of IMF resources, and defined as "either an interval of more than six months between different annual or multiyear IMF arrangements or a delay of more than six months in completing a program review" (Mecagni, 1999: 217). This definition seeks to capture all potentially significant policy deviations, while avoiding mere procedural delays.

One might expect that the main cause of these interruptions was slippage in the fulfilment of agreed policy commitments. But in fact only 20 of the 34 interruption episodes were due to this (table 26). In six episodes, three of which were in Asian LDCs, there were no major deviations from the planned policies prior to implementation, but rather what are identified as "forward-looking disagreements". Such disagreements occurred "when either the IMF staff and authorities were unable to agree on the extent or pace of financial and structural programmes to be implemented in the period ahead, or the authorities needed more time to formulate a policy response to unexpected changes in the economic environment" (Mecagni, 1999: 220). A further eight interruption episodes were due to "political disruptions serious enough to call into question the continuing authority of the government and, therefore, to prevent meaningful negotiations" (p. 220).

An important question is the extent to which slippages are built into the programmes from the outset.

Of the 20 episodes in which there was slippage from agreed policy commitments, the main source of slippage was failure to meet fiscal targets (15 episodes). Slippage on structural reforms was only a source in 5 out of the 20 episodes. Moreover, where slippage occurred, a variety of exogenous influences also played a role in what happened. In 15 out of the 20 episodes, external shocks, natural disasters, or social unrest which could be related to the effects of adjustment programmes either strongly or weakly, played a role in the slippage. Of the remaining five cases, two had overambitious fiscal targets (out of a total of four cases identified as such in the sample), and of the remaining three, interruptions in two can be related to the democratic process, particularly by the pre-electoral climate (see table 26).

An important question is the extent to which slippages are built into the programmes from the outset. The internal evaluation background study examines this question in relation to five dimensions of policy design: (i) overly ambitious fiscal targets; (ii) insufficient prioritization of structural reforms; (iii) inadequate technical assistance; (iv) insufficient staff contact and monitoring; and (v) weak contingency planning. Of these aspects, the last emerges as the most problematic (although the evaluation study considers it hard to build contingency measures into programmes).

Focusing on a sub-sample of cases where slippage from policy commitments is due to external shocks, the study finds that terms-of-trade deterioration and shortfalls in external financing were often considered by IMF staff to be risks *ex ante*, but contingency measures and adjusters were not built into the programme. Thus, for example, for 10 LDC episodes in the sub-sample, uncertainty about external financing was perceived as an *ex ante* risk in six and materialized in four, and terms-of-trade deterioration was perceived as a risk in six and materialized in five of these. But in only one of these cases were contingent measures discussed to compensate for the potential effects on fiscal

TABLE 26: CLASSIFICATION OF CAUSES OF INTERRUPTIONS OF SAF/ESAF PROGRAMMES IN THE LDCS

Country		Starting date of interruption	Forward-looking disagreements Only (time needed to formulate a policy response to shocks; no major policy slippages)	Political disruptions (serious enough to prevent meaningful negotiations or call into question continuing authority of current government)	*Deviation from policy commitments*						
					Type of deviation		Contributing factors				
							External shocks	Natural disasters	Social unrest		Democratization or pre-electoral climate
					Fiscal issues	*Structural reforms*			*Weakly related to adjustment effects*	*Strongly related to adjustment effects*	
Bangladesh	1	Dec.1989	X								
Benin	1	Jun.1990		X						X	
	2	Jun.1992	X								
Burkina Faso	1	Mar.1992			X		X	X			X
	2	Nov.1993			X						
Burundi	1	Aug.1987			X		X				
	2	Jul.1990			X						
	3	May.1993		X							
Eq. Guinea	1	Dec.1989				X	X				
	2	Sep.1993			X						X
	3	Oct.1994			X						
Guinea	1	Jul.1988			X		X				
	2	Mar.1990			X					X	
	3	Nov.1992			X		X				X
Lao PDR	1	Sep.1990	X								
	2	Jun.1994				X					
Madagascar	1	Jun.1991		X							
Malawi	1	Jun.1992			X		X	X		X	X
Mali	1	Jan.1991		X					X		
	2	Aug.1993			X					X	
Mauritania	1	Nov.1988				X					
	2	May.1990	X								
Mozambique	1	Dec.1993				X	X				
	2	Feb.1995			X		X				
Nepal	1	Nov.1990		X							
	2	Oct.1993	X								
	3	Sep.1994				X					X
Niger	1	Dec.1989			X		X	X			
	2	Mar.1991		X					X		
Sierra Leone	1	Nov.1987		X							
	2	Mar.1995	X								
Togo	1	Jun.1991			X			X	X		X
	2	Nov.1992		X							
UR of Tanzania	1	Mar.1993			X						
Total			**6**	**8**	**15**	**5**	**9**	**4**	**3**	**4**	**6**

Source: UNCTAD secretariat estimates based on Mecagni (1999), including from text table 9.10, table 9.11 and table 9.12.

accounts and balance of payments. In general, "these programmes implicitly assumed that any financing shortfall would have to be offset fully and immediately by a tightening of policies or a contraction of imports, or dealt with in a subsequent review. In no case were the modalities of the additional adjustment effort to address external financing shortfalls specified in advance, and hence agreed by authorities" (Mecagni, 1999: 236).

Related to the lack of contingency measures are problems of forecasting. The data from the background study for the internal evaluation on programme interruptions show that there is an important difference between LDCs in which programmes were uninterrupted and those in which programmes were interrupted and in which little or no progress was made towards external

TABLE 27: FORECASTS OF OFFICIAL LOANS AND MERCHANDISE EXPORTS: DEVIATION OF OUT-TURN FROM PROJECTIONS IN INTERRUPTED AND UNINTERRUPTED LDC SAF/ESAF PROGRAMMES

	Official loan targets versus out-turns[a]			Merchandise exports targets versus out-turns[a]		
	(O = overestimate; U = underestimate; E = on target)					
	t	t+1	t+2[d]	t	t+1	t+2
Interrupted programmes in which limited or no progress was made to external viability						
Burundi (SAF, 1986)	O	E	O	O	O	O
Equatorial Guinea (ESAF 1993)	U	O	O	O	O	O
Guinea (ESAF 1991)	O	O	O	E	O	O
Madagascar (ESAF 1989)	O	O	O	U	O	O
Mali (ESAF 1992)	O	O	U	E	O	O
Mozambique (SAF 1987)	O	O	O	U	E	O
Mozambique (ESAF 1990)	O	O	O	E	U	O
Niger (ESAF 1989)	O	O	O	O	O	O
Sierra Leone (SAF 1986)	..	..	..	O	O	O
Togo (ESAF 1989)	O	O	U	U	E	O
Summary frequency distribution:						
Overestimates	8	8	7	4	7	10
On target	-	1	-	3	2	-
Underestimates	1	-	2	3	1	-
Uninterrupted programmes[b]						
Bangladesh (ESAF, 1990/1991)[c]	..	..	..	E	U	U
Benin (ESAF 1993)	O	O	O	O	O	O
Gambia (ESAF 1988/1989)	O	O	O	E	E	U
Lesotho (SAF 1988/1989)	U	U	U	U	U	O
Lesotho (ESAF 1991/1992)	U	U	U	E	U	U
Mozambique (SAF 1987)	O	O	O	U	E	O
Nepal (SAF 1987/1988)[b]	..	..	..	U	..	..
United Rep. of Tanzania (SAF 1987/1988)[b]	..	..	..	O	O	O
Uganda (ESAF 1989/1990)	U	U	O	O	O	O
Summary frequency distribution:						
Overestimates	3	3	4	3	3	5
On target	-	-	-	3	2	-
Underestimates	3	3	2	3	3	3

Source: Tsikata (1999), tables 7.19 and 7.20.

a "Targets" are the projections contained in the IMF staff report for the first annual arrangement. Out-turns that fall within 5% of the projection are classified as being "on target" (E); projections that exceed the out-turn by more than 5 per cent are classified as "overestimate" (O); and those below out-turns by more than 5 per cent are classified as "underestimate" (U).

b Coverage is for multiyear arrangements that ran their full course without major interruption.

c Gross official borrowing not reported in the IMF staff report.

d The initial annual arrangement is designated t, and the subsequent two years are t + 1 and t + 2.

viability. Forecasts were much more realistic in those programmes which were uninterrupted (table 27). Forecasts of merchandise exports were over-optimistic in two thirds of the interrupted programmes, but in under half of the uninterrupted programmes. More strikingly, projections of official lending were overestimated in eight out of nine programmes in the first and second years of the interrupted programmes, but in only three out of six of the uninterrupted programmes.

Given that the success of the programmes depends critically on whether they are adequately financed, an important policy issue is the extent to which programme slippage occurred because of underfinancing. This can occur owing to unforeseen shocks, or a general tendency to underestimate the financing requirements of adjustment efforts. These are calculated on the basis of estimates of financing gaps, and they may underestimate requirements either because of overoptimistic forecasts or because of adjustment of financing gaps in the light of the ability to mobilize donor support for programmes. This latter possibility arises because "supporting underfunded programmes is", as the evaluation of the Special Programme of Assistance for Africa explains, "not feasible for the Bank and the Fund, so if donor pledges fell short of financing requirements, the gap had to be adjusted in a somewhat ad hoc manner to meet donor allocations" (World Bank, 1998: 42). An inevitable consequence of such adjustment of financing gaps according to ability to mobilize funds rather than actual requirements is that a certain number of programmes are fated to break down from the outset because of underfunding and shortages of foreign exchange.[10]

A certain number of programmes are fated to break down from the outset because of underfunding and shortages of foreign exchange.

3. The role of macroeconomic policies and structural reforms

The positive benefits which follow if the foreign exchange constraint is loosened by increased concessional finance, if this is sustained, and if programmes are not interrupted and so there is low volatility in foreign financing, are enhanced by the domestic policy environment. It is extremely difficult to identify the elements of policy reform which contribute most to positive outcomes. However, many observers have concluded that the domestic policy changes which are likely to contribute most are the removal of gross macroeconomic distortions.[11]

The effectiveness of the structural reforms is more controversial. There is little hard evidence from the IMF evaluation studies that structural reforms have positive effects on growth. It is worth quoting here from the key background study for the internal evaluation for its measured language. The passage in question states that:

> A more detailed examination of structural policies in the ESAF countries, with the aid of score indices constructed for the purpose, does not provide findings that are sufficiently robust to support firm policy conclusions. This may well reflect the enormous difficulties in measuring differences in structural policies across countries and over time. Bivariate correlations suggest that reductions in structural distortions are associated with more rapid growth over time. But such effects are barely discernible when full account is taken of macroeconomic policies, human capital accumulation, initial conditions and exogenous shocks (Kochhar and Coorey, 1999: 87).

This result reflects the fact that in low-income countries, structural constraints and institutional weaknesses impede a positive response to private incentives which are intended to be at the centre of adjustment processes. The problem is that some key markets hardly exist, or they are so thin that they are characterized by monopolistic or oligopolistic pricing. The domestic entrepreneurial class, which hypothetically will act as the key agent of market-based growth, is weak. But foreign investors are not yet ready to step into the breach. As shown in the last chapter, although economic reforms can guarantee a more liberal and pro-business policy regime, there are more fundamental factors which deter investment decisions and which are not addressed by the structural reforms.

In low-income countries, structural constraints and institutional weaknesses impede a positive response to private incentives which are intended to be at the centre of adjustment processes.

The main deficiencies of the structural reforms in low-income contexts have been particularly highlighted in earlier UNCTAD work on structural adjustment in Africa (UNCTAD, 1998). Agricultural liberalization has often not been associated with a strengthening of output price incentives owing to falling world prices for export commodities, the removal of subsidies on food crops, and imperfect marketing systems. Input supply and credit provision have also dwindled, particularly in less accessible and low population-density regions and locations, since private agents have been unable to take up many of the functions previously discharged by market boards. Financial liberalization has led to high and unstable interest rates, widespread insolvencies, and a rapid accumulation of public domestic debt (Nissanke, 1998). Trade liberalization, where formal sector enterprises have weak technological and managerial capabilities, has often undermined domestic industry. There can be vigorous informal sector development where import compression ends, but this is not necessarily sustainable given the lack of export orientation of informal sector activities and constraints on their access to finance (Wuyts, 1998).

4. External indebtedness and ESAF outcomes

The outcomes of economic reform processes in developing countries also depend critically on the initial conditions in which efforts at structural adjustment are launched. It is now clear that supply responses are likely to be more muted in poor countries where physical and human infrastructure and market institutions are underdeveloped, and where there is only a small domestic entrepreneurial class. There is also growing evidence that economic liberalization does not deliver developmental integration into the world economy for countries which are more remote from the core growth areas of the world economy and with geographical constraints on access to international trade. Structural adjustment reacting to a situation of economic crisis is always likely to be more difficult and vulnerable than positive restructuring in line with a long-term developmental vision (ESCAP, 1990). Finally, an important factor which affects the working of economic reforms as well as their outcomes is the initial level of external indebtedness.

The current policy of making successful adjustment a condition which must be met before debt relief is irrevocably provided puts the cart before the horse, condemning both the adjusting country and the official creditor-donors supporting the adjustment process to considerable frustration.

The effects of external debt on processes of adjustment are an underexplored issue. But it is quite vital. If it is the case that once external indebtedness passes a certain threshold, reform effectiveness is undermined, a necessary condition for economic reforms to work in severely indebted countries is prior debt reduction. The current policy of making successful adjustment a condition which must be met before debt relief is irrevocably provided puts the cart before the horse, condemning both the adjusting country and the official creditor-donors supporting the adjustment process to considerable frustration. Increased resource inflows in the form of aid and increased national policy effort towards

structural adjustment simply cannot move the economy to external viability until the burden of external debt is reduced.

There is, surprisingly, little exploration of the effects of external debt on reform outcomes or the mechanisms through which external debt affects the working of adjustment programmes. However, simple comparisons between LDCs undertaking ESAF programmes classified according to initial levels of indebtedness suggest that this merits much more research. When countries with a debt-to-GNP ratio of less than 80 per cent are compared with those with a higher ratio, there appears to be a stronger investment and export response to reforms in the former group. The difference in performance between more indebted and less indebted ESAF programmes is particularly marked for the period when terms of trade movements were positive (table 28). As with all exercises of this sort, the results are sensitive to the country composition of the groups. Ideally, the effects of initial indebtedness should be examined in relation to the concessionality of the debt, and thus in present value (PV) terms . Account must also be taken of the levels of transfers, for these can offset the crowding-out effects of the debt. However, these simple results do provide some limited empirical support for the notion that initial indebtedness affects the efficacy of policy reforms.

High levels of external indebtedness are likely to reduce the efficacy of economic reforms in various ways. First, a large external debt greatly complicates stabilization efforts. This is highlighted in the only document that seeks to set out theoretical underpinnings of the ESAF reforms (IMF, 1987). This

TABLE 28: INITIAL INDEBTEDNESS AND ECONOMIC PERFORMANCE OF THE LDCS BEFORE AND AFTER THE INITIATION OF SAF/ESAF PROGRAMMES

	3 years before the initiation	1st 3 years after the initiation	2nd 3 years after the initiation	1996–1998
Average annual growth rates (%)				
Real GDP per capita				
Low initial indebtedness[a]	0.23	0.37	-0.33	2.56
High initial indebtedness[b]	-3.56	-0.54	-2.02	1.14
Exports of goods and services (volume)				
Low initial indebtedness	3.37	4.30	7.86	13.12
High initial indebtedness	-2.09	6.55	0.29	5.69
Gross domestic investment (volume)				
Low initial indebtedness	1.89	-0.44	0.49	11.24
High initial indebtedness	-0.56	3.46	1.03	0.77
Average annual ratio (as % of GDP)				
Gross domestic investment				
Low initial indebtedness	17.2	20.1	21.2	22.1
High initial indebtedness	15.3	18.4	16.9	16.7
Gross domestic savings				
Low initial indebtedness	-4.0	-2.2	-1.7	3.0
High initial indebtedness	3.0	4.8	1.8	2.6

Source: UNCTAD secretariat estimates, based on World Bank, *World Development Indicators 2000* and *Global Development Finance 2000*.

a LDCs with initial debt stock ratio to GNP < 80%: Bangladesh, Benin, Burkina Faso, Burundi, Central African Republic, Chad, Haiti, Lesotho, Mozambique, Nepal, Uganda.

b LDCs with initial debt stock ratio to GNP > 80%: Ethiopia, Gambia, Guinea, Madagascar, Malawi, Mali, Mauritania, Niger, Togo.

analysis shows that external indebtedness serves to bring into conflict the two main elements of the stabilization process – expenditure reduction through cutting the fiscal deficit, and expenditure switching through devaluation of the domestic currency. Devaluation increases the proportion of income going towards meeting interest payments on external debt (of both the public and private sector), thereby reducing aggregate demand and contracting domestic output. Devaluation is also likely to increase the fiscal deficit in countries with a large public-sector external debt. This occurs the "when interest payments have become such a large proportion of government expenditures that their rise following a devaluation, together with the increase in the domestic-currency equivalent of other foreign-exchange components of government expenditures, outweighs the normally dominant increase in revenues resulting from the rise in domestic-currency equivalents of foreign grants and foreign trade taxes" (IMF, 1987: 45). The results of these developments "may be increased capital flight, which puts further pressure on the domestic currency (to depreciate further) and on domestic interest rates (to be pushed higher to combat capital flight)", and these secondary effects "tend to lead to further deterioration of the fiscal situation" (p. 45). This problem may also be further exacerbated by a "big bang" approach to adjustment in which financial and trade liberalization is undertaken along with stabilization. The rising interest rates associated with financial liberalization increase expenditure requirements on domestic debt, whilst the falling revenues from trade taxes associated with trade liberalization cut government revenue (Toye, 2000).

If the effectiveness of reforms intended to promote economic growth and external viability is undermined by external indebtedness in these ways, a vicious circle is likely to ensue... Both international creditor-donors and debtor countries are then caught in an aid-cum-debt trap.

Secondly, high levels of external indebtedness reduce the probability that structural adjustment will be investment-led. High levels of external debt constrain domestic investment in various ways. Debt service payments absorb foreign exchange and thus reduce capacity to import capital goods. As much of the external debt is owed by government, debt service payments also adversely affect government budgets, reducing domestically driven public investment in physical and human infrastructure. The debt overhang creates uncertainty for domestic and foreign investors. It adversely affects country credit ratings and perceptions of country risk, limiting the access of potentially profitable firms within indebted countries to international capital markets.

Thirdly, high levels of external indebtedness can have perverse effects on aid flows. These arise when aid allocations start to be influenced by levels of external debt (see section F below). Diversion of aid, either directly or indirectly, to service debts reduces its developmental effectiveness, compounding the negative effects of the external debt on stabilization and investment during the reform process.

If the effectiveness of reforms intended to promote economic growth and external viability is undermined by external indebtedness in these ways, a vicious circle is likely to ensue. On the one hand, high levels of indebtedness undermine aid effectiveness, including in particular the investment and export response to economic reforms. On the other hand, the low level of aid effectiveness and the weak response to reforms mean that progress to sustained growth and external viability is slow and indebtedness remains severe. Both international creditor-donors and debtor countries are then caught in an aid-cum-debt trap.

F. The aid-debt service system

1. Evidence and motivations

Negative effects of the external debt on aid arise if allocations of aid by official creditors are dependent on the size of debt service payments. That this is so has only recently been realized. But now a number of experienced analysts of the aid and debt problems of poor countries have pointed out the fact.

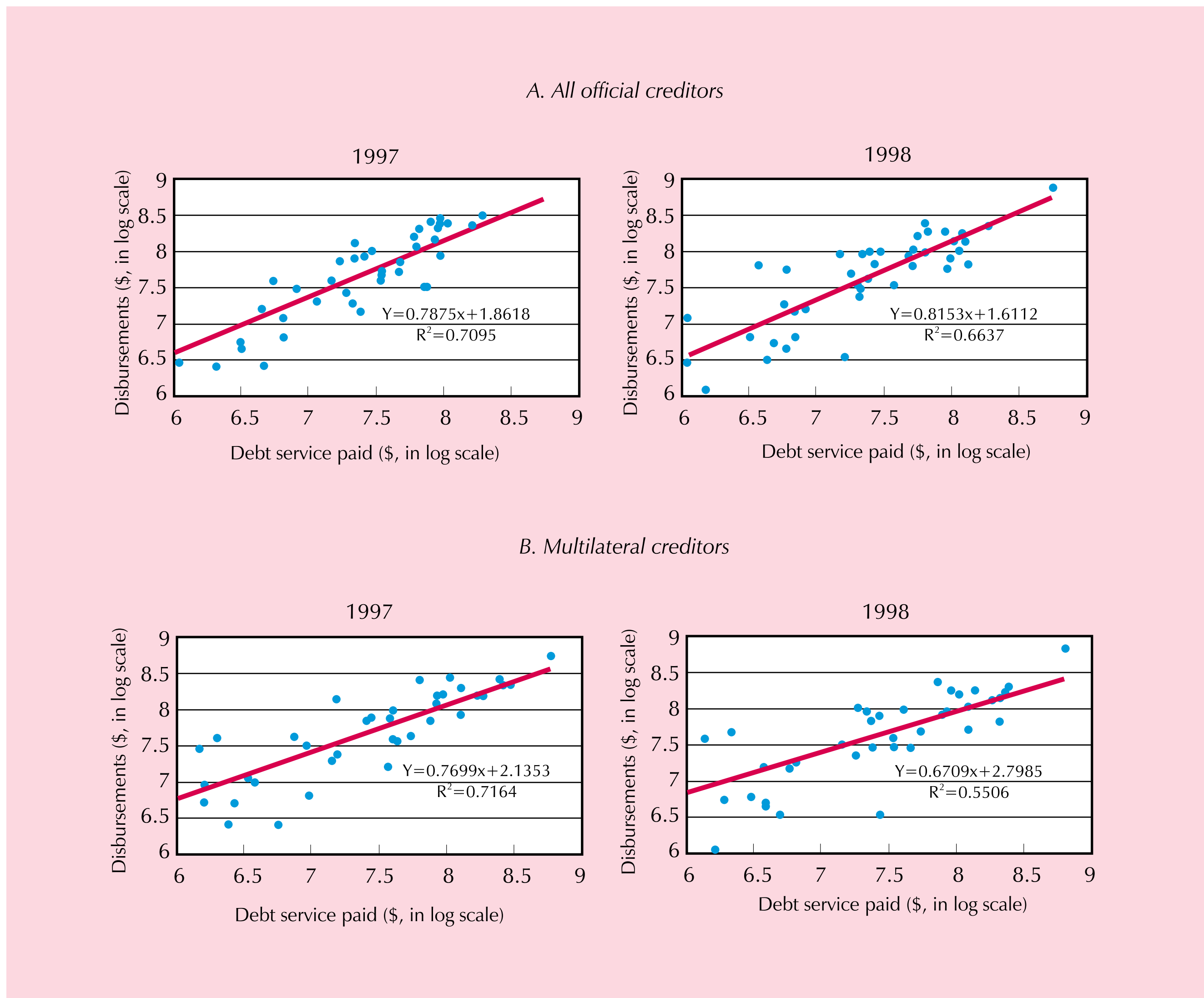
Thus, the former Director of the *World Development Report, 2000/2001* has recently written that "much of the aid inflows are motivated simply to ensure 'normal relations' with regular debt servicing… For their own reasons – to do with the institutional importance of avoiding certain types of balance sheet adjustments – the official donors, who are also the main creditors, are putting money in so that the debt can be serviced" (Kanbur, 2000: 688). Tony Killick, who was perhaps the first to highlight the system has written that: "Aid receipts are commonly treated by creditors as a government revenue item, permitting the servicing of more external debt than would otherwise be affordable. Creditor governments have been taking away with one hand what they have given with the other" (Killick and Stevens, 1997: 165). Moreover, Sachs, and his colleagues, speaking specifically of the HIPCs, describe the interrelated aid disbursements and debt service payments as "a complex shell game, in which large-scale debt servicing is very imperfectly offset by debt postponements, arrears, new loans and grants from donor governments" (Sachs et al., 1999: 5).

The more debt service payments a country has to make, the more official finance it receives.

Evidence for the extent to which the "debt-tail" has been wagging the "aid-dog" is apparent in the relationship between the geographical distribution of aid disbursements amongst LDCs and the geographical distribution of debt service payments. Both official and multilateral disbursements are highly correlated with total debt service, and multilateral disbursements are highly correlated with multilateral debt service (see Killick and Stevens, 1997; Birdsall, Claessens and Diwan, 2000). The more debt service payments a country has to make, the more official finance it receives (chart 42). This pattern has prevailed throughout the 1990s (table 29).

These patterns stem from a number of motivations. On the one hand, they reflect efforts to mobilize resources to support the economic reforms in countries facing debt problems. Until the HIPC Initiative also, the only way to respond to the growing multilateral debt-servicing difficulties of the clients of the World Bank and the IMF was to maintain a sufficient flow of new lending to debtor countries to ensure that they could continue to service past credits. This situation will continue until HIPC countries reach their decision point and start to receive interim assistance (see chapter V). The patterns also reflect "defensive disbursements" by creditors designed to ensure continued debt service of their own old loans, to avoid embarrassing arrears and to avert growing risks of documented development failure (Birdsall, Claessens and Diwan, 2000). Accounting reasons have also favoured the refinancing approach. Claessens et al. (1997a) note that "the upfront account loss resulting from a debt-reduction operation is likely to be much larger than the economic loss if the loan is still kept at face value or is otherwise overvalued on the creditors' books, and adequate or realistic loan-loss provisions have not been set aside" (p. 32). "In practice, some creditors", they note, "may be reluctant to grant debt forgiveness because they are unwilling or unable to take a large accounting loss. Also, explicit debt reduction may expose the extent of past imprudent lending decisions with adverse effects on the reputation of the creditor vis-à-vis borrowers and financial markets" (p. 32-33).

CHART 42: GROSS OFFICIAL DISBURSEMENTS TO, AND DEBT SERVICE OF, LDCS, 1997 AND 1998: ALL OFFICIAL CREDITORS[a] AND MULTILATERAL CREDITORS[a]



Source: UNCTAD secretariat calculations, based on World Bank, *Global Development Finance 2000.*
a Excluding IMF.

TABLE 29: STATISTICAL RELATIONSHIP BETWEEN OFFICIAL DISBURSEMENTS TO, AND DEBT SERVICE PAYMENTS OF, LDCS, 1990–1998

	All official creditors		Multilateral creditors	
	R-Square[a]	*T-statistic*[b]	*R-Square*[a]	*T-statistic*[b]
1990	0.77	11.70**	0.70	9.60**
1991	0.56	7.14**	0.58	7.42**
1992	0.82	13.35**	0.79	12.13**
1993	0.74	10.64**	0.69	9.30**
1994	0.71	9.67**	0.68	9.12**
1995	0.70	9.71**	0.45	5.74**
1996	0.73	10.45**	0.61	7.67**
1997	0.71	9.89**	0.72	9.93**
1998	0.66	8.77**	0.55	6.82**

Source: UNCTAD estimates, based on World Bank, *Global Development Finance 2000.*
a The R-square estimates the association between gross official (or multilateral) disbursements and official (or multilateral) debt service payments amongst LDCs (in log. scale). The sample is 40 to 42 LDCs depending on the year.
b ** Significant at 1% level.

2. Implications

The aid-debt service system reduces the developmental impact of aid for both highly and less severely indebted LDCs. For less indebted LDCs, the problem is that the geographical distribution of aid resources is skewed according to indebtedness rather than other criteria of potential and need. For the more heavily indebted LDCs, the problem is that the aid-debt service system acts to reduce the developmental impact of aid.[12]

The system reduces the developmental impact of aid because it subtracts from the level of aid resources available for developmental purposes, and it adversely affects the quality of aid. Subtractionality occurs directly through ODA grants being directly committed for debt relief. As indicated in chapter II, this was increasing in the 1990s. According to DAC information on ODA commitments, the proportion of grants going to debt relief rose from 2.7 per cent in 1992 to 14.1 per cent in 1998.[13] It also occurs through the direct contributions of bilateral donors to pay the arrears and current debt service of multilateral financial institutions. Taking a rather broad view of such diversion (which includes subventions to the Fifth Dimension Programme of the World Bank and IMF's Rights Accumulation Programme (RAP), contributions to balance-of-payments support for debt-related adjustment programmes, particularly through the Special Programme of Assistance for Africa, and subventions to ESAF and to IDA), the Commonwealth Secretariat has estimated that around $9 billion per year, which was nearly a quarter of bilateral aid to developing countries, was being diverted to debt relief through such channels in the early 1990s (Killick, 1995b). Finally, subtractionality occurs at the level of the debtor country as newly acquired external bilateral resources have to be employed for the service of external debt rather than for economic and social development purposes. A recent econometric analysis in 18 SSA countries over the period 1970-1995 found that 31 cents of every additional dollar of grants and concessional loans was used to finance principal repayments of foreign loans, and as much as 50 cents of every additional dollar of grants was used for the same purpose (Devarajan, Rajkumar and Swaroop, 1999).

The aid-debt service system reduces the developmental impact of aid because it subtracts from the level of aid resources available for developmental purposes, and it adversely affects the quality of aid.

The aid-debt service system not only reduces the resources available for developmental purposes but also adversely affects the developmental effectiveness of aid flows in various ways. The system may act as a disincentive to effective resolution to the debt problem because the better a country does in terms of reducing its debt service burden, the worse it is likely to do in terms of concessional flows of aid. Box 5 indicates with a simple numerical example how this can be part of the debt overhang effect, as all additional output benefits of

Box 5: A numerical example of the disincentives of the aid-debt service system

"A country owes official creditors $30 next period. Next period output will be $110, so in the absence of foreign aid, the resources available for consumption and investment would be $80. However, the country expects official creditors to provide foreign assistance (either in the form of grants or concessional loans) to prevent the country's resources from falling below the threshold value of $100. If creditors indeed behave as expected, foreign aid next period will be $20, and the country's net transfer of resources to official creditors will be $10 (the difference between the debt service payment and the aid inflow). The country has the opportunity to engage in an investment plan that will increase next period output by 10 per cent to $121. How would investment change the inflow of foreign aid? Output net of debt service payments would be $91, so foreign aid would fall to $100 - $91 = $9, instead of $20. The resources available for consumption and investment, on the other hand, would still be $100, so the indebted country would not benefit from investment. All the additional output obtained from investment goes to official creditors in the form of reduced assistance" (Claessens et al., 1997b: 242 – 243).

new investment go to official creditors in the form of reduced assistance. The system also creates uncertainty and undermines government capacity, a process which will be examined in much greater depth in chapter VI. Moreover, maintaining a given level of net transfers to a country involves high transaction costs associated with the continual negotiation of what proportion of scheduled debt payments will be serviced from the country's own resources.

Negotiations include: Paris Club and London Club agreements; accords with individual bilateral creditors, which are negotiated after an overall agreement with the Paris Club has been reached; discussion with IMF missions, which include annual consultation exercises, preparatory and negotiation missions for new programmes, and three-to-six-monthly review missions for programmes already in place; discussion with World Bank missions; negotiations with creditors outside the Paris and London Clubs, in particular the Governments of the former Eastern bloc countries and OPEC, and non-bank commercial creditors; Consultative Group preparations and meetings for ODA coordination (usually annual); and ODA negotiations with individual bilateral and other multilateral donors, such as regional development banks and UN agencies. There are unfortunately no estimates of all this activity in LDCs as a whole. But it has been estimated that the total number of negotiations of these types is 7,800 for 30 African Governments during the period 1980-1992, and updating this figure to 1997 would scarcely leave it below 10,000 (Killick and Stevens, 1997: 166). These negotiations make huge demands on senior staff and divert them from constructive analysis and implementation of policy options to servicing the informational and other requirements of the external creditors, thus effectively undermining efforts to increase ownership.

Maintaining a given level of net transfers to a country involves high transaction costs associated with the continual negotiation of what proportion of scheduled debt payments will be serviced from the country's own resources.

A further feature of the aid-debt service system is that for any given level of net transfers, countries are both "aid dependent", in the sense of the size of aid inflows in relation to economic activity, investment and imports, and highly indebted. The attempt to ensure that low-income countries receive a certain level of positive net transfers by increasing aid inflows to offset debt service payments, rather than by a straightforward upfront debt reduction, inevitably also increases the domination of capital formation processes in the debtor country by official creditor-donors.

Finally, "the ability to refinance nonperforming loans, thereby concealing the losses, may create a moral hazard problem on the creditor side" (Claessens et al., 1997a: 33). There is a marked contrast here with private commercial banking, where regulatory limits on banks' exposure to individual borrowers constrain the use of a refinancing strategy to deal with a debt problem. The effect of a refinancing strategy is to insulate official creditors from the full effect of their lending mistakes. This applies particularly to the international financial institutions, whose preferred creditor status has allowed them to make loans in the knowledge that if things do not work out and the sums invested do not yield positive returns they will get their money back anyway.

G. Conclusions and policy implications

This chapter has three main findings. First, in spite of problems of implementation, many LDCs have undertaken significant policy reforms during the 1990s, particularly trade liberalization, pricing and marketing reform, and the creation of a policy regime favourable to FDI. The national policy environment at the end of the 1990s in many LDCs is thus very different from

that at the end of the 1980s. It has moved decisively in the direction of economic liberalization.

Secondly, the key mechanism by which ESAF programmes work has been through the expansion of production and consumption possibilities, which occurs when foreign exchange constraints are lifted and import compression is eased as grants and concessional loans are increased, or relief on scheduled debt service payments is provided. Repairing gross macroeconomic distortions related to the real exchange rate and reducing inflation also creates a positive enabling environment for increased production, and this process has been greatly facilitated when the global market developments for key exports have been positive. But structural reforms have not taken sufficient account of structural constraints, the small indigenous entrepreneurial class and weaknesses of market institutions, which all impede a positive response to private incentives. Moreover, high levels of external indebtedness undermine the effectiveness of reforms through debt overhang effects on both debtor countries and the international creditor-donor community.

Thus – and this is the third main conclusion – although significant policy changes have been made in many LDCs, the new policy environment does not deliver sufficiently high growth rates to make significant inroads into poverty except where the external trade environment is favourable and reforms are adequately or stably financed. In those countries and periods where economic growth has accelerated, the sustainability of growth is questionable as it depends on the continuation of positive global developments and sustained high levels of concessional finance.

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The recent experience of African LDCs shows that some degree of adjustment can certainly take place without much new investment (UNCTAD, 1998: 166–171). As incentive structures change, small-scale producers, particularly in peasant agriculture, can switch resources between different activities, and there can also be a positive "vent-for-surplus" effect as land and labour resources which were previously underutilized are brought into production. But it is clear now that there is a limit to this process. Without the necessary finance, adjustment can be driven by intensified self-exploitation of all the family driven by pressing minimal consumption needs, as much as by improved incentives. Cheaper imports and less government regulation catalyse a flourishing informal sector. But businesses in this sector are not automatically going to become internationally competitive exporters, and the best domestic firms which might be able to do so fall far short of internationally realized productivity levels, and thus when exposed to sudden liberalization can face bankruptcy.

The disappointing results of economic reforms in low-income countries, and their questionable sustainability, have already prompted an international policy response to adjust the reform process. The principal elements of this response are: (i) tightening the links between aid flows and economic reform, and between debt relief and economic reform ("selectivity"); (ii) altering the design of economic reforms to ensure that they are more pro-poor; and (iii) shifting from a donor-driven to a country-owned reform process ("partnership and ownership"). The nature and potential effectiveness of these changes will be treated in more detail in the next two chapters. However, a major policy implication of this chapter is that making the existing reforms more pro-poor by changing the pattern of public expenditure and by ensuring that increased social spending is not inflationary will not get to the heart of the problem. The challenge is boldly to redesign adjustment programmes in such a way that they

will promote a sustained acceleration of economic growth to rates at which significant inroads can be made into poverty.

There are two basic policy requirements for this. First, a much more pragmatic approach needs to be adopted in the design of structural reforms. Second, adjustment programmes need to be adequately funded in ways which take account of the vulnerability of LDC economies to shocks and the social stresses which they entail.

Analysis of successful development experiences shows that sustained and accelerated economic growth is built on the development of productive capacities and international competitiveness, and on a structural transformation away from a narrowly specialized primary commodity economy. Success depends on establishing a virtuous circle between the growth of investment, exports and savings. In this process, exports support investment because they earn foreign exchange required for the import of goods and technology needed for capital accumulation and growth, while investment supports exports by providing the basis for technological change, productivity growth, increased competitiveness and structural change. As incomes and profits are raised through investment, they increasingly provide additional resources for capital accumulation (UNCTAD, 2000). Poverty reduction occurs as an integral part of the circle of cumulative causation if employment opportunities expand rapidly, although the poverty-reducing effects of growth are less in high-inequality countries than in low-inequality ones. Policy efforts are required in order to strengthen these effects by ensuring wide access to assets and by creating linkages which incorporate marginal sectors into the space of productivity growth.

The challenge is boldly to redesign adjustment programmes in such a way that they will promote a sustained acceleration of economic growth to rates at which significant inroads can be made into poverty.

It is well understood that such a sustained process of economic growth and poverty reduction is best realized by providing a greater role for market forces and private initiative. However, leaving growth to market forces without adequate attention to the shortcomings in markets, institutions and infrastructure in LDCs is not going to do the trick. A pragmatic approach to the design of structural reforms is thus required. Such an approach would seek a better balance between public action and private initiative than that mandated under ESAF reforms.

This certainly does not mean a rush back to public ownership and isolationism. However, beneficial and sustained integration into the world economy will be best achieved if growth-oriented macroeconomic policies are complemented by specific meso policies designed to increase productivity and competitiveness at the enterprise level and to improve the enabling environment for enterprise.[14] The design of these measures should take advantage of the policy leeway which countries at low levels of development have, by right, within international trade regimes (see *Least Developed Countries 1998 Report*).

The nature of these measures has been discussed in more detail elsewhere (see in particular, UNCTAD, 1998, and Griffin, 1996, for sub-Saharan Africa; and *Least Developed Countries 1999 Report*: part two, chapter 3). But it may be reiterated here that higher levels of public investment are necessary in order to rectify deficiencies in physical infrastructure, to promote educational attainment and human capital development, and to address pressing public health problems and the weaknesses of current health care service systems. Public investment is also required in order to strengthen administrative capacities so as to increase the effectiveness of the public sector. Policies which increase agricultural investment and productivity growth are particularly important in the

Box 6: Foreign aid and export promotion in Bangladesh

Two important aid projects have been launched in Bangladesh to promote and diversify exports: the Export Development Project, and the Bangladesh Export Diversification Project. These projects exemplify some of the types of special incentives which are required to promote export development in LDCs.

The Export Development Project

The Export Development Project, which lasted from 1989 to 1994, primarily consisted of a credit line of a $25 million equivalent financed by the International Development Association (IDA) to augment the Government of Bangladesh's (GOB) contribution of $5 million in an Export Development Fund (EDF) managed by the Central Bank of Bangladesh. The project also included a technical assistance component of around a $1.2 million equivalent financed by a grant from the United States Agency for International Development (USAID). The overall objectives of the project were to assist the Government's efforts to promote exports by: (i) providing a line of pre-shipment foreign exchange credit to private sector exporters, particularly to new non-traditional exporters; (ii) strengthening the export financing and guarantee elements of the credit delivery system; and (iii) addressing policy and procedural issues which constrain the active development of Bangladesh's export potential.

Overall, the project achieved many of its objectives. The first objective mentioned above was realized, to a great extent, by setting up a revolving Export Development Fund (EDF) at the Central Bank with $3 million contributed by the Government of Bangladesh and into which the entire credit proceeds of the project were added. The cumulative utilization of around $75 million from the EDF by the non-traditional exporters financed more than $150 million non-traditional exports during the four and a half year period (January 1991–June 1995). The export financing system was strengthened by the setting up of the EDF, which provided exporters in the early 1990s with the only local source of foreign currency pre-shipment financing at internationally competitive rates. The second objective was only partially achieved, as the export credit guarantee system did not work efficiently. The project's third objective has also been achieved up to a point since institutional reforms need to be expanded and deepened further. Financing from the EDF provided the exporters with import finance in foreign exchange at an international market rate (LIBOR+1%), thereby putting them on an equal footing with their foreign competitors insofar as the cost of financing imports is concerned. Procedural improvements in the Duty Drawback Scheme were also achieved since the exporters could expect to receive their drawback cheques within a week for flat rates and within a month for actual rates.

Bangladesh Export Diversification Project

On the basis of the experience of the Export Development Project, and in an attempt to promote trade-related capacity building, a three-year IDA-aided *Export Diversification Project* (BDXDP), amounting to $48 million, has been launched. The project will also receive parallel financing from the British Department for International Development (DFID). The agreement was signed between IDA and the GOB on 1 June, 1999 and the project started operation on 1 August, 1999.

The project activities of BDXDP are grouped under two broad categories: product and market development support (PMDS) activities; and trade management capacity-building (TMCB) activities. The former comprises: funding through the *Matching Grant Facility* (MGF) for exporting firms, groups of such firms, and service providers (this will involve a total of $12 million); administration and advisory services for the operation of the above MGF (this will involve a total of $3.10 million); and developing new sub-projects to strengthen selected public, private and public/private support service providers (this will involve a total of $4 million). The latter consists of: institutional capacity-building, for example, reforms in customs administration, in conjunction with the Government's proposed Revenue Administration Modernization Programme (RAMP) for providing better bonded warehousing and duty drawback and more rapid clearance.

Given the innovative features of the Matching Grant Facility, this particular component of the BDXDP project requires special attention. Under the MGF, grants are available (on a 50 per cent cost-sharing basis) to (i) exporters of goods and services to increase their international competitiveness, and (ii) local service providers to enhance their capabilities. These grants are intended to enable exporters to undertake the appropriate level of market and product development efforts needed for attaining competitiveness resulting in increased exports and profitability. The focus of this programme is to induce exporters to buy expert services for diversifying their products and markets.

The MGF is yet to complete its first year of operation. Projects approved are closer to targets for export development grants than for service development grants, and thus some improvements in the efficiency of the customer advisory team dealing with clients of the facility are warranted. However, this type of assistance programme has yielded high returns for exporters in other countries such as Argentina, India, Indonesia, Ireland, Uganda and the United Kingdom, and promising results are expected in Bangladesh as it seeks to diversify exports.

Source: Bhattacharya, 2000.

LDCs, and from the Asian experience, it is apparent that there can be a large pay-off in terms of both output growth and poverty reduction from promoting a Green Revolution in African LDCs (Mosley, 2000). But manufacturing or service sector development should not be neglected. In this regard, there is wide agreement that the spur of competition will have the desired results only if there are complementary measures which enable the improvement of technical and managerial capabilities, and special incentives and financing facilities may have to be created to develop new export activities (see box 6). In economies where markets are weakly developed, there is a strong case for targeted and time-limited fiscal and financial incentives to address specific market failures, and in particular to promote market development (Overseas Economic Cooperation Fund, 1990), as Japanese development policy analysts have been advocating for a long time. Recent work by the International Finance Corporation on a market-oriented strategy for small and medium-scale enterprises provides a theoretical case for, and limits to, subsidies for market development for the business services which form the support structure that helps build SME competitiveness (Hallberg, 2000).

It seems highly likely that the removal of the debt overhang from the official creditor-donor community is as important for successful structural adjustment and enhanced aid effectiveness as the removal of the debt overhang from the debtor countries themselves.

Pragmatic adjustment policies will not be successful unless they are adequately funded. This is a matter of the volume of external resources, how they are delivered (which will be discussed in chapter VI), and also the purposes to which resources are tied. From the evidence of this chapter, the bias towards underfinancing which results from the tension between projections of minimum resource requirements and creditor-donors' resource ceilings, together with the political impossibility of having an underfunded adjustment programme, creates misleading expectations for the public and private sectors and has worked against the effectiveness of adjustment programmes.

Finally, it is important that adequate funding of structural adjustment programmes takes account of the debt overhang and the net transfers associated with aid disbursements and debt service payments. The ways in which the interrelationship between aid disbursements and debt service payments affect aid effectiveness deserves much more research. But for now, it seems highly likely that the removal of the debt overhang from the official creditor-donor community is as important for successful structural adjustment and enhanced aid effectiveness as the removal of the debt overhang from the debtor countries themselves.

Notes

1. See UNCTAD (1989) for an overview of LDCs' experience with structural adjustment in the 1980s.
2. There is a much wider literature on structural adjustment. Particularly relevant for African LDCs are UNCTAD (1998), Griffin (1996), and Mkandawire and Soludo (1999), and for Asian LDCs, ESCAP (1990). There is also now a growing literature on ESAF reforms in academic journals; see, in particular, Green (1993); Killick (1995a); Schadler (1995); EURODAD (1998); Rivas and Morrison (1999); Collier and Gunning (1999); Comboni (1999); and Dicks-Mireaux, Decagni and Schadler (2000). Other IMF documents which evaluate the ESAF reforms are Abed et al. (1998) and Gupta et al. (2000).
3. The origins of the SAF and ESAF can be traced to the Baker Plan, announced in October 1985. This mainly dealt with the debt problems of middle-income countries, but it also included a short special section on dealing with the debt of low-income countries in SSA. Partly as a response to this, the IMF's SAF and ESAF were introduced.
4. The list of ESAF programme countries is set out in the "Status report on the follow-up to the reviews of the Enhanced Structural Adjustment Facility", 30 August, 1999 (http://www.imf.org/external/np/esaf/status/index.htm).
5. We are grateful to the IMF for furnishing this information.
6. For debt statistics in the 1990s, see chapter 2, tables 17 and 18.
7. The close relationship between ODA flows and ESAF reforms is also noted in IMF (1995). It is observed that "Within the group of low-income countries, in particular, bilateral ODA to countries pursuing IMF-supported adjustment programs grew more rapidly than to those countries without such programs. For example, the 41 ESAF-eligible countries with IMF arrangements completed between 1990 and 1993 experienced a 35 percent increase in bilateral net ODA on average from the period between 1987 and 1989 to that between 1990 and 1993 compared with an increase of 6.5 percent for ESAF-eligible countries without IMF arrangements. Some countries pursuing IMF-supported programs recorded remarkable increases in net ODA flows – for instance, Uganda completed three annual ESAF arrangements before the end of 1993 and received almost twice the level of ODA flows on average between 1990 and 1993 compared with the average for the period between 1987 and 1989" (IMF, 1995: box 14, p. 34).
8. This result also conforms to econometric analysis which shows that the presence of an ESAF programme has been found to have had no significant effect on private capital flows (Rodrik, 1995, quoted in IMF, 1998: 32).
9. For a useful discussion of growth sustainability in Africa, see ECA (1999).
10. For a case study of the juggling of the financing gap by adjusting projections to fit the available finance, see Martin (1991: 61–66). Killick (1993:10), writing specifically on IMF programmes in Africa, states that "a good many of the agreed programmes are unrealistic, fated to break down because of underfunding and shortages of foreign exchange. A former head of the key Exchange and Trade Relations Department of the IMF has stated privately that up to a third of programmes are inadequate and doomed from the start". Mistry (1996: 37) reports that "IMF/WB financing programming exercises underlying individual adjustment programmes were invariably recalibrated by making casual changes in elasticities when calculations of funding needs collided with the reality that these funds could not be mobilized", citing research in Martin and Mistry (1994; 1996).
11. UNCTAD (1998) and Helleiner (1992). One of the background studies for the IMF internal evaluation analyses, which seeks to isolate the sources for the narrowing of the growth differential between ESAF and non-ESAF countries for the period 1981–1995, finds that "over two-fifths of the narrowing in the actual growth differential over the past decade [to 1995] was attributable to improvements in macroeconomic policies" (Kochhar and Coorey, 1999: 84).
12. See Martin (1997) for a good discussion of these effects.
13. In theory, this type of aid should reduce debt service outflows and thus have equivalent effects on net transfers as aid inflows. However, grants committed to debt relief may apply to debt service payments which are not actually being made and are simply accumulating as arrears. If this occurs, grant commitments in the form of debt forgiveness do not necessarily free resources which can be used for more imports, and if these commitments substitute for forms of ODA which do increase import capacity, then the net effect can be smaller imports. Research for African countries in the early 1990s suggests that such a decline in imports did not actually occur in countries receiving this form of aid. But this was not because the mechanism described was not in operation. Rather, countries in which debt forgiveness accounts for a high proportion of grants were tending at the same time to obtain additional resources from multilateral

sources. They were thus able to finance a larger import bill "mainly because multilateral sources have made up for the decrease in new financing from bilateral sources, which in turn are partially substituting debt relief for new lending" (Hernandez and Katada, 1996: 20). Further research will be required in order to clarify whether such a mechanism continued in the late 1990s, and in non-African LDCs, but there is little reason to believe that any change occurred.

14. On the importance of meso policies, see Ocampo (1999).

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Debt relief, the new policy conditionality and poverty reduction strategies

Chapter 5

A. Introduction

In spite of extensive policy reforms, rates of external indebtedness increased in many LDCs during the 1990s, and according to World Bank calculations, 28 LDCs - including two-thirds of LDCs that are not island economies – are entering the new millennium with levels of external indebtedness that are unsustainable even after the full deployment of traditional (pre-HIPC) debt relief mechanisms. One of the arguments of the last chapter was that the effectiveness of reforms in LDCs depended on the severity of their debt problems. This chapter assesses from the point of view of LDCs the effectiveness of the HIPC Initiative, which was introduced in 1996 as a new mechanism to deal with the debt problems of low-income countries. It addresses five questions:

1. How have the mechanisms, modalities and conditionalities of debt relief changed for LDCs with the introduction of the HIPC Initiative? (sections B and C);
2. What is the reach of the HIPC Initiative, and what are the financial costs for creditors and the financial benefits for LDCs? (section D);
3. Does the HIPC Initiative offer LDCs debt sustainability in the medium and long term? (section E);
4. To what extent can the Initiative contribute to poverty reduction in LDCs? (sections F and G);
5. What are the policy implications of the analysis in this chapter? (section H)

Particular attention is paid to the transformation of the IMF's ESAF into the Poverty Reduction and Growth Facility (PRGF), the introduction of the Poverty Reduction Strategy Papers (PRSPs), and associated changes in policy conditionality (sections C and G). It is the HIPCs, including HIPC LDCs, that are setting the pace in the implementation of these new policy mechanisms. But the PRGF and PRSP have much wider significance than for HIPC LDCs alone. The PRGF now will act as the gatekeeper mechanism for access to concessional finance, as well as debt relief, in all low-income countries, and the PRSP is intended as the framework for better aid coordination. As the OECD (OECD, 2000: 21) has insightfully and succinctly put it, "The decision to place the implementation of the enhanced HIPC into the larger context of the new development partnership paradigm has in effect leveraged political support for debt relief into a reform of the whole concessional financing system".

Almost three quarters of all HIPCs (30 out of 41) are currently LDCs, and the HIPC problem is rapidly becoming a LDC problem exclusively.

It must be stressed at the outset that the HIPC Initiative is targeted at poor countries, rather than LDCs as such. But it is a vital component of the international enabling environment for future growth and poverty reduction prospects for those 30 LDCs that are HIPCs. Moreover, the manner of the financing of the HIPC Initiative, if it reduces resources available for aid, particularly through IDA, could have important implications for LDCs that are not HIPCs. Finally, it is important to note that almost three quarters of all HIPCs (30 out of 41) are currently LDCs, and that the HIPC problem is rapidly becoming an exclusively LDC problem. After the end of 2000, if the schedule of

implementation set by the international community stays on track, all except two of the HIPCs that have not reached their decision point will be LDCs.

B. Traditional debt relief mechanisms and the HIPC Initiative

Since the mid-1970s, the international community (including Paris Club creditors, non-Paris Club bilateral and commercial creditors, and multilateral institutions) has introduced and implemented a variety of instruments to deal with the debt problems of developing countries. In middle-income countries, where most of the debt was owed to commercial creditors, a resolution of the debt problem of the 1980s was achieved following the financial innovation of the Brady Plan (conversion of debt into bonds, with a discount). The debt relief process in these cases was informed by market valuations of the probability of debt repayment, together with hard-headed calculations of the returns which had already been realized on outstanding debts.[1]

In contrast, the debt relief process in low-income countries, where most of the outstanding debt was lent or guaranteed by Governments and owed by Governments, has been founded upon a complex intergovernmental process. Creditors, hedged in by the different degrees of freedom which diverse national legal and public accounting practices give them, have sought to recoup as much of their original loans as possible and to ensure that the burden of debt relief is fairly shared among themselves.

1. Traditional debt relief mechanisms

The major traditional (pre-HIPC) mechanisms of debt relief for LDCs have been: (i) rescheduling of principal and interest payments with Paris Club creditors on either concessional or non-concessional terms, most generally without extinguishing any of the debt stock; (ii) the pursuit of comparable terms from non-Paris Club creditors; (iii) forgiveness of bilateral ODA debt by converting concessional loans into grants; (iv) reduction of commercial debt through the IDA Debt Reduction Facility; and (v) special programmes supported by bilateral donors to enable debtor countries to meet multilateral debt service obligations, notably the “fifth dimension” programme of the World Bank, which was introduced in 1988 to enable IDA-only countries to repay interest on past IBRD loans, and the Rights Accumulation Programme of the IMF, introduced in 1991 to enable countries to clear arrears to the IMF.[2] In addition, as indicated in chapter 4, debt relief has also taken the form of new concessional financing.

Most LDCs have taken advantage of the traditional debt relief mechanisms to alleviate their debt burden.

Most LDCs have taken advantage of these opportunities to alleviate their debt burden. Many have been granted debt forgiveness on at least part of their ODA debt. Between 1978 and 1986, 33 LDCs benefited from retroactive terms adjustment measures provided by 15 DAC countries, for an overall nominal value of $4.1 billion, of which $3 billion was in the form of debt cancellation (UNCTAD, 1986: 128-134). Between 1988 and 1998 almost all LDCs benefited, and total debt forgiveness according to statistics on grant commitments has a face value of $ 7.2 billion (table 30). The number of Paris Club reschedulings in the 1990s (51) was somewhat lower than during the period 1980-1989, which was 70, but the amount of debt consolidated was, at $14.1 billion, higher than in the former period (table 31). Twenty-two LDCs undertook Paris Club reschedulings in the 1990s, and most of these countries

TABLE 30: OFFICIAL BILATERAL DEBT FORGIVENESS GRANTS TO LDCs, 1988–1998
($ millions)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	Total (1988–98)
Afghanistan	-	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	**0.7**
Angola	-	-	4.3	-	2.4	-	-	63.7	13.9	13.7	11.4	**109.2**
Bangladesh	-	1.5	2.4	298.2	6.5	3.7	16.4	3.8	6.0	151.6	189.0	**679.0**
Benin	-	2.9	5.0	20.8	51.5	3.9	5.3	6.4	6.1	15.5	10.6	**127.9**
Burkina Faso	-	8.1	8.5	14.3	12.1	12.7	19.2	14.0	22.9	6.2	19.7	**137.8**
Burundi	-	2.4	10.2	6.5	7.0	7.4	7.9	8.6	9.6	0.6	8.7	**68.9**
Cambodia	-	0.0	-	-	-	-	11.1	-	-	-	-	**11.1**
Cape Verde	-	0.0	0.4	0.6	0.7	0.6	0.7	0.7	0.7	-	0.7	**5.2**
Central African Republic	-	2.1	3.0	4.6	6.7	8.0	18.4	17.4	19.4	0.1	14.2	**94.0**
Chad	-	0.5	2.1	2.9	3.8	3.3	4.0	8.8	6.5	0.4	8.5	**40.7**
Comoros	-	0.2	0.9	1.1	1.1	1.2	1.7	1.7	1.9	0.0	2.7	**12.5**
Dem. Rep. of the Congo	-	3.7	32.8	274.0	7.7	8.5	18.3	20.8	17.0	5.5	12.8	**401.0**
Djibouti	-	0.7	2.6	2.6	2.8	2.6	2.7	3.0	3.0	-	2.5	**22.3**
Equatorial Guinea	-	-	-	-	-	-	-	0.6	0.6	-	2.4	**3.5**
Eritrea	-	-	-	-	-	-	0.0	-	-	-	-	**0.0**
Ethiopia	0.1	0.3	0.4	0.3	68.1	0.2	42.2	13.7	1.4	10.8	34.6	**172.1**
Gambia	3.0	1.0	2.5	2.4	2.3	2.1	2.3	2.6	2.4	0.2	2.0	**19.9**
Guinea	-	40.6	6.9	11.0	13.9	17.2	15.8	26.0	22.8	4.0	50.0	**208.2**
Guinea-Bissau	-	0.3	0.1	0.1	0.1	0.1	1.6	12.6	7.0	4.7	5.3	**31.8**
Haiti	-	-	-	99.0	-	-	16.3	46.6	8.8	-	4.5	**175.3**
Lao People's Dem. Rep.	-	-	-	-	-	-	0.3	-	35.1	2.5	3.7	**41.7**
Lesotho	-	0.0	0.0	0.0	-	-	0.1	0.1	0.2	-	0.3	**0.6**
Liberia	-	0.7	0.8	0.8	0.9	0.8	0.6	0.6	0.5	-	0.5	**6.1**
Madagascar	0.0	3.9	152.4	74.2	23.6	26.4	40.8	45.7	44.1	135.1	220.6	**766.8**
Malawi	-	2.9	2.0	19.0	2.7	2.2	2.2	6.3	11.2	13.4	15.0	**76.8**
Mali	0.1	0.1	4.6	7.1	7.7	8.4	24.6	12.3	30.0	1.3	18.3	**114.4**
Mauritania	-3.3	56.1	3.0	4.5	4.7	6.3	7.9	9.5	8.3	3.2	7.6	**111.1**
Mozambique	20.5	19.7	44.1	153.7	168.0	33.5	39.9	255.6	55.0	81.3	208.6	**1 059.4**
Myanmar	-	-	-	-	-	-	1.5	-	1.9	49.6	49.7	**102.7**
Nepal	-	0.2	0.2	0.2	0.2	0.2	0.2	-	0.9	9.1	19.9	**31.1**
Niger	-	1.9	10.1	12.0	9.0	8.0	29.2	17.6	21.1	1.4	33.0	**143.3**
Rwanda	-	0.9	3.3	3.1	3.6	4.8	6.6	7.3	10.9	4.1	22.5	**67.2**
Samoa	-	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-	-	-	**0.1**
Sao Tome and Principe	-	-	-	-	-	-	-	1.0	1.8	3.7	2.5	**9.0**
Sierra Leone	-	8.3	1.3	1.2	1.1	96.4	6.4	8.2	3.3	4.1	0.2	**130.6**
Somalia	-	7.3	1.7	1.8	2.0	2.3	2.8	3.1	3.3	-	4.1	**28.3**
Sudan	0.3	24.2	1.7	1.8	0.8	0.6	3.4	3.8	3.8	0.6	5.3	**45.9**
Togo	-13.5	9.1	5.0	12.4	5.3	5.5	16.8	40.2	24.3	3.5	24.9	**146.8**
Uganda	-10.0	0.9	13.1	17.4	3.0	0.8	1.5	35.1	30.2	21.0	16.6	**139.6**
United Rep. of Tanzania	27.5	20.0	61.4	112.8	0.8	256.1	7.5	35.9	11.4	25.3	190.2	**721.4**
Vanuatu	-	-	-	-	-	-	0.6	-	0.7	-	0.6	**1.9**
Yemen	2.4	-	-	0.2	0.2	0.2	7.4	4.0	14.6	26.1	29.2	**81.9**
Zambia	3.2	-	355.6	79.5	78.8	139.6	35.1	60.3	74.0	87.4	111.3	**1 021.5**
Total LDCs	**30.2**	**220.8**	**742.3**	**1 240.3**	**499.2**	**663.5**	**418.9**	**797.5**	**536.4**	**686.0**	**1 364.2**	**7 169.0**

Source: UNCTAD secretariat estimates, based on OECD/DAC database.

TABLE 31: PARIS CLUB DEBT RESCHEDULINGS WITH OFFICIAL CREDITORS, 1980–1998: LDCS

Country	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	Amount consolidated ($ million)			Total number debt reschedulings		
																				80-89	90-98	80-98	80-89	90-98	80-98
Angola										365										365	-	365	1	-	1
Benin										199		116		37			20			199	173	372	1	3	4
Burkina Faso												53		36			64			-	153	153	-	3	3
Cambodia																258				-	258	258	-	1	1
Central African Rep.		28		15		17			39		11				30				23	99	64	163	4	3	7
Chad										33						24	n.a			33	24	57	1	2	3
Dem. Rep. of the Congo		276		1417		385	425	740		1602										4845	-	4845	6	-	6
Equatorial Guinea						44				12			32		51					56	83	139	2	2	4
Ethiopia													371					184		-	555	555	-	2	2
Gambia							19													19	-	19	1	-	1
Guinea							232			161			169			163		123		393	455	848	2	3	5
Guinea-Bissau								24		40						150				64	150	214	2	1	3
Haiti																117				-	117	117	-	1	1
Liberia	21	24		18	13															76	-	76	4	-	4
Madagascar		172	107		389	141	181		236		111							1247		1226	1 358	2 584	6	2	8
Malawi			26	15					43											84	-	84	3	-	3
Mali									48	33			107				33			81	140	221	2	2	4
Mauritania						40	36	39		66				211		72				181	283	464	4	2	6
Mozambique					317			429			739			343			664			746	1 746	2 492	2	3	5
Niger				37	44	48	34		34+57		151				194		128			254	473	727	6	3	9
Rwanda																			54	-	54	54	-	1	1
Sierra Leone	39				88		65						276		47		39			192	362	554	3	3	6
Somalia						126		95												221	-	221	2	-	2
Sudan			211	546	231															988	-	988	3	-	3
Togo		120		125	67	25			118	82	101		50			246				537	397	934	6	3	9
Uganda		63	16					102		86			172			110			148	267	430	697	4	3	7
Utd. Rep. of Tanzania							676		236		245		779					1 608		912	2 632	3 544	2	3	5
Yemen																	113	1 444		-	1557	1 557	-	2	2
Zambia				302	263		355				1 174		874				566			920	2 614	3 534	3	3	6
Amount in $millions	60	683	360	2 475	1 412	826	2 023	1 429	811	2 679	2 532	169	2 830	627	322	1 140	1 627	4 606	225	12 758	14 078	26 836			
Total number of LDCs	2	6	4	8	8	8	9	6	7	11	7	2	9	4	4	8	9	5	3						

Source: World Bank, *Global Development Finance 2000*; Official debt restructuring (Paris Club Agreed Minutes).

were returning to reschedule their debts again. By 1998, 12 LDCs had gone to the Paris Club five or more times to restructure their debts, and 21 out of the 29 LDCs which had ever undertaken such rescheduling had, by the end of the 1990s, done so three or more times. Ten LDCs benefited from commercial debt reduction through the IDA Debt Reduction Facility. The total commercial debt extinguished in debt buy-back operations in LDCs through that Facility was equivalent to $0.62 billion. The debt was bought back for 8 - 13 cents for every nominal dollar in LDCs (table 32).

Although these "traditional" debt relief mechanisms have alleviated the debt burden of many LDCs, their deployment proved unable to engineer a durable exit from their debt problems. In deciding on the scale of debt relief which they provide, the question for creditors has been "What is the minimum amount of relief that must be granted to debtors such that the remaining debt-service burden can be paid without recourse to further relief?" (Killick and Stevens, 1997: 154). There has been a persistent tendency to underestimate what has been needed, which has in itself contributed to the build-up of the debt. The Paris and London Club reschedulings for most of the 1980s were on non-concessional "standard terms" with relatively short grace periods (five years) and maturity (ten years), and market-related interest rates. This inevitably led to repeated reschedulings and growth of the stock of debt.[3] The international community introduced the principle of concessional rescheduling in October 1988 with the "Toronto terms", and then progressively increased the percentage reduction in future debt service obligations on eligible debt with the introduction of "London terms" in December 1991, "Naples terms" in January 1995 and "Lyons terms" in 1998.

There has been a persistent tendency to underestimate what has been needed, which has in itself contributed to the build-up of the debt.

TABLE 32: IDA DEBT REDUCTION FACILITY: SUMMARY OF COMPLETED OPERATIONS IN THE LDCS
(*$ millions*)

Date completed	Country	Principal extinguished (*$ millions*)	Price (*Cents per dollar*)[a]	Interest extinguished (estimates) (*$ millions*)	Total debt (incl. interest) extinguished/GDP (*%*)
March 1991	Niger	107	18	100	9
December 1991	Mozambique	124	10	74	14
February 1993	Uganda	153	12	24	5
August 1994	Sao Tome	10	10	..	20
September 1994	Zambia	200	11	208	13
September 1995	Sierra Leone	235	13	51	30
January 1996	Ethiopia	226	8	58	5
August 1996	Mauritania	53	10	36	8
December 1997	Togo	46	13	29	5
Total		**1 154**	**12**[b]	**580**	**9**[c]

Source: World Bank, www.worldbank.org/hipc/progress-to-date/progress-to-date.html.

Notes: Up to end of December 1998.
a Of original face value of principal.
b Weighted by principal extinguished.
c Weighted by GDP.

2. The innovations of the HIPC Initiative

The HIPC Initiative widens the coverage of the types of debts which are eligible for relief to include multilateral debt.

The HIPC Initiative is a further extension of this process, which innovates in three important ways. First, it widens the coverage of the types of debts which are eligible for relief to include multilateral debt. This is the critical shift, since it recognizes the need for a formal mechanism of multilateral debt relief. Before the HIPC Initiative, the only way in which the World Bank and the IMF could respond to the growing debt-servicing difficulties of some of their clients was through provision of new financing, i.e. maintaining a sufficient flow of new lending to debtor countries to ensure they could continue to service past credits. Multilateral debt has become increasingly important to LDCs, constituting over 60 per cent of long-term debt (including use of IMF credit) in 1998 in half of the LDCs for which information is available. (see chapter 2, table 17)

Secondly, the Initiative sets an explicit target for debt sustainability, and provides a commitment to the HIPCs that if traditional debt relief mechanisms cannot bring their debts down to a level at which they are sustainable, additional action will be taken by the international community to do so. A country can be considered to have achieved external debt sustainability "if it is expected to be able to meet current and future external debt-service obligations in full without recourse to debt relief, re-scheduling of debts, or accumulation of arrears, and without unduly compromising growth" (Boote et al., 1997: 126). But a central question is the criteria which are used to decide the target for debt sustainability. The lower the target, the greater the likelihood that there will be a durable exit for the indebted country, but the greater the costs will be for the creditors.

An important innovation of the HIPC Initiative is that new sources and mechanisms for financing debt relief were introduced.

Within the HIPC Initiative, the target for debt sustainability is set as a threshold ratio of the present value (PV) of debt to exports or to government revenue.[4] The present value is a measure of the value of a country's future debt service obligations which is calculated within the HIPC Initiative by discounting the future debt service flows at the commercial interest reference rate (CIRR). This is calculated for each country at a particular moment in time, and then an estimate is made of by how much a country's future debt service obligations have to be reduced in order for the debt to be sustainable. The maximum ratio of PV debt to exports considered sustainable was initially set at 200 – 250 per cent, but with enhancements of the Initiative announced at the G-8 Cologne Summit in June 1999, these were lowered to a fixed level of 150 per cent. The maximum sustainable level for the ratio of the PV debt to fiscal revenue was also lowered – from 280 to 250 per cent – and the thresholds required to qualify for HIPC assistance under this criterion were lowered from 40 to 30 per cent in the case of the export-to-GDP ratio, and from 20 to 15 per cent in the case of the revenue-to-GDP ratio. Creditors are expected to share the reduction in the future debt service obligations required to bring the PV debt-to-exports and debt-to-revenue ratios down to sustainable levels according to their share of the present value of the debt at the decision point. But they can choose how to provide their share of the reduction in future debt service obligations. Debt relief is distributed on future maturities of the loans, and it may take up to 20 years or more before the relief has finally been delivered.

Thirdly and finally, an important innovation of the HIPC Initiative is that new sources and mechanisms for financing debt relief were introduced. These include IMF gold sales, enabling the World Bank and other multilateral institutions to use some of their own resources, and the setting up of the HIPC Trust Fund to which bilateral donors may contribute to help the multilateral institutions provide debt relief.

C. The new policy conditionality

1. The nature and scope of policy conditionality

The HIPC Initiative was introduced in 1996, but as indicated above, enhanced in 1999. This continued the pattern of the 1980s and early 1990s whereby creditors progressively realized the inadequacy of past debt relief mechanisms. Details of the enhancement are set out in *The Least Developed Countries 1999 Report* (pp.30-34), but in brief it entailed setting lower debt sustainability targets (see above), fixing the magnitude of debt relief which creditors will deliver in the future at the time of the decision point, providing interim assistance between the decision point and completion point (at which latter point debt relief would be irrevocably committed), and increasing the flexibility in the timing of the completion point. Also, the Paris Club agreed to increase the concessionality of its relief on eligible debt ("Cologne terms").[5]

With the enhancement of the HIPC Initiative, there is more debt relief on offer. But equally, there has been a significant change in the nature and extent of conditionality attached to debt relief. In HIPC I, a country had to establish a three-year track record of good performance under an ESAF programme before it reached decision point, and was expected to follow with a further three years of ESAF-based economic reforms before it reached completion point, after which point debt relief was provided unconditionally and irrevocably. In HIPC II, a country still has to establish a three-year track record of good performance under IMF- and World Bank-supported adjustment programmes before the decision point (chart 43). But the completion point is "floating" in the sense that it can be reached in less than three years if a country can implement reforms which would normally be expected to take three years in less time, and conversely later, if they take longer. Moreover, the achievement of the completion point is conditional on a track record, which encompasses, firstly, appropriate macroeconomic policies in place, and "a macroeconomic position conducive to sustainable growth and poverty reduction", indicated by low inflation, a fiscal policy consistent with a low and sustainable level of bank financing and an adequate reserve cushion; secondly, the implementation, as in ESAFs, of agreed and monitorable structural reforms; and thirdly, the implementation of agreed and monitorable social development policies.[6]

With the enhancement of the HIPC Initiative, there is more debt relief on offer. But equally, there has been a significant change in the nature and extent of conditionality attached to debt relief.

With the introduction of the floating completion point it is possible for exceptionally good performers to shorten the amount of time which elapses before which they receive unconditional and irrevocable relief. But equally, the completion point may float into a distant future if countries cannot stay on track. However, more significant than the change in the period of time during which performance is monitored is the change in the content and extent of policy conditionality and in the procedures for setting it.

The key change in the content of policy conditionality is that the goal of poverty reduction has been added to existing policy conditionalities. Policy reforms are now much more geared towards the achievement of poverty reduction objectives, and should seek to ensure the complementarity between macroeconomic, structural and social policies. Not only does this involve a change of emphasis, but it also represents a significant extension of policy conditionality. As no policy conditionalities have been subtracted, there is a net addition to the extent of conditionality faced by Governments that want to take advantage of HIPC assistance (Killick, 2000: 3).

CHART 43: ENHANCED HIPC INITIATIVE: FLOW CHART OF THE DELIVERY OF DEBT RELIEF

First stage

Country establishes a three-year track record of good performance and develops together with civil society a Poverty Reduction Strategy Paper (PRSP); in early cases, an interim PRSP may be sufficient to reach the decision point.

- Paris Club provides flow rescheduling as per current Naples terms, i.e. rescheduling of debt service on eligible debt falling due during the three-year consolidation period (up to 67 per cent reduction on eligible maturities on a net present value basis).
- Other bilateral and commercial creditors provide at least comparable treatment.
- Multilateral institutions continue to provide support within the framework of a comprehensive poverty reduction strategy designed by Governments, with broad participation of civil society and donor community.

EITHER

Paris Club stock-of-debt operation under Naples terms and comparable treatment by other bilateral and commercial creditors

is adequate

for the country to reach sustainability by the decision point.

→ **Exit**

(Country is not eligible for HIPC-assistance.)

OR

Paris Club stock-of-debt operation under Naples terms and comparable treatment by other bilateral and commercial creditors

is not sufficient

for the country to reach sustainability by the decision point.

→ **Decision Point**

(World Bank and IMF Boards determine eligibility.)

All creditors (multilateral, bilateral, and commercial) commit debt relief to be delivered at the floating completion point. The amount of assistance depends on the need to bring the debt to a sustainable level at the decision point. This is calculated based on latest available data at the decision point.

Second stage

Country establishes a second track record by implementing the policies determined at the decision point (which are triggers to reaching the floating completion point) and linked to the (interim) PRSP.

- World Bank and IMF provide interim assistance.
- Other multilateral and bilateral creditors and donors provide interim debt relief at their discretion.
- All creditors continue to provide support within the framework of a comprehensive poverty reduction strategy designed by Governments, with broad participation of civil society and donor community.

"Floating" completion point

- Timing of completion point is tied to the implemention of policies determined at the decision point.
- All creditors provide the assistance determined at the decision point; interim debt relief provided between decision and completion points counts towards this assistance:
  - Paris Club goes beyond Naples terms to provide more concessional debt reduction of up to 90 per cent in NPV terms (and, if needed, even higher) on eligible debt so as to achieve an exit from unsustainable debt.
  - Other bilateral and commercial creditors provide at least comparable treatment on stock of debt.
  - Multilateral institutions take additional measures, as may be needed, for the country's debt to be reduced to a sustainable level, each choosing from a menu of options, and ensuring broad and equitable participation by all creditors involved.

Source: World Bank, www.worldbank.org/hipc/about/about.html.

The new orientation towards poverty reduction is most dramatically indicated in the replacement of ESAF by the Poverty Reduction and Growth Facility (PRGF), which became effective in November 1999. The purpose of the new Facility is "to support programs to strengthen substantially and in a sustainable manner [qualifying low-income members'] balance of payments position and to foster durable growth, leading to higher living standards and a reduction in poverty". These programmes will stem from and be consistent with Poverty Reduction Strategy Papers (PRSPs), which will replace the Policy Framework Papers (PFP) which underpinned ESAFs.[7]

The PRSPs would normally be prepared every three years, with annual progress reports prepared by authorities updating the strategy as appropriate in the intervening years. They are meant to be context-specific and should vary between countries. However, their likely elements should include: a description of the nature and locus of poverty; an analysis of macroeconomic, structural, social and institutional obstacles to faster growth and poverty reduction; long-term goals for key poverty reduction targets together with annual (or six-monthly) targets covering a three-year horizon for related intermediate and proxy indicators; an action plan focusing on priorities for increasing sustainable growth and reducing poverty, which takes into account what is known of the linkages between different policies, their appropriate sequencing and the expected contribution of policy actions to the attainment of intermediate indicators; and a macroeconomic framework which incorporates the priorities for increasing sustainable growth and reducing poverty set out in the action plan. PRSPs are expected to be clearly linked to international development goals for poverty reduction, education, health and gender equality.

The PRSP is intended to be a country-owned document prepared through a participatory process which elicits the involvement of civil society, other national stakeholders and elected institutions.

Conditionality in PRGF arrangements will seek to evaluate implementation of the PRSP with a view to ensuring its objectives. The PRSP would contain a quantified medium-term macroeconomic framework, and specific quarterly performance benchmarks deriving from the framework would be elaborated in the PRGF-supported programme. It is expected that macroeconomic monitoring would be based on established practice, setting intermediate targets in fiscal, monetary and external sectors. Structural reform conditions in PRGF-supported programmes would be drawn from or elaborate on the universe of structural measures contained in the PRSP. A timetable of key policy actions over a three-year period could be included in a policy matrix, which, if set out in sufficient detail, would provide the basis for the monitoring of lending operations and lessen the need for lengthy negotiations to specify the conditions of both PRGF and IDA operations. The focus and efficiency of conditionality may also be tightened by reducing overlapping Fund and Bank conditionality through identifying, for each measure which is to be monitored, whether the Bank or the Fund would take primary responsibility for supporting the Government's policy formulation and for monitoring.

The change in the content of policy conditionality is complemented by a change in the procedures through which conditions are agreed. The PRSP is intended to be a country-owned document prepared through a participatory process which elicits the involvement of civil society, other national stakeholders and elected institutions. "Ownership" in this context refers to the Government's taking the lead in the preparation of the PRSP, including the animation of the participatory process (which is expected to increase public accountability) and the drafting of the action plan. As comparison of the documentation requirements of ESAFs and PRGFs shows, the critical shift is in the leadership in the preparation of the PFP and PRSP (table 33), although the authorities may draw on outside expertise as required, including from the Bank and the Fund.

TABLE 33: CHANGES IN DOCUMENTATION REQUIREMENTS WITH THE TRANSFORMATION OF ESAF INTO PRGF

Document	Periodicity	Ownership	Audience
A. Documents needed for ESAF arrangement			
Policy Framework Paper	Annual	Prepared jointly by Fund and Bank; country's document	Fund and Bank Boards; most countries now publish
Letter of Intent (may include Memorandum of Economic Policies)	With every request for arrangement or review	Country prepares jointly with Fund; country's document	Fund Board; most countries now publish
Staff Report	With every request for arrangement or review	Fund staff prepares	Fund Board
B. Proposed documentation for PRGF arrangements			
Poverty Reduction Strategy Paper (PRSP)	PRSP every 3 years; with annual progress report in intervening years	Country prepares and owns, in consultation with civil society and donors, with assistance from Funds and Bank	Public document; Fund and Bank endorsement needed to underpin their operations; donors may use to organize support
Staff Assessment of PRSP	With every PRSP progress report, and interim PRSP	Fund and Bank staff prepare jointly	Fund and Bank Boards; to be published
Letter of Intent (may include Memorandum of Economic Policies)	With every request for arrangement or review	Country prepares jointly with Fund; country's document	Fund Board; most countries now publish
Staff Report	With every request for arrangement or review	Fund staff prepares	Fund Board

Source: IMF, www.imf.org./external/np/pdr/prsp/poverty2.htm.

Once it is finalized, the PRSP will be presented to the Boards of the Fund and the Bank for endorsement. The latter would be a condition for Fund approval of a PRGF arrangement, or for completion of a review thereunder. A short assessment, prepared by Fund and Bank staff, would be circulated to both Boards alongside the PRSP and would recommend endorsement (or rejection) of the strategy as a basis for Bank and Fund concessional lending to the country concerned. It would include a description of the participatory process followed in the preparation of the strategy, but the joint assessment would not recommend rejection or acceptance on the basis of the participatory process.

Access to debt relief under the HIPC Initiative and access to concessional lending by the Fund and the Bank are now linked to the preparation of poverty reduction strategies.

Access to debt relief under the HIPC Initiative and access to concessional lending by the Fund and the Bank are now linked to the preparation of poverty reduction strategies. On a transitional basis, to reduce the tension between the desire to deliver debt relief faster and the pace at which effective country-owned and participatory poverty strategies can be prepared, an interim PRSP, which sets out the Government's commitment to, and plans, for developing a PRSP, will be sufficient for a country to reach decision point within the HIPC Initiative. Special provisions are also being made for retroactive cases which reached their decision point under HIPC I. But in general, PRSPs, interim PRSPs or annual PRSP progress reports, supported by Joint Staff Assessments and broadly endorsed by the Boards of both the Bank and the Fund within the previous 12 months, will now be a necessary condition for approval of new PRGF arrangements or reviews of existing arrangements and for HIPCs to reach a decision or completion point under the HIPC Initiative. They will also be

necessary for all IDA borrowers, at a date to be determined no later than 1 January, 2001, in the light of experience during the first year, for a high case lending scenario and adjustment lending, except in special circumstances such as emergency or crisis situations. As table 34 shows, 27 LDCs have been engaged in the process of producing PRSPs in 2000.

2. Some dangers of policy conditionality

For creditors, policy conditionality and performance monitoring are a vital mechanism to ensure that bad policies are not rewarded, problems of moral hazard on the part of debtor countries are minimized, and the right policy framework is put in place to maximize the chances that the benefits of debt relief will be used to promote economic growth and poverty reduction. Whilst debtor countries generally accept the principle of conditionality, its precise content and manner of implementation can be costly, both for creditors and debtors, and the international administrative guidance of a process of poverty reduction potentially counter-productive.[8]

Table 34: LDCs: expected progress in PRSP process, PRGF arrangements and reviews, and HIPC Initiative during 2000

	I	P	F	R	D	C	S
Benin	x		x		x		x
Burkina Faso		x		x	x	x	x
Cambodia	x			x			x
Central African Rep.	x			x			
Chad	x	x		x	x		x
Djibouti	x			x			
Ethiopia	x		x				
Gambia	x			x			
Guinea	x			x	x		
Guinea-Bissau	x		x	x	x		
Haiti	x		x				
Lao PDR	x		x				
Lesotho	x		x				
Madagascar	x			x			
Malawi	x		x	x	x		x
Mali	x			x	x	x	x
Mauritania		x		x	x		
Mozambique	x			x	x		x
Nepal	x		x				
Niger	x		x	x			
Rwanda	x			x	x		
Sao Tome & Principe	x		x	x			
Sierra Leone	x		x				
Uganda		x		x	x	x	x
U.R. of Tanzania	x	x	x	x	x		
Yemen	x			x			
Zambia	x			x	x		

Source: IMF, www.imf.org/external/np/hipc/doc.htm#1999.

Notes: I- Interim PRSP; P- PRSP; F- new PRGF 3-year arrangement; R- review of PRGF arrangement, or new annual arrangement; D- HIPC decision point under enhanced Initiative; C- HIPC completion point, enhanced or original Initiative; S- Country Assistance Strategy.

The greatest costs arise if the conditions which a country is obliged to meet as part of its policy reform programme diverge from those which are actually necessary to promote capital accumulation, increase economic efficiency and underpin sustained development and beneficial integration into the world economy. The new approach to PRSPs considerably reduces the probability that off-the-shelf strategies which are inappropriate to the particular situation of a country will guide policy conditionality, particularly if countries are actually given sufficient space to develop their own innovative approaches. But certain other dangers remain.

First, even with home-grown, fully owned policy conditionality, countries will be on a "short-leash" for between four and six (or more) years before debt relief is irrevocably and unconditionally committed. Within this period, policies and performance are monitored frequently. The critical problem with this short-leash approach is that it increases uncertainty and unpredictability. Linking debt relief to poverty performance creates the risk that the volume and timing of aid will be interrupted if performance falls below target, and the consequent squeeze in funding puts the whole reform process off track (Deusy-Fournier, 1999). Rather than a once-and-for-all debt reduction, short-leash conditionality leads to an approach to relief delivery which is not conducive to boosting economic growth by providing a strong private sector expectations shock.

There are high transaction costs associated with fulfilling conditions with policy reforms and debt relief.

Secondly, as indicated in chapter 4, there are high transaction costs associated with fulfilling conditions with policy reforms and debt relief. To the extent that the conditions are the right ones, these transaction costs will be an important investment for a country. But as the international community has switched the development agenda towards poverty reduction, a new process of learning has to be put in place within LDCs. The requirements for producing a PRSP are incredibly demanding (see chart 44), and "to reach a decision point, countries will have to undertake extremely complex and lengthy discussion processes, both internal (with civil societies) and externally (with the Bretton Woods Institutions, regional banks and donors) to build a consensus on priorities, best policies and instruments to reduce poverty, and the selection of appropriate indicators and targets to measure government efforts" (Debt Relief International, 2000a: 5). The World Bank and the IMF estimate that a full poverty reduction strategy can be produced in two years. But Uganda, which is in the forefront of this approach (see box 7), has been working on a strategy for five years. Even then, World Bank and IMF staff consider that Uganda needs to provide additional estimates of the cost of poverty reduction programmes and strengthen the links between expenditures on poverty reduction and indicators of poverty (GAO, 2000: 57).

Thirdly, a curious feature of the form of conditionality which is associated with the HIPC Initiative is that the more effective policy reforms are in promoting exports during the first three years before the decision point, the less the debt relief for which the country becomes eligible. This situation arises because countries have to establish a track record of performance for three years under IMF- and World Bank-supported programmes, and the level of debt relief is calculated in terms of the PV debt-to-exports ratio, based on exports over those years. The higher the exports, the less the relief. Moreover, if the export performance is so good that it brings the PV debt-to-exports ratio down to a level where the debt is sustainable after the full use of traditional debt relief mechanisms, the country, by its good performance, renders itself ineligible for HIPC assistance. In HIPC I this occurred in the case of Benin.[9]

Chart 44: Sao Tomé and Principe: roadmap for the preparation of a full PRSP

	Activity	Responsibility	Actors	Outputs	1999: N D; 2000: J F M A M J J A S O N D; 2001: J F M A M J J A S O N D
1	Launching of the PRSP preparation	Government	Civil society, donors		
2	Launching of the participatory process	Government	Civil society, donors		
3	Methodology and first outline	Government		First outline	
4	Regional Workshop, Abidjan	AfDB, IMF, UNECA, WB	Senior officials	Process and formulation of PRSP	13-14
5	Presentation of the government interim PRSP to IMF and WB boards	Government			
6	Definition of PRSP outline and methodology				
7	Consultations with local communities	Government	Communities, NGOs, civil society	Issues, strategies	
8	Household survey implementation	Statistical Office, AfDB, WB			
9	Poverty analysis and sectoral strategies	Government, sectors, WB, AfDB, UNDP	Communities, NGOs, civil society		
10	IMF & WB joint mission	WB, IMF	WB & IMF staff, Government	Road map, action plan, financing plan	
11	Production of the poverty profile	Statistical Office, WB, IMF		Poverty analysis, indicators	
12	Synthesis of macroeconomic and sectoral analysis and strategies	Government	Sector ministries		
13	Consultations with civil society and donors	Government	Communities, NGOs, civil society, donors		
14	Preparation of the first draft	Government		First draft	
15	Forwarding the first draft to WB and IMF, and comments	Government	WB, IMF	Comments from WB and IMF	
16	Production of the second draft	Government			
17	Consultations with civil society and donors	Government	Communities, NGOs, civil society, donors		
18	Finalization of PRSP	Government	Communities, NGOs, civil society, donors	**Final PRSP**	
19	Forwarding of the final PRSP to WB and IMF	Government			
20	IMF & WB Board presentations	WB, IMF		Joint staff assessement	

Source: Sao Tome and Principe authorities (2000); table 5.

Box 7: The development of anti-poverty policy in Uganda

Uganda's Poverty Eradication Action Plan (PEAP) is often cited as a good example of a poverty reduction strategy and held up as a model. Since its inception in 1997, it has guided the formulation of government policy. While providing national priorities for poverty reduction and guiding sector policies, the PEAP is established on four major pillars: (i) creating a framework for economic growth and transformation; (ii) ensuring good governance and security; (iii) directly increasing the ability of the poor to raise their income; and (iv) directly increasing the quality of life of the poor.

The PEAP involves wide consultation with individuals inside and outside government. The consultation process has been extended directly to the poor communities via the Uganda Participatory Poverty Assessment Programme (UPPAP) to assess the people's needs, priorities, and perceptions of the quality of service delivery and of government policies. The UPPAP aims to institutionalize a participatory approach to poverty planning and monitoring that extends to the district level.

In 1998/99, the Government adopted a Medium-Term Budget Framework (MTBF), under which budget priorities are formulated consistent with the PEAP and medium-term financial stability. Also, local government officials prepared medium-term expenditure plans to better reflect district poverty priorities, and civil society is involved in the dialogue on priorities and spending commitments. This process feeds into the budget framework paper and annual budgets.

Poverty monitoring involves a large number of institutions, including the Poverty-Monitoring Unit in the Ministry of Finance, Planning and Development (MFPED), the Uganda Bureau of Statistics and the UPPAP. The Poverty-Monitoring Unit integrates annual household surveys with other data sources (e.g. participatory analysis, sector surveys and line ministry data sources) to ensure that policy is continually influenced by poverty data and by perceptions of the poor.

The PEAP is monitored through the Poverty Status Report (PSR), which was first prepared in 1999 and is expected to be repeated every two years. The PSR synthesizes information on recent poverty trends and makes recommendations on the poverty eradication strategy, to be incorporated in future PEAP revisions.

The 1997 PEAP drew particular attention to the need for increased expenditure on the delivery of those services directly benefiting the poor. As a key element of the management process, the Government of Uganda established the Poverty Action Fund (PAF), designed to direct funds made available as a result of HIPC Initiative debt relief, and donor resources more broadly, towards the implementation of programmes focused on poverty. The PAF is fully integrated into the budget and includes the high-priority public expenditures from the poverty-eradication perspective as expressed by the poor communities (rural roads, agricultural extension, primary health, primary education, water supply, equalization grants across districts to reduce marginalization). Under the 2000/2001 PAF budget, the priority attached to water supply was increased and adult literacy was introduced as a priority. To ensure and enhance transparency, all releases of PAF resources are published and discussed at quarterly donor meetings, whose participants include relevant government officials, as well as NGO representatives and the media. The priorities contained in the PAF are to evolve in line with PEAP implementation and with the country's economic and social development.

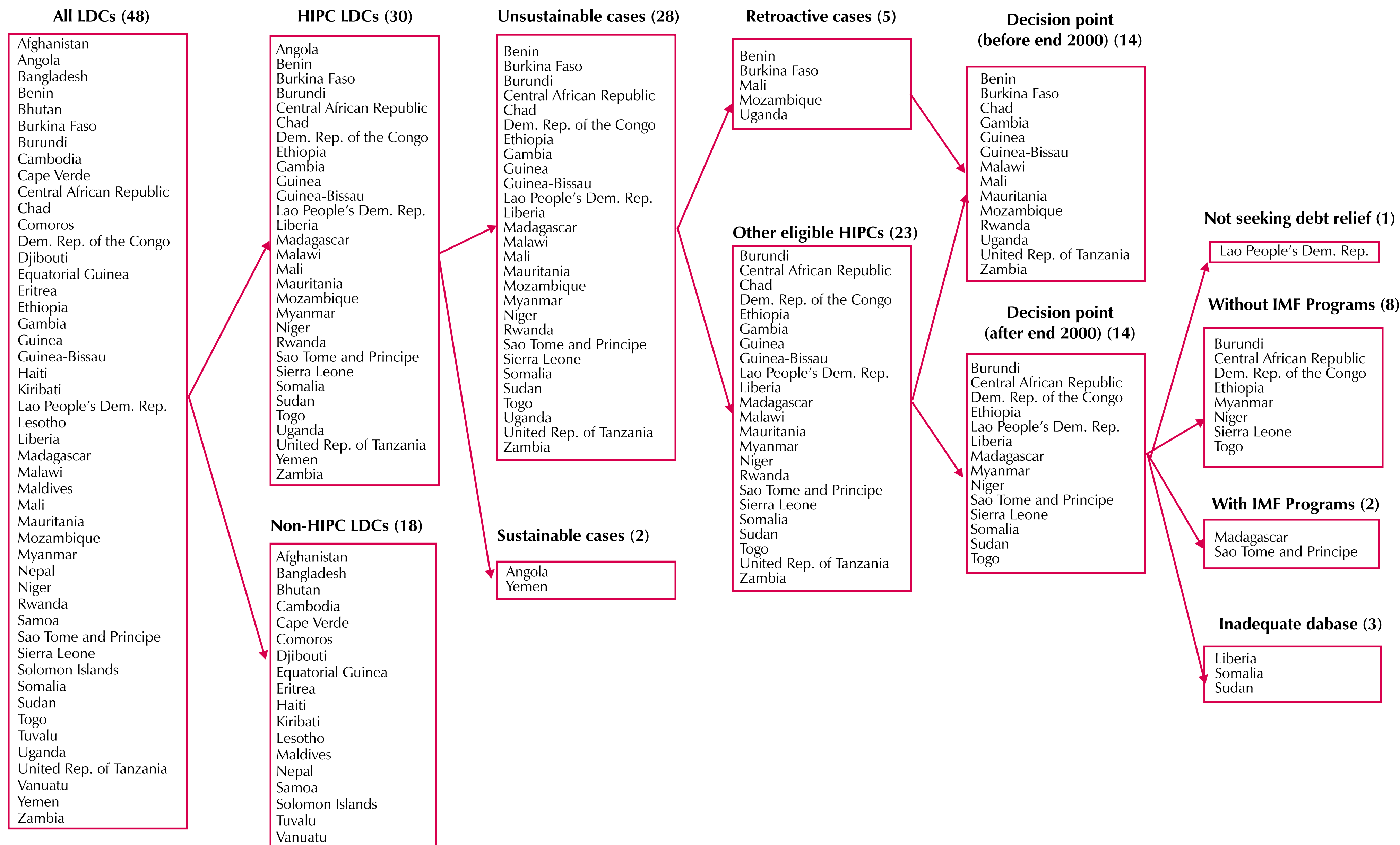
The PEAP is currently being revised. So that it remains relevant, it is envisaged that its revision will be a regular process carried out every two years.

D. The costs and benefits of HIPC debt relief

1. The reach of relief

Chart 45 indicates the current status of LDCs' eligibility in relation to the HIPC and also the likely timing of decision point. Eighteen LDCs are currently excluded from the Initiative, although the justification for doing so, if their debt situation warrants, is doubtful. One of the underlying principles in establishing the HIPC Initiative was that debt relief should be targeted at the poorest member countries for which excessive debt can be a particularly formidable obstacle to development. Application of this principle should logically take account of the special problems of the least developed countries, and as argued in *The Least Developed Countries 1999 Report*, debt sustainability analysis should be undertaken for all LDCs with a view to determining their debt relief needs. Malawi, which was originally categorized as a severely indebted non-HIPC, has already been moved from this group to join the HIPCs, and the

CHART 45: ELIGIBILITY OF LDCS FOR HIPC ASSISTANCE



Source: UNCTAD secretariat, based on www.imf.org/external/np/prsp/pdf/diagram.pdf

Gambia has also recently been reclassified as the latest HIPC. Cambodia and the Comoros have PV debt-to-exports ratios which are above the HIPC threshold of sustainability. Moreover, if workers' remittances as well as re-exports are not included in the calculation of the PV debt-to-exports ratio, it is possible that a number of other LDCs might also be above HIPC thresholds of sustainability.

For the LDCs that are HIPCs, the time it is taking to reach the decision point is, for most of them, a problem. Of the 28 unsustainable countries, only four countries – Mauritania, Mozambique, Uganda and the United Republic of Tanzania – had reached decision point by July 2000, and only one of these (Uganda) had reached completion point. The other three are now eligible for interim assistance, but Mozambique and the United Republic of Tanzania are expected to reach the floating completion point in 2001 and Mauritania in 2002. Three other LDCs – Benin, Burkina Faso and Mali – are retroactive cases which reached their decision point under HIPC I, and they can be confidently expected to reach the new decision point in the second half of 2000. Bank and Fund staff are also committed to do everything possible to bring a further 10 HIPCs, including seven LDCs, to their decision point by the end of 2000.

There are 14 LDCs whose external debt is considered unsustainable after traditional debt relief but which will not reach decision point before the end of 2000. Of the 13 in this group that are seeking relief under the HIPC Initiative, only two were identified as meeting eligibility requirements in June 2000. Eight countries are judged not to meet the requirement of having IMF- and World Bank-supported programmes currently in place (even though they have undertaken ESAFs in the past). In principle, these countries will become ineligible for relief if they do not initiate such programmes before the end of 2000, although it is possible that this "sunset clause" may be extended as it was in 1998. Finally, three countries – Liberia, Somalia and Sudan - are classified apart owing to difficulties regarding how the large arrears of these countries will be dealt with and an inadequate database.

2. The financial costs of debt relief: creditors' perspective

From the creditors' perspective, the financial costs of debt relief are estimated by the World Bank and the IMF as the difference between future debt-service payments (principal and interest) which are due prior to HIPC assistance and those which are due after implementation of HIPC assistance. A recent estimate of the costs of HIPC assistance for 36 of the 40 HIPCs is $28.2 billion in 1999 PV terms.[10] This excludes Ghana, which has decided to keep its options open regarding whether to pursue HIPC relief, and three LDCs – Liberia, Somalia, and Sudan. If these three are included, a further $6.3 billion would be added to the total costs. The estimates are indicative in that they depend heavily on assumptions regarding the timing of decision points and projections of exports, revenue and debt to those points, and they also calculate the additionality of HIPC relief. Alongside HIPC relief, countries would be expected to receive a stock-of-debt operation under Naples terms from Paris Club creditors and comparable treatment from other creditors, which together with the HIPC relief would result in a total reduction in future service obligations equivalent to about $45 billion in PV terms (i.e an additional $17 billion).[11]

It is impossible to make a precise estimate, from published sources, of the share of LDC HIPCs in total costs for all HIPCs. But of the non-LDC HIPCs, two are regarded as sustainable and the total costs that the assistance levels provided to the six non-LDC HIPCs which have reached decision point is $5 billion. Thus

the financial costs of HIPC assistance to LDCs, including estimates for Liberia, Somalia and Sudan, may be put at $29.5 billion, less the costs of relief for the three remaining non-LDC HIPCs which have not yet reached decision point – Cameroon, Congo and Senegal.

To put these numbers in perspective, it is worth recalling that it has been estimated that private banks forgave the equivalent of more than $60 billion in nominal terms in the debt workout associated with Brady Plan operations (Cline, 1997: 143). The affordability of HIPC debt relief also needs to be placed in the context of the extent to which the debt is deemed collectable (Cohen, 2000). In some countries, the value of the debt has been discounted, or reduced, in recognition of the risk that the loans may not be repaid. For example, according to United States Treasury officials, the budgetary cost to the United States is about $346 million (in present value terms) to forgive about $3.8 billion in debt (in nominal terms) owed by 22 countries under the enhanced Initiative (GAO, 2000: 19).

3. The financial benefits of debt relief: debtors' perspective

From the debtors' perspective, what matters is whether the scale of debt relief is sufficient to remove the debt overhang on investment activity and ease the crowding-out effects of debt service payments on foreign exchange earnings and government expenditure. Also critical are the degree of front-loading of debt relief, and the latter's delivery in a form that can positively affect private sector expectations, and have an immediate impact on debt service payments, easing the liquidity constraint on the government budget which is reducing investment in both productive capacity and poverty reduction.

From the debtors' perspective, what matters is whether the scale of debt relief is sufficient to remove the debt overhang on investment activity and ease the crowding-out effects of debt service payments on foreign exchange earnings and government expenditure.

Table 35 provides estimates of the total debt relief in PV and nominal terms and the average annual reduction in debt service payments from 2000 to 2005 for the four LDCs which reached their decision point within the enhanced HIPC framework by July 2000. Mozambique has the highest debt relief. Total debt relief of $1.97 billion in PV terms and $4.3 billion in nominal terms translates into expected average annual debt service relief over the period 2000–2005 of $116 million per annum. Uganda, which has reached completion point, is expected to receive annual debt service relief over the same period of $102 million as a result of total assistance of $1 billion in PV terms, whilst the United Republic of Tanzania, which is expected to reach completion point in 2001, should receive $94 million as a result of total assistance of $2 billion in PV terms. Finally, Mauritania, which is expected to reach completion point in 2002, should receive debt service relief of $25 million per year from 2000 to 2002 and $49 million from 2003 to 2005 on the basis of total assistance of $622 million in PV terms.

These figures on annual debt service relief in the period 2000–2005 are estimates which depend on assumptions about the timing of completion points and the way in which creditors deliver their share of the reduction in the PV value of the debt.[12] Following the convention of the World Bank and IMF estimation of the costs of the HIPC Initiative to creditors, the estimates exclude debt relief through traditional relief mechanisms (stock-of-debt operation on Naples terms) which would also be undertaken together with the additional HIPC assistance to bring future debt service obligations down to sustainable levels. Such traditional relief would certainly increase total assistance and the financial benefits. However, as an estimate of the debt relief accruing through the HIPC Initiative per se, these figures are more likely to be overestimates than underestimates.

TABLE 35: ESTIMATED FINANCIAL COSTS AND CASH-FLOW BENEFITS[a] OF HIPC INITIATIVE

LDCs for which Decision Point reached under Enhanced Framework	Completion Point[b] under Enhanced Framework	Estimated total[b] assistance level (in $ million, present value)	Estimated total[b] nominal debt relief (in $ million)	Annual average debt service relief (in $ million)	
				2000-2002	*2003-2005*
Mauritania	Floating	622	1 100	25.1[c]	49.1[c]
Mozambique	Floating	1 970	4 300	117[d]	115[d]
United Rep. of Tanzania	Floating	2 026	3 000	94.5[e]	93.8[e]
Uganda	May 2000	1 003	1 950	111.0[f]	92.3

Notes: *a* Financial costs and benefits are estimated after the full useof traditional debt relief mechanism.
b IMF/World Bank (2000); Assistance levels at countries' respective decision or completion points, as applicable.
c From IDA/IMF (2000a), box 4, tables 9 and 13. Assumes a hypothetical stock of debt operation on Naples terms at end 1998 and at least comparable treatment from other official bilateral creditors. Completion point under HIPC in July 2002.
d From IMF/IDA (2000a), tables 9 and 10. Assumes a hypothetical stock-of-debt operation on Naples terms at end 1998, and full delivery of assistance under the original Initiative of July 1999.
e From IDA/IMF (2000b), tables 11 and 12. Assumes a hypothetical stock-of-debt operation on Naples terms at end 1999 and at least comparable treatment from other official bilateral creditors. Data are for fiscal years; completion point is assumed to be in 2001/02.
f From IMF/IDA (2000a), tables 9 and 10. Incorporates effects of the Paris Club stock-of-debt operation before first decision point in 1997. Data are for fiscal years.

The simple reason for this is that they assume that the Initiative is going to be adequately financed and that the debt relief which is hypothetically due according to the terms of the Initiative will actually be delivered. There are two problems in this regard. First, the enhancement of the HIPC Initiative can be achieved only if full financing will come available for multilateral debt relief which the international financial institutions (IFIs) cannot finance themselves. Under the present timetable, 85 per cent of the irrevocable commitments for HIPC relief are needed before the year 2000, but the IFIs can only make these irrevocable commitments if financing is secured. But "many creditors, especially the multilateral and smaller bilateral creditors, report that they are having difficulty identifying their share of the necessary financing from their own resources due to budgetary and other constraints" (GAO, 2000: 18).

Second, the delivery of HIPC assistance depends on non-Paris Club creditors providing comparable treatment to Paris Club creditors. By June 2000, none of the cases which had reached decision point within the enhanced Initiative had received assurances that they would receive the relief. For the front-runner, Uganda, "non-OECD creditors have steadfastly refused to offer terms comparable to those granted by the Paris Club" (Tumusiime-Mutebile, 1999:7). The implications, as summarized by a principal architect of Uganda's economic reform strategy, are that:

1. The Enhanced HIPC Debt Initiative will not be seen as a first step towards a comprehensive debt relief/poverty reduction strategy, leading to increased criticisms from pressure groups.
2. HIPC countries will not receive the full amount of relief which is deemed necessary at the completion point. This will preclude the attainment of a sustainable debt and will undermine efforts to finance poverty reduction programmes, thus defeating the dual objectives of the Initiative.
3. The non-OECD debt stock will remain on a country's books creating a debt overhang. This may threaten prospects for the increased private sector investment which is a crucial element of our poverty reduction programme (Tumusiime–Mutebile, 1999: 8).

Recent information on the status of country cases suggests that LDC HIPCs which have reached decision point now have received satisfactory assurances from non-Paris Club creditors. But ensuring full burden-sharing amongst all creditors may still be a problem for new cases.

All the foregoing estimates of debt relief under the HIPC Initiative calculate the magnitude of financial costs and benefits as the difference between what countries would have had to pay after the implementation of traditional debt relief measures and what they would have to pay after implementation of HIPC measures. As we have seen in earlier chapters, however, many of the countries concerned have been unable to meet all their contractual payment obligations and, with arrears building up, actual payments are below contractual payments. This implies that in some cases it is possible that even with debt service relief under the HIPC Initiative, the debt service payments due after debt relief may be larger than those actually paid before relief.

Table 36 compares estimates of debt service due after the application of traditional relief mechanisms and provision of HIPC assistance, with debt service paid before the establishment of the Initiative, for four LDCs on the basis of IMF/IDA estimates. Within HIPC I, debt service due after completion point is actually more than debt service paid in 1993–1998 for two out of the four cases. Within the enhanced framework, in three out of four cases, debt service payments due are lower than debt service paid, and by over 40 per cent if debt relief from the World Bank and the IMF is front-loaded in the first five years. But for Mali, debt service payments due after completion point under the enhanced HIPC Initiative are estimated to be 20 per cent higher than those actually paid in the period 1993–1998 without front-loading of multilateral debt relief and still 7 per cent higher with front-loading.

Although Mali is just one case, it is relevant as a number of LDC HIPCs had arrears accumulating during the period 1994–1998. For such cases, the putative gains from the HIPC Initiative, estimated by the difference between contractual payments obligations under different relief schemes, may be virtual gains rather

TABLE 36: DIFFERENCE BETWEEN AVERAGE ANNUAL DEBT SERVICE DUE POST-HIPC AND AVERAGE ANNUAL DEBT SERVICE PAID PRE-HIPC[a]

($ millions)

	Original Framework	Enhanced Framework[b]		*Memo*: Net ODA in 1997[e]
		without frontloading of multilateral debt relief[c]	*with frontloading of multilateral debt relief*[d]	
Burkina Faso	6	-11	-27	370
Mali	32	15	5	455
Mozambique	-41	-50	-64	963
Uganda	-13	-52	-69	840

Source: IMF/IDA (1999a: table 6), and OECD, 2000 (tables 1-2).

a Difference between average debt service paid 1993–1998 and estimated debt service due between completion point and 2005.

b Figures are highly illustrative.

c Based on assumption of 70 per cent of total IMF assistance, and 25 per cent of total assistance from the World Bank and other multilateral development banks, being delivered over years 1–5.

d Based on assumption of 100 per cent of total IMF assistance, and 45 per cent of total assistance from the World Bank and other multilateral development banks being delivered over years 1–5.

e OECD 2000 (tables 1 and 2).

than actual gains. If the countries meet their obligations under the Initiative, no extra resources will be released for building productive capacities and for poverty reduction. On the contrary, they will be paying more than they were before.

Even for countries in which debt service payments due after receipt of HIPC relief are lower than debt service payments actually made before, the actual resources released through the Initiative are small in comparison with aid flows. As table 36 shows, the average reduction in annual debt service through 2005 under HIPC II compared with debt service actually paid during 1993–1998 for Burkina Faso, Mozambique and Uganda is equivalent to just 6–8 per cent of net ODA in 1997 (see also OECD, 2000: table 1-2). Recent estimates for all HIPC countries taken together similarly show that the annual savings on debt servicing from HIPC II levels of relief are equivalent to only about a tenth of total net resource flows to those countries (Martin, 2000: table 1).

The actual resources released through the Initiative are small in comparison with aid flows.

E. The medium-term outlook for debt sustainability

Under the HIPC Initiative, the debt relief which is believed to be sufficient to achieve debt sustainability is decided at one point in time, the decision point. The PV debt-to-exports and debt-to-revenue ratios are useful rule-of-thumb numbers for making judgements about present creditworthiness, i.e. the risk in the short term that default will be provoked by a liquidity crisis.[13] But reducing the debt-to-exports or debt-to-revenue ratios at a single point in time provides no automatic guarantee of debt sustainability in the medium and long term, particularly in the face of external shocks. Within HIPC II there is the possibility of reviewing debt relief needs at the completion point if the situation has changed. But even with this provision, a critical issue for both creditors and debtors is the medium-term outlook for debt sustainability.

1. Impact of external shocks: lessons from HIPC I

The experience of countries qualifying for debt relief under the initial version of the HIPC Initiative (including non-LDCs) provides instructive lessons in this regard. Under HIPC I, the amount of assistance committed was calculated at the decision point but was based on projected data for the completion point three years later. For all four front runners, including two LDCs (Mozambique and Uganda), the total debt relief committed at decision point proved, either at the completion point or during the next year, to be insufficient to achieve the debt sustainability threshold targets, as predicted through the balance-of-payments forecasts. In each case the projections on which the debt sustainability analysis was based proved to be wrong, and in each case they were overoptimistic.

For Mozambique, although economic performance remained strong, exports of goods and non-factor services were significantly lower in 1998 than had been projected at the decision point owing, *inter alia*, to a marked fall in commodity prices. For Uganda, the assistance committed was sufficient to bring the PV debt-to-export ratio down to below the thresholds of sustainability at the completion point, but the ratio increased to above the threshold levels in the following year owing to: reduced exports of good and services due to lower commodity prices (principally coffee) and adverse weather conditions associated with El Niño; an increase in new borrowing, mainly from multilaterals, to avoid a

financing gap in the balance of payments; a global fall in interest rates, which increased the PV stock of debt despite the Government's prudent adherence to its debt strategy; and the refusal of non-OECD creditors to grant relief on terms comparable to those offered by the Paris Club.

2. Forecasts of the debt overhang and debt service ratios in HIPC II

The enhancements of the Initiative through provision of lower PV debt-to-exports and debt-to-revenue thresholds are designed to provide an appropriate cushion against exogenous shocks of the type which rendered debt relief under HIPC I insufficient to ensure debt sustainability. But whether they actually provide such a cushion, and how external debt will develop in the medium term, depend on rates of growth of the economy, exports, imports and government revenue, and the terms of external finance to fill any financing gaps.

For countries which have reached their decision point, future scenarios have been constructed to show how external indebtedness indicators are expected to change in the medium and long term. Built into these scenarios is a profile for the delivery of total debt relief which, whilst taking account of creditors' constraints and also "any absorption capacity and implementation constraints in the country concerned in executing additional social expenditures", "should aim *ex ante* at a steady declining trend of the PV of debt-to-exports and -revenue ratios, and of debt service-to-exports and -revenue ratios, in order to provide a reasonable assurance that debt sustainability has been achieved and that debt problems will not re-emerge at a later stage" (IMF/IDA, 1999a: 14).

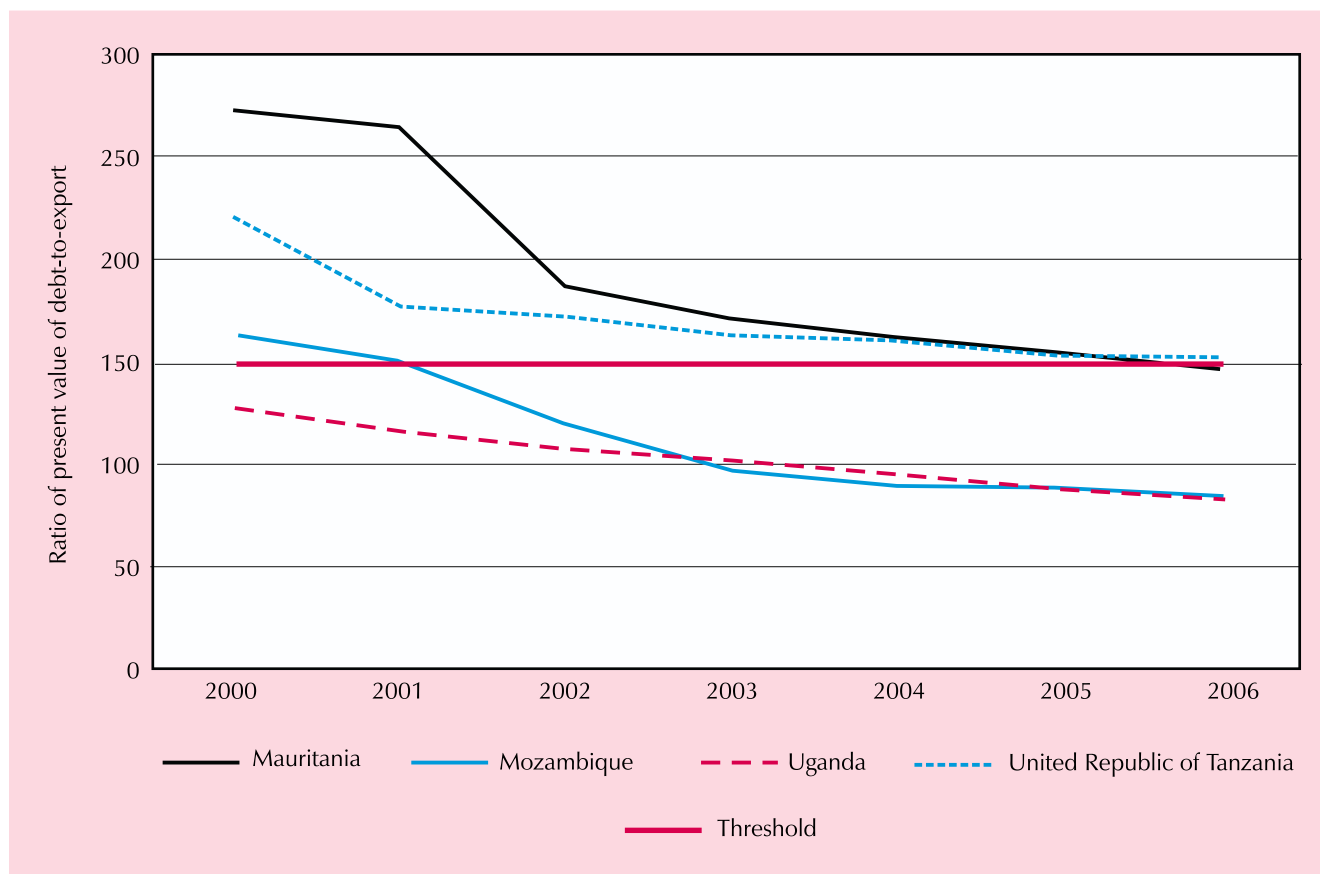
For countries which have reached their decision point, future scenarios have been constructed to show how external indebtedness indicators are expected to change in the medium and long term.

Analysis of the medium-term scenarios within the decision point documents for LDC HIPCs indeed shows the smooth, steadily declining trends in key indebtedness indicators. The debt relief provided under HIPC II, together with traditional relief mechanisms, is expected to reduce debt service ratios significantly, according to the desired profile. However, in two of the four cases – Mauritania and the United Republic of Tanzania - the application of the reduction factor to existing debt which has been decided as necessary to bring the PV debt-to-exports and -revenue ratios down to the threshold of sustainability will not remove the debt overhang or provide an effective cushion against shocks.

The basic reason for this is that there is an accumulation of new debt to finance substantial investment in physical and social infrastructure. In the United Republic of Tanzania, for example, without new borrowing, the PV debt-to-exports ratio is expected to fall 125.5 per cent by 2001/02, but with new borrowing the PV of total debt to exports is expected to be 177.9 in that year, which is assumed to be the completion point. The new borrowing (mainly new multilateral disbursements assumed to be obtained on IDA terms) is projected for physical and social infrastructure. If there was a write-off of eligible Paris Club ODA debt at the assumed completion point, the PV of debt-to-exports after enhanced HIPC assistance would decline by a further 17.6 percentage points to about 160 per cent at the end of 2001–2002. Without such assistance, the PV debt-to-exports ratio is projected to reach the 150 per cent threshold in 2007–2008 (chart 46).

Sensitivity analysis shows that the persistence of the debt overhang is likely to be further aggravated by small deviations from forecast assumptions. In Mauritania, a 5 per cent drop in the volume of fish exports would raise the

CHART 46: RATIO OF THE PRESENT VALUE OF DEBT-TO-EXPORTS AFTER ENHANCED HIPC ASSISTANCE, 2000–2006: LDCS WHICH HAVE REACHED DECISION POINT BY MID 2000



Source: Same as table 37.

average PV debt-to-exports ratio by 29 percentage points over the baseline to an average of 195 during the projection period (1998–2017) and to more than 251 during the period 1998–2007. In the United Republic of Tanzania, with lower growth of traditional exports, the ratio would not reach the 150 per cent threshold until 2013/14, and with a less favourable outlook for gold production the average ratio for each year during the period from 1999/2000 to 2017/18 would remain above the threshold. The PV debt-to-exports ratio would remain at 184 during the period from 1999/2000 to 2008/09.

3. THE REALISM OF THE FORECASTING ASSUMPTIONS

The medium-term scenarios of debt sustainability are founded on both macroeconomic and balance-of-payments forecasts. Key variables, whose future behaviour has to be projected, include: real GDP growth; the income elasticity of imports; growth in the volume and prices of traditional and non-traditional exports, including both goods and services; future flows of grants and FDI, and future debt-creating flows; and the conditions attached to loans. Medium-term debt sustainability requires that the current account deficit be covered by non-debt-creating capital inflows, or debt-creating flows which are sufficiently concessional that the external debt stock does not build up once again. Small changes in projections of individual elements of the balance of payments (such as exports, grants and FDI) can over time have quite large effects on the external financing gap, i.e. the residual in the balance of payments after estimation of the extent to which the current account balance is covered by net capital flows (see box 8). If an external financing gap starts to open up, this is not necessarily a problem for a country if it can be covered by non-debt-creating flows over and

Box 8: Forecasting the external financing gap after HIPC assistance: a sensitivity analysis for the United Republic of Tanzania

Whether HIPC debt relief is sufficient to enable debt sustainability in the medium term is appropriately assessed through sensitivity analysis of the baseline forecast of the future balance-of-payments trends after debt relief. Such an exercise was undertaken to test the effects of small changes in some of the key assumptions of the balance-of-payments forecast produced by Tanzanian authorities and IMF staff.

The baseline forecast assumes that in current price terms: (i) exports of goods and non-factor services will increase by 9.9 per cent per annum from 2000 to 2018; (ii) grants will grow at an average of 2.1 per cent from 2000 to 2018, with rates of 2.4 per cent per annum during 2002–2004 and 2.5 per cent during 2005–2018; and (iii) net FDI inflows will grow at 8.3 per cent per annum from 2000 to 2018. The sensitivity analysis examined what would happen if: (i) the growth rate of exports and non-factor services was 10 per cent lower (a change which would mean that, other things being equal, the export-to-GDP ratio would increase to 16.3 per cent rather than 18.1 per cent by 2010 as predicted in the baseline); (ii) official grants remained the same from the year 2000 onwards at the level assumed for that year in the IMF and Tanzanian authorities' forecast; and (iii) there was a reduction of 20 per cent in the growth rates in foreign direct investment.

Each of these changes is likely to have repercussions elsewhere in the economy. However, the sensitivity analysis focused simply on what the changes implied for the residual financial gap (that is, the financing gap which remains after expected net capital flows are subtracted from the forecast current account deficit and reserve changes). Scenarios were created using DSM+ version 2.0.0, a programme developed by the World Bank for debt sustainability analysis. Estimates were made of how the size of the financing gap would change relative to the baseline scenario with the assumed changes. The size of the financing gap depends on the precise format used to present the balance-of-payments statistics, and in the present simulation private-sector interest payments and changes in reserves are included in the calculation of the baseline gap.

The results indicate that the greatest impact results from the slower than forecast export growth rate. By 2005, the financial gap will be 120 per cent higher than the baseline forecast of $107.30 million if exports grow by 10 per cent less than predicted, 27 per cent higher if grants stay constant, and 66 per cent higher if FDI grows at 20 per cent less than predicted.

These results are, of course, quite predictable. But the intention is simply to underline the implications of small deviations from the baseline forecast. In the end such gaps will not build up because imports can be cut. But this will jeopardize the high growth rates which are expected in the next 20 years, and therefore also, rates of poverty reduction. This can be avoided if the larger financing gaps are covered by higher levels of grants or deeper debt relief. But if, to be covered, they depend on new loans there is the possibility that a debt problem will snowball out of control again. Policies to accelerate export growth remain essential.

Source: Olortegui, 2000.

above those assumed in the baseline scenario (such as extra grants). However, if these are not available, the country will face the prospect of a new snowballing external debt unless: (i) the financial gap is closed through a reduction in imports, which will inevitably reduce the rate of growth; or (ii) there is a return to the pattern of build-up of arrears coupled with further debt rescheduling.

A critical issue is whether the economic forcasts underlying the medium-term scenarios of debt sustainability are characterized by optimism or caution.

A critical issue, therefore, is whether the economic forecasts underlying the medium-term scenarios of debt sustainability are characterized by optimism or caution. Experience is not encouraging in this regard. It had become normal practice for the IMF to project zero balance-of-payments financing gaps after whatever relief terms the Paris Club was prepared to provide. With the introduction of the HIPC Initiative such practices changed. In the case of Uganda, for example, the balance-of-payments projections were recast in 1996 for the debt sustainability analysis, because they were no longer obliged to show that Paris Club relief made the debt and balance of payments sustainable, and as a result they changed fundamentally, with lower exports, higher imports and considerable financing gaps (Tran-Nguyen, Addison and Martin, 1996: 35). However, forecasts in HIPC I, including the sensitivity analysis, have still erred

on the side of optimism.[14] Moreover, recent analysis of HIPC II indicates a similar bias:

> Most recipient countries that GAO has analyzed are projected by World Bank and Fund staffs to have robust growth in export earnings, with projected growth for four of these countries – Honduras, Nicaragua, Tanzania and Uganda – expected to average at least 9.1 per cent a year over 20 years. The staffs also assume strong growth in gross domestic product and government revenue for most of the recipient countries that GAO analyzed. The average annual growth (in nominal dollars) of these two factors was assumed to be greater than 6 per cent in all cases and to exceed 9 per cent for Honduras, Mozambique, Tanzania and Uganda in one or both of these factors (GAO, 2000: 14).

The medium-term outlook for the HIPC Initiative hangs precariously on international and national actions which will ensure that the optimistic forecasts, on which future trends in debt sustainability are predicated, come true.

Table 37 summarizes some of the key assumptions underlying the balance-of-payments forecasts up to 2005 in the medium-term scenarios of debt sustainability for LDCs under HIPC II. It is difficult to obtain comparable data to compare these figures with those of the recent past. However, export growth rates appear to be high, given trends in demand for the traditional exports in the main markets, and the high export growth rates often depend on future positive events such as mines coming on stream or rapid development of non-traditional exports such as tourism. The income elasticity of imports is assumed to be around or just over 1, but in two out of four cases in which macroeconomic assumptions are clearly set out, the imports-to-GDP ratio is expected to decline over the period by 5–6 percentage points. In effect, it is assumed that extra growth and exports will be achieved without increasing import intensity of growth. The medium-term outlook for the HIPC Initiative, even in its enhanced form, thus hangs precariously on international and national actions which will ensure that the optimistic forecasts, on which future trends in debt sustainability are predicated, come true.

F. Linkage between debt relief and poverty reduction

A central goal of the enhanced HIPC Initiative is to strengthen the link between debt relief and poverty reduction. Two broad approaches can be taken to achieve this goal. The first, "direct" route is to use welfare criteria as a basis for deciding the depth, breadth and speed of debt relief. The second, "indirect"

Table 37: Some assumptions of the medium-term projections of the debt sustainability analysis of HIPC-LDCs

	Real GDP growth	Real Export growth	Export % GDP		Import % GDP		Official transfers % GDP		Private capital Inflows % GDP	
	2000–05	*2000–05*	*2000*	*2005*	*2000*	*2005*	*2000*	*2005*	*2000*	*2005*
Burkina Faso	5.7	8.4	..	..	Rising very slowly		6.6	4.5	0.8	1.0
Guinea	5.8	5.9	26.6	27.0	27.5	27.1	2.6	1.8	0.7	0.8
Mali	5.0	..	..	..	Unchanged		5.5	4.2	0.3	0.5
Mauritania	5.2	1.6	41.8	36.0	54.4	48.5	11.1	7.4	0.3	0.6
Mozambique	5.8	..	13.0	21.0	30.0	25.0	..	..	..	..
Uganda	6.2	6–7	..	..	Rising very slowly		5.1	1.9	10.1[a]	8.7[a]
U.R. of Tanzania	5.8	11.8	13.8	16.7	27.4	27.6	9.1	6.1	2.3	2.3

Sources: UNCTAD secretariat estimates based on IDA/IMF (1999b), tables 10 and 11; IDA/IMF (2000a), tables 4 and 7; IMF/IDA (2000a), box 3; IDA/IMF (2000b), tables 8 and 9; IMF/IDA (2000b), box 6 and table 9; IMF/IDA (1997b), box 1 and table 1; IMF/IDA (1998), box 1 and table 1. Growth rates are annual averages (per cent).

a Private transfers.

route is to decide the depth, breadth and speed of debt relief according to criteria of debt sustainability but to design the debt relief process in such a way that it promotes poverty reduction. The HIPC Initiative takes the second route. This is not necessarily the wrong choice. However, it is wrong to assume that "the *only* way to ensure that there is a robust link between debt relief and poverty reduction is by ensuring that HIPC Initiative debt relief is an integral part of broader efforts to implement outcome-oriented poverty reduction strategies."(IMF/IDA, 1999b: 19; emphasis added). Moreover, simple comparison of HIPC relief with some proposals based on the first route indicates that the indirect approach it is likely to lead to less debt relief, provided more slowly, for fewer countries.[15] It is this that perhaps leads to the mix of congratulation and scepticism with which some observers have greeted the enhanced HIPC Initiative. Box 9, quoted from a paper on Rwanda by W. Nyamugasira presented at the ECA HIPC Review Seminar in 1999, exemplifies this dual response.

Following this indirect route, the enhanced HIPC Initiative seeks to strengthen the link between debt relief and poverty reduction, on the one hand, by providing incentives for Governments to adopt pro-poor economic reforms (through the new policy conditionality and the PRSP process), and, on the other hand, by seeking to ensure that resources released through debt relief will be channelled into increased social expenditures on health and education, and into poverty action funds. Of these two means, the latter is politically significant as it can reduce the force and impact of one of the most compelling popular critiques of the HIPC I, which entailed comparison between debt service payments and social expenditures. However, it is the former – strengthening requirements and incentives for government to adopt pro-poor economic reforms and development policies – which is likely to be more important for poverty reduction in practice.

Debt service due was 112 per cent of total social sector spending in Mali during 1995–1997, 184 per cent of total social sector spending in Mauritania in 1997–1998, and 228 per cent of total social sector spending in Tanzania from 1995/1996 to 1997/1998.

There are two reasons. First, as indicated earlier, the magnitude of additional resources which will be released through HIPC assistance is not great, particularly in the near-term. Table 38 shows recent levels and projections of debt service payments and social expenditure in Mali, Mauritania, and the United Republic of Tanzania over the period 1995–2002, as reported by IDA and IMF. Debt service due was 112 per cent of total social sector spending in Mali during 1995–1997, 184 per cent of total social sector spending in Mauritania in 1997–1998, and 228 per cent of total social sector spending in Tanzania during 1995/1996 to 1997/1998. When these countries begin to receive HIPC assistance, it is expected that there will be a dramatic drop in these ratios. The IDA and IMF documents report a fall to 43 per cent of total social spending in Mali in 2000–01, and to 76 per cent of total social spending in Mauritania in 2000-02. But in practice, debt service actually paid in these countries during the pre-HIPC periods stood at 59 per cent of total social spending for Mali, 115 per cent for Mauritania, and 75 per cent for Tanzania.

Box 9: The fable of the goats: a southern perspective on poverty and the HIPC Initiative

"Heavily indebted countries are also poverty stricken. That is a given. Where poverty abounds, debt overhang and debt servicing are unsustainable. That is also a fact. The HIPC Initiative is a welcome attempt at addressing these unacceptable states of affairs. A farmer has lost his goats which represent the few assets in the form of money, dignity and confidence [which he has]. A neighbour from a village to the north joins the farmer in the search for the lost animals. He [the neighbour] works harder even than the farmer but in reality he does not want the farmer to find his lost treasure. The search for solutions to poverty are questions of the will, and of integrity, for the neighbour knows where the goats are."

Source: Nyamugasira, 1999: 1.

TABLE 38: DEBT SERVICE PAYMENTS AND SOCIAL SECTOR EXPENDITURES IN SELECTED LDCs, 1995–2002

	United Republic of Tanzania		Mauritania		Mali[a]	
	1995/96–1997/98	2000/01–2002/03	1997–98	2000–02	1995–97	2000–01
Total social sector expenditure *($ millions)*	213.4	..	77.5	109.4	125.8	215.0
of which:						
Health	60.8	..	17.9	24.2	48.3	81.0
Education	152.5	..	53.1	60.5	77.4	135.0
Total debt service paid	160.1	146.5	89.4	82.3	74.4	93.4
% of total social sector expenditure	75	..	114	75	59	43.0
Total debt service due	480.5	146.5	142.9	82.3	139.5	93.4
% of total social sector expenditure	225	..	184.4	75	111	43.0

Source: IMF/IDA (1999e), table 6; IDA/IMF (2000a), box 4.3; IDA/IMF (2000B); IMF/IDA (1998), box 4.
a Assistance under HIPC I.

Thus the difference between debt service actually paid pre-HIPC and debt service due in 2000-2002 after preliminary HIPC assistance is only a reduction of $13.6 million for the United Republic of Tanzania and a reduction of $7.1 million for Mauritania, whilst payments increase for Mali debt service. It must be stressed that the Mali figures are based on calculations of HIPC I, and that Tanzania and Mauritania are only expected to reach completion point in 2001/2002 and July 2002 respectively, and so deeper HIPC assistance can be expected thereafter. But these figures give some idea of the magnitude of additional resources which will become available in the near future and also show that the future behaviour of the ratio of debt service paid to total social sector expenditure will depend significantly on the ability to increase social spending, which is projected in these figures to increase by 41 per cent between 1997–1998 and 2000–2002 in the case of Mauritania, and by 72 per cent between 1995–1997 and 2000–2001 in the case of Mali.

There is a large gap between more social expenditures and the realization of better social outcomes and reduced poverty rates.

Secondly, there is a large gap between more social expenditures and the realization of better social outcomes and reduced poverty rates.[16] There are major problems of reaching the poor through social spending, and even if this is successful, long-term poverty reduction depends on economic growth and the expansion of employment opportunities and productivity per worker. Channelling small amounts of HIPC assistance into social spending is more likely to provide short-term poverty relief than long-term poverty reduction.

G. The PRSP process: a preliminary assessment

From this it follows that the most effective way in which the HIPC Initiative may be expected to strengthen the link between debt relief and poverty reduction is through its impact on the content of the national policies of LDC HIPCs. But how effective will the Poverty Reduction Strategy Paper (PRSP) process be?

Some observers are concerned that the PRSPs will not entail any major change in the policies which countries were pursuing under the Policy Framework Papers (PFPs). For these observers, the change from ESAF to PRGF is cosmetic, entailing the repackaging of old economic reform programmes in a new poverty language. Since few PSRPs have been completed, it is early to make a judgement on this. However, there is no reason to doubt that the international

community is seriously intent on promoting poverty reduction, and there is every reason to believe that the PRSPs will seek to enhance the quality of growth by making it more pro-poor. But the central issue is that the efficacy of the PRSP process in poverty reduction in LDCs will depend not simply on its effects on the quality of growth but also on its effects on the rate of growth.

It should be noted in this respect that the scenarios which are being constructed to assess the medium-term outlook of debt sustainability for LDC HIPCs assume, in most cases, that higher growth rates will be achieved than those achieved under the ESAF programmes. These growth rates are still below the growth rates which economists suggest are necessary for reducing extreme poverty by half by 2015 (table 39). Nevertheless, if the rates of economic growth which are forecast are actually achieved, and if growth-distributional dynamics are managed in a way to ensure that the quality of growth is pro-poor, this will have a major impact on poverty. But the policy issue is how to achieve these higher economic growth rates.

The central issue is that the efficacy of the PRSP process in poverty reduction in LDCs will depend not simply on its effects on the quality of growth but also on its effects on the rate of growth.

The ESAF-programme experience is not encouraging in this regard since the favourable growth rates during 1996–1998 were founded on positive terms-of-trade movements. In assessing the PRSPs therefore, the basic question is how they can promote faster and sustained growth. In short, in the words of the Deputy Managing Director of the IMF, Eduardo Aninat, “Why should we expect better results this time around?” (Aninat, 2000: 4).

1. Growth acceleration through enhanced ownership?

One possible reason for expecting accelerated growth is that economic reforms will now be nationally owned, participatory and developed through partnership between the international creditor-donor community and national authorities. The idea that past reform programmes did not achieve the expected results because Governments did not own the economic reforms is now widely canvassed. The next chapter will consider the issues of ownership and partnership in broader terms, but here some specifics of the problem of implementing national ownership in relation to PRSPs will be addressed.

As noted earlier in this chapter, enhanced “ownership” is expected to be achieved through the Government taking the lead in the preparation of the PRSP, including the animation of a participatory process (which is expected to increase public accountability) and the drafting of the action plan. This is

Table 39: Real GDP growth rates in HIPC-LDCs: actual, forecast and required to meet poverty reduction targets
(Per cent)

	Actual 1994–98	Forecast[a] 2000–05	Required[b] 2000–15
Burkina Faso	4.6	5.7	6.8
Guinea	4.5	5.8	7.3
Mali	4.9	5.0	7.7
Mauritania	4.4	5.2	7.7
Mozambique	8.1	5.8	8.9
Uganda	7.7	6.2	8.1
United Republic of Tanzania	3.3	5.8	8.0

Source: UNCTAD secretariat estimates.
a See table 39.
b Economic Commission for Africa estimates of growth rates required to reduce headcount poverty rates by half by 2015 (Economic Commission for Africa, 1999: table A11.7).

certainly likely to bring benefits in the sense that strategies should more closely reflect different national contexts and not be replica blueprints carried from one country to another. However, how national ownership will work in practice depends on the relationship between national authorities and international creditor-donors.

This relationship is certainly likely to be complex. Since 1996, attempts have been made by the World Bank to promote the ownership of country assistance strategies (CAS) by the Government and people of the client country. Evaluation of this experience suggests that rather than providing ownership, the shift to participatory CAS is most accurately described as "an attempt by the Bank – the owner of the CAS – to enhance the relevance and effectiveness of the CAS while also generating a sense of shared ownership among interested parties in country government and civil society" (McGee and Norton, 2000: 21). The PRSP may be different. However, national ownership is still not totally unconstrained.

First, what is being owned is a model conceived by the Bank and the Fund which is keyed in to the achievement of international development targets which have been selected by the OECD as a subset of international development targets set in all the global conferences of the 1990s. What is owned is not the development agenda itself, but rather the means of implementing this agenda.

The preparation of PRSPs is very demanding, and in a number of LDCs the technical capabilities for producing poverty reduction strategies may be weak.

Secondly, it is clear that the preparation of PRSPs is very demanding, and in a number of LDCs the technical capabilities for producing poverty reduction strategies may be weak. It is likely that the design of the programmes will draw upon the expertise of the Bank and the Fund, and indeed they are expected to provide national authorities with advice in their appropriate areas. But the giving of advice will have to be very open-ended if it is not to undercut the goal of genuine national ownership. Initial evidence on this is discouraging. A recent field survey of bilateral donor views of how the PRSP process is working found that the staff of the Bretton Woods Institutions were perceived to be in the driving seat in most cases, including in the United Republic of Tanzania and Zambia. Significant degrees of government co-leadership were perceived only in Ghana, Mozambique and Uganda (SPA, 2000: 10, reported in Killick, 2000).

Thirdly, the country-prepared PRSP will be presented to the Boards of the Fund and the Bank for endorsement. This endorsement process is critical for the degree to which genuine national ownership of the policies is created. The test case would arise if countries produce nationally owned strategies which do not incorporate all the elements of the poverty reduction approach favoured by the IFIs. It is unclear whether this would be endorsed or not. However, it may not reach open disagreement. Another feature of the joint assessment is that it would not be sight unseen. Indeed, it is envisaged that a joint Bank–Fund mission will be needed to prepare for the presentation of the PRSP to the Boards. This mission "would discuss with the authorities any modifications to the strategy which might be considered necessary to allow managements to recommend to the Boards that the PRSP be endorsed " (IMF/IDA, 1999d: 16). The views of the mission should be shared more widely with participants in the participatory process and "would be an important input into the authorities' decision as to at what stage, and in what form, they wished to present the PRSP for consideration by the Boards" (p. 16).

The overall result is that the country-owned policy could be altered to fit expectations. As it is put, "It is expected that, as under current arrangements, in general, authorities would only wish to seek a discussion of their PRSP when

managements would recommend its endorsement" (p. 16). In essence, this could imply that ownership is actually deeper internalization of the norms of the IFIs.

2. Growth acceleration through poverty reduction?

A second reason why economic growth could be expected to accelerate with the new generation of economic reforms under PRSPs is that pro-poor policies will actually be growth-enhancing. This idea is intuitively appealing. But it cannot be assumed as given. Most recent poverty research has focused more on the question of whether economic growth leads to poverty reduction, and the policies through which poverty-reducing effects of economic growth can be maximized, than on whether poverty reduction leads to economic growth and the policies through which the growth-enhancing effects of poverty reduction can be maximized.

Indeed, there is a danger that rather than poverty reduction promoting economic growth the contrary will pertain. That is to say, an overconcern within PRSPs with short-term results in terms of increasing the consumption per capita of the poor may easily conflict with the need to increase savings, investment, efficiency and exports, which are the bases for accelerated economic growth, a durable exit from the debt problem and also long-term poverty reduction. There is, to be sure, some awareness of possible trade-offs between the goals of poverty reduction and growth within the operational guidelines for PRSPs. The effort to integrate macroeconomic policies, structural reforms and social policies within PRGF programmes and PRSPs is particularly concerned with the need to ensure that increased social expenditure associated with poverty reduction is compatible with macroeconomic stability, and does not trigger inflation which then eats into the real incomes of the poor. But it is generally assumed that structural reforms including trade liberalization, financial liberalization, agricultural pricing reforms and privatization are all compatible with poverty reduction. As the recent robust debates on the draft of the World Bank's *World Development Report 2000/01* indicate, there is a wide spectrum of opinion on this issue. It may well therefore be the case that the addition of poverty conditionalities within IMF and World Bank adjustment programmes is putting countries in an impossible position, in which they are trying to meet policy objectives which are irreconcilable in the short run.

An overconcern within PRSPs with short-term results in terms of increasing the consumption per capita of the poor may easily conflict with the need to increase savings, investment, efficiency and exports, which are the bases for accelerated economic growth, a durable exit from the debt problem and also long-term poverty reduction.

Experience also shows that an initial effect of the PRSP process has been to raise expectations amongst all sectors of society. This is putting Governments in an exposed, high-risk position. These expectations are difficult to manage, particularly given the paucity and slowness of resources released through the HIPC process.[17] The PRSP process carries the danger, therefore, that it may revive and reinforce populist impulses.

It is certainly possible that poverty reduction could become integral to the acceleration of capital accumulation in LDCs. But this would require a pluralistic view of appropriate development strategies which allowed the types of mesopolicies discussed in the last chapter. Unfortunately, PRSPs are being rushed into place in situations where all the trade-offs and synergies between growth and poverty reduction are not well understood. Their implementation in low-income countries should rightly be recognized as an experimental process, the brunt of whose outcomes will be borne by the people of the countries which are implementing the PRSPs, and which indeed have to do so, in order to gain access to concessional finance and debt relief.

3. Growth acceleration through debt relief?

Finally, it is possible that growth acceleration will occur because of the removal of the debt overhang and also the easing of the crowding-out effects of debt service payments. In practice, this is the surest way in which the link between debt relief and poverty reduction is likely to be achieved. However, its realization depends on the scale of debt relief and on complementary aid flows, which are sufficient and sufficiently predictable to ensure both a private sector expectations shock which boosts private investment and an easing of the government budget constraint so that the Government can make the public investments necessary to enhance productive capacity. But the evidence of the scale of relief and the medium-term outlook presented in sections D and E makes this unlikely.

A particular worry here is that, as shown in chapter 4, levels of ODA to LDCs have in the recent past been closely related to levels of indebtedness. If the behaviour of the international creditor-donor community in the 1990s continues under the HIPC Initiative, it is likely that to the extent that the Initiative succeeds, aid flows will decline. Indeed, recent estimates suggest that "large amounts of aid are being diverted from bilateral budgets to fund relief by multilateral institutions... . The total amounts represent more than 50 per cent of bilateral donor aid flows to HIPCs in 1998: though their disbursements will be spread over several years, there is strong evidence of aid diversion to fund debt relief" (Martin, 2000: 9). All observers agree that such substitution will undermine the effectiveness of the Initiative.

If the behaviour of the international creditor-donor community in the 1990s continues under the HIPC Initiative, it is likely that to the extent that the Initiative succeeds, aid flows will decline.

H. Conclusions and policy implications

The main finding of this chapter is that for the LDCs, current expectations regarding the impact of the implementation of the enhanced HIPC Initiative are unrealistic. As the Report to Congressional Committees of the United States General Accounting Office has rightly put it, "the initiative is not likely to provide recipients with a lasting exit from their debt problems, unless they achieve strong sustained economic growth" (GAO, 2000: 9). Unfortunately, the Initiative is not designed in such a way that it contributes enough to creating either the national or international conditions for "strong sustained economic growth" in the recipient countries.

The problem is more fundamental than the speed with which countries reach a point where they can receive debt relief, although that has been, and even with enhancements remains, painfully slow. Rather, it is a question of the scale and timing of debt relief, the conditionalities attached to it, and its financing.

The primary role of debt relief should be to enable countries which are in a situation where their debt burden undermines economic growth and public and private investment to make a fresh start. The cases of Indonesia and Egypt show that this is best achieved through a significant upfront reduction of debt stocks. But debt relief within the HIPC Initiative is not working like this. Rather, it is functioning like ODA, which is being provided in the form of a reduction in contractual debt service obligations on official debt rather than in the form of official capital inflows. The requirement to ensure that resources released through HIPC assistance are used for poverty reduction further reinforces this role which debt relief has been given.

The magnitude of the cash-flow benefits of HIPC assistance is small relative to net resource inflows and relative to aid flows to the LDC HIPCs, and it is unlikely to be sufficient to achieve the objective of a lasting exit from their debt problems, even if delivered in full. The medium-term forecasts of a durable exit from the debt problem are over-optimistic. They depend on rates of economic growth within HIPC LDCs, in most cases over and above rates in the 1990s, achieved with very high and stable export growth rates and without an increasing import intensity. The lessons from the forecasting experience under HIPC I, as well as the volatility of export earnings in LDCs, suggest that these expectations are unlikely to be met. The most probable outcome if export earnings are not achieved will be reduced imports and lower growth. This is all the more likely as thresholds of debt sustainability are set at levels at which, when countries receive new concessional loans to finance essential physical and social infrastructure after receiving HIPC assistance, the debt overhang persists for a number of years and there is no cushion against adverse external shocks.

The medium-term forecasts of a durable exit from the debt problem are over-optimistic.

The "implicit assumption" of the forecasts which underpin the medium-term prediction of debt sustainability is, as GAO (2000) points out, that "the process of preparing and implementing a poverty reduction strategy will result in a more effective and productive use of resources, leading to both economic growth and poverty reduction" (p. 14). Indeed, the rationale for the new policy conditionality is to ensure that resources released through debt relief are productively utilized for poverty reduction. The way in which PRSPs will work in practice over the long term is still unclear. But it is difficult to see how they will deliver accelerated growth, particularly as they are a new and untested policy mechanism, being put together on the ground in a rush. The way in which short-leash policy conditionality worked in the past under ESAF economic reforms, with interruptions to aid flows and uncertainty undermining effectiveness, does not augur well for the PRGF. Moreover, there is a danger that the extension of policy conditionality which stems from linking debt relief and poverty reduction will actually divert attention from the fundamental task of increasing domestic savings and the volume and productivity of investment, and promoting exports. The laudable attempt to increase domestic ownership of reform programmes may easily be undermined through low domestic policy capacities, and a narrow view of acceptable programmes within the endorsement process.

The danger that debt relief will be substituted for development assistance becomes all the more likely as HIPC assistance is functioning as development assistance.

Finally, there is a danger that, even within its own limited terms, the Initiative will be underfinanced or financed through the diversion of aid resources. One positive aspect of the recent situation is that a number of OECD Governments have declared that they are cancelling bilateral ODA debts. But how this is happening is complicated.[18] Moreover, budgetary and other constraints are making it difficult for many creditors, particularly smaller multilateral organizations, to find their share of the necessary financing. In addition to this, non-OECD creditors have expressed a feeling of exclusion from the design and implementation of the Initiative, and this is making it hard for the HIPC LDCs to achieve comparable treatment from these creditors which is necessary in order to secure the projected debt service relief.[19] The danger that debt relief will be substituted for development assistance becomes all the more likely as HIPC assistance is functioning as development assistance. But if this occurs, the effectiveness of the Initiative will necessarily be undermined.

There is a need for deeper, faster and broader debt relief.

There are three main policy implications of the foregoing analysis. First, there is a need for deeper, faster and broader debt relief which is based on lower thresholds for judging debt sustainability, more realistic forecasts of economic growth, exports and imports, and more upfront extinction of debt stocks and the front-loading of debt service relief.[20] The major obstacle to deeper debt relief is

how it can be financed. The degree of enhancement which occurred with the shift from HIPC I to HIPC II was constrained by the need to ensure that additional costs could be met (World Bank, 1999), and even now it is proving difficult to ensure that HIPC II is adequately financed. It is therefore imperative that international policy efforts focus clearly on the financing bottleneck affecting debt relief for poor countries. Costs of debt reduction need to be calculated in a way which takes account of the risk of non-payment (see Cohen, 2000). Assessment of the real financing costs of debt relief to creditors should also take account of the benefits of removing the debt overhang from official creditor-donors, which, as argued in chapter 4, is a necessary condition for enhanced aid effectiveness.

Assessment of the real financing costs of debt relief to creditors should also take account of the benefits of removing the debt overhang from official creditor-donors, which is a necessary condition for enhanced aid effectiveness.

No durable exit from the debt problem will be possible unless domestic policies promote faster economic growth. Policies should be based on lessons learned from the adjustment period under ESAFs as well as on retooling to add a pro-poor dimension to economic policy. As argued in chapter 4, there is a need for more pragmatic policies which focus on the fundamentals of increasing investment, productive capacities, productivity, savings and international competitiveness. Poverty reduction ultimately depends on rapid economy-wide growth and meso policies which effectively ensure that such growth is translated into positive outcomes in terms of poverty reduction at the individual and household levels. The reorientation of public expenditure towards social sectors, and within the latter towards basic health and education, is certainly an aspect of such mesopolicies. However, the necessary meso policies should be market-oriented, as well as State-centric, focusing on public action to animate private enterprise through the promotion of agricultural investment and productivity growth, and business development,[21] as well as on public investment in physical and social infrastructure.

It is essential that the tension between policy conditionality and domestic ownership be managed in a way which accepts a pragmatic view of the key policy ingredients for accelerating growth, and actively promotes a pluralistic conception of development strategies which is not wedded to a single model. As the declaration of the second HIPC ministerial meeting held in Geneva in June 2000 suggested, "There needs to be few, clear and realistic conditions, based on things that government can actually control" (p. 3). Strengthening the capacity of debtor countries to implement effective debt management policies is also important. One immensely positive side effect of the HIPC Initiative is that it is impelling capacity improvement in debt management. But further technical assistance is required in order to enable debtor countries to participate as equal partners in the HIPC process. Full domestic ownership of the debt sustainability analysis is a sine qua non for full domestic ownership of a poverty reduction strategy.

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Finally, it is imperative that domestic development strategies be supported by an appropriate international policy environment. The Progress Report of April 1999 by the Managing Director of the IMF and the President of the World Bank on the HIPC Initiative explicitly argues that the HIPC Initiative "needs to be reinforced by wider actions by our better-off members". In particular:

> First, larger ODA flows should provided to HIPCs and these flows concentrated on those countries implementing strong policies... Second, trade liberalization [in industrial countries] needs to be reinvigorated so that the export products of HIPCs – which are largely raw materials and agricultural products – have unrestrained access to industrial country markets. We urge redoubled efforts on both the aid and trade fronts:

without such efforts, the HIPC Initiative cannot by itself achieve sustained poverty reduction (IMF/World Bank, 1999b: 3).

In effect, there can be no such thing as a good poverty reduction strategy in a bad international enabling environment. Poverty reduction cannot be dealt with by focusing on national determinants alone, but must be treated as an international issue. Realizing international development goals will require international development means.

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Notes

1. For discussion of the lessons of the resolution of the debt problem in middle-income countries in the 1980s for poor countries, see Cline (1997).
2. A useful summary of these debt relief mechanisms is OECD (1997).
3. Daseking and Powell (1999:8) describe the situation in the 1980s as follows: "The secondary market prices for low-income country private debt, where they existed at all, were typically below those of the middle-income countries, but export credit agencies continued to argue publicly that official exposure would eventually be recovered in full...and [they]were not generally obliged to follow the accounting practices required of other commercial lenders and insurance companies. Throughout the 1980s, therefore, ECAs generally reported the value of their sovereign claims at full contractual value and had not made any provisions for bad and doubtful debt. These accounting practices allowed bilateral creditors to continue to provide comprehensive rescheduling or refinancing of payments falling due, without paying much attention to the medium term prospects for ultimate repayment of these debts".
4. The present value of the debt is usually, though wrongly, referred to as the "net present value". For a important discussion of this issue, see Cosio-Pascal (1997).
5. A full analytical summary of proposed changes to the HIPC Initiative can be found in IMF/IDA, (1999a), whilst a listing of key changes can be found in IMF (2000b). For an insider's view of the political process behind the introduction and enhancement of the HIPC Initiative, from someone who was an official in the international finance area of the United Kingdom Treasury from 1986 to 1994 and United Kingdom Executive Director at the IMF and World Bank from 1994 to 1997, see Evans (1999).
6. The way in which floating completion points are related to performance assessment is clearly set out in IMF/IDA (1999a: 14 – 17).
7. The following account draws on IMF (1999), and the evolving discussion of PRSPs is set out in IMF/IDA (1999b); IMF/World Bank (1999a); IMF/IDA (1999c); IMF/IDA (1999d); World Bank (2000a); IMF/World Bank (2000); World Bank (2000b).
8. For a recent critical statement of the negative effects of conditionality within HIPC II, see Killick (2000).
9. The situation of Benin has, however, been reassessed under HIPC II, and a debt reduction package was announced on 18 July, 2000.
10. IMF (2000b); IMF/World Bank (2000). This excludes the Gambia, which was added to the list of HIPCs in late August.
11. This estimate is from www.worldbank.org/hipc/faq/faq.html.
12. For full assumptions, see documents referred to in table 35.
13. For a discussion of these indicators, see IMF (1998; 2000a), and Cosio-Pascal (1997).
14. In the case of Uganda, for example, the baseline scenario assumed constant real coffee prices for most of the projection period, but the differential between the peak and the trough of the most recent coffee price cycle in the 1990s exceeded 200 per cent of the trough price, and the average deviation of coffee prices in the previous nine years (the length of the latest full coffee cycle) from a 25-year trend was 22 per cent of the trend price. Moreover, the baseline assumed an income elasticity of imports of 0.95, whereas for the four years before the forecast, real GDP increased at about 8 per cent per annum, with real imports increasing at 12 per cent per annum (i.e. on income elasticity of 1.5). Another example of such optimistic forecasting is that of Bolivia, where national government officials proposed to replicate, during the HIPC I negotiations, the last two large price shocks experienced by the country, but the vulnerability analysis simulated the effects of a price shock which was one third of that proposed. The Ugandan figures are taken from IMF/IDA (1997a: 22–25), whilst the Bolivian example is drawn from Comboni (2000).
15. Amongst the interesting proposals which take the direct route are CAFOD (1998) and Sachs et al. (1999).
16. For a sophisticated discussion of this issue, see Heller and Schiller (1999).

17. These points were raised in the Declaration of the second HIPC ministerial meeting, Geneva, 7 June 2000, organized by Debt Relief International.
18. See Debt Relief International (2000b: 5) which reports that "Some governments are cancelling only pre cut-off aid (ODA) debt, some pre post cut-off date debt. Others are cancelling export credit debt as well. Most (with the notable exception of Canada, the UK, the US and some other like-minded governments) seem determined to delay their cancellations until completion points, which means that most HIPCs will not see them until well into the new millennium".
19. This was stressed in the Declaration from the second HIPC ministerial meeting, held in Geneva on 7 June 2000.
20. Proposals set out in United Nations (1999) are still relevant. Recent research has questioned in particular the fiscal thresholds for sustainability and has proposed a reduction of PV debt-to-fiscal revenue criterion by more than one third from its HIPC II level to 155 per cent, as well as a lowering of the qualifying criteria for application of this threshold (see Martin, 1999).
21. On the importance of meso policies within anti-poverty strategy, see Gore and Figueiredo (1997).

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Chapter 6

Aid effectiveness, coordination failures, and ownership

A. Introduction

Analyses of aid effectiveness usually focus on the empirical regularities in the relationship between aid inflows and development outcomes without looking at the underlying processes. In order to promote better aid effectiveness, however, it is necessary to understand the mechanisms that link aid with development. Any serious attempt at analysing the question of aid effectiveness has thus to be able to address at least some of the following questions:

- What are the main mechanisms for allocation and utilization of aid flows?
- How have these interacted with domestic policies and development strategies?
- How have the resulting outcomes influenced the overall processes of resource mobilization and allocation?
- Has aid exerted a stabilizing influence at the macro level, or has it increased vulnerability?
- Has aid increased the quantity and quality of public services, and, if so, how has this affected overall productive potential and competitive position?

This chapter addresses these questions with respect to the LDCs. It begins with an overview of the shifting paradigms of the international aid system, focusing in particular on the World Bank's and the donor community's diagnosis of past aid ineffectiveness, and the assumptions which underlie current changes designed to increase aid effectiveness through partnership, ownership and selectivity. Much of the recent debate on aid effectiveness has been founded on cross-country regression analyses which focus on national correlates of the impact of aid. But a central contention of this chapter is that although national policy certainly matters, aid effectiveness has been undermined by the nature of the international aid delivery system, in particular by the working of a diverse and uncoordinated aid delivery system in the era of liberalization. Section C provides an overview of the modalities of the aid delivery system during the adjustment period and up to the present. This is followed in section D by a discussion of the lack of correspondence between evaluations of aid effectiveness at the micro level and the macro level. Sections E, F and G analyse the implications of the international aid delivery system for the macro effectiveness of aid. Section H assesses the new concepts of policy "ownership", "partnership", and "selectivity" in the light of this analysis, and the main conclusions and policy implications are set out in the final section.

Although national policy certainly matters, aid effectiveness has been undermined by the nature of the international aid delivery system, in particular by the working of a diverse and uncoordinated aid delivery system in the era of liberalization.

B. The commonality and diversity of the international aid system

1. Shifting paradigms of the international aid system[1]

There have been three major shifts in donors' approaches to aid since the 1950s. During the earlier decades, up to the late 1970s, foreign aid mainly took the form of project aid in support of the investment plans of the recipient countries. Insufficient savings and/or insufficient import capacity (to import capital goods) were identified as the key constraints on investment, in the tradition of two gap models. The role of foreign aid was to boost investment by reducing the savings gap or the foreign exchange gap. Aid-financed investment, therefore, was seen as the solution to the problem of development. Typically, the recipient Governments would draw up development plans of one sort or another and, on the basis of such plans, produce a list of investment projects. Donors would then choose which projects to finance. Most investment projects consisted of a package (usually managed from the donor side) of aid-financed imports of capital goods and the provision of technical and managerial expertise, coupled with local production and employment financed by recipient Governments. With the exception of food aid, therefore, aid mainly consisted of investment support in the context of project aid.

There have been three major shifts in donors' approaches to aid since the 1950s.

During the 1980s a mainstream consensus emerged – expressed in IMF- and World Bank- inspired structural adjustment programmes – that put the blame for the lack of effectiveness of aid squarely on inappropriate domestic economic policies. The approach to aid policy, therefore, shifted away from a strategy of aid-financed investment towards a strategy of aid-induced economic reforms. Aid policy lost its near-exclusive preoccupation with aid as a resource transfer to finance investment and came to consider aid also as a means of forging policy change. Access to aid was made contingent upon the adoption of an appropriate policy framework through the imposition of policy conditionality. Throughout the 1980s and the 1990s policy conditionality was mainly concerned with the adoption of economic reforms through stabilization, liberalization and deregulation of the economies of aid recipients.

The shift in emphasis towards policy conditionality led to the making of the "donor community" as an entity with a dominant, if not overriding, voice in the domestic policy discourses of the recipient countries. Structural adjustment programmes, propelled by the IMF and the World Bank, and the shift in emphasis towards programme aid, created a common platform amongst donors jointly to exert policy leverage on recipient countries. In their relationship with donors, therefore, LDCs no longer only faced a multitude of different parties, but also the donor community as a single negotiating partner in its own right.

Under structural adjustment policies, programme aid gained prominence alongside project aid and became a key instrument to render access to aid contingent upon acceptance of policy conditionalities. As structural adjustment policies took hold, programme aid changed its emphasis in terms of the balance between its main constituent elements – from import support to budget support and debt relief. This was in part a consequence of economic reforms in progress, and in part a reflection of shifting donor concerns. In quantitative terms net disbursements via programme assistance formed a small part of aid flows. According to OECD/DAC figures, programme assistance, inclusive of debt relief, constituted no more than 20 per cent of aid to developing countries in the late 1990s. Under the impulse of structural adjustment, however, project aid also

changed its tune – away from the more traditional investment support within the framework of a development plan and towards semi-autonomous, donor-managed public sector activities with often a considerable recurrent cost component, notwithstanding the almost general practice of listing projects within the development budget (Wuyts, 1996). It is these processes which, as will be shown later in this chapter, have had important consequences for the macro effectiveness of foreign aid.

In the latter half of the 1990s there has been a rapid change in donors' thinking about aid policy, and although this process of rapid change is still unfolding, it has all the makings of a new paradigm. Increasing realization of the failure of adjustment programmes in the low-income countries first led to a rethinking of policy conditionality. The World Bank critique of aid, *Assessing Aid,* conveyed three principal messages; first, aid works in "good" policy environments; second, aid cannot buy "good" policy; and third, aid allocation does not appear to be based on policy environment (World Bank, 1998). The second proposition drew on a growing number of evaluation reports, case studies and research papers, which indicated that sustainable and effective policy change critically depends on local "ownership" of policies. *Assessing Aid* combined this message with the remnants of the old thinking during the conditionality era, i.e. "we" know what "good" policies are, but we cannot force "them" to "own" such policies by old-style conditionality. Consequently, if there is no internal political platform within a country to set and "own" the right policy environment, aid will fail to be effective. If, however, such a platform (rooted in democracy, good governance and good policies) does exist – it was argued – aid will not only prove to be effective, but also essential for sustained development. The conclusion which has been drawn from this is that aid effectiveness can be increased by directing aid to countries with "good" policies, and persuading the laggards to "own" good policies by giving them advice, consultation and incentives through withholding of aid. This is expressed in the idea of *ex-post* conditionality or "selectivity".

Increasing realization of the failure of adjustment programmes in the low-income countries first led to a rethinking of policy conditionality.

The driving force for change is coming more from serious concerns on the part of aid practitioners, associated with bilateral donor agencies, or multilateral agencies such as DAC/OECD, UNDP and World Bank Operations Evaluation Department (OED). Helleiner's report on aid to the United Republic of Tanzania and its follow-up (see Helleiner et al., 1995), and the OECD/UNDP joint project on aid to Mali (see OECD/UNDP, 1999), constituted the beginning of a new "official" approach to aid effectiveness which was very distinct from the conditionality paradigm. The new Comprehensive Development Framework (CDF), launched by the World Bank's president in 1999, also seems to herald a new approach by the World Bank, which is self-styled as part of a new development paradigm as set out in the 1999 *Annual Review of Development Effectiveness* by the Bank's Operations Evaluation Department (see World Bank, OED, 1999a).

The summary of the World Bank/OED document (World Bank, OED, 1999b) points out that "in the era of adjustment the Bank often ignored local knowledge and expertise and was assumed to have all the answers – its only problem was selling those answers to the clients" (p.3). The new CDF is said to pay attention to institutions and hence the specificity of local situations, and "aims to put the country in the driver's seat in formulating and implementing development strategy which must involve also the private sector and the civil society". Donors and multilateral institutions are expected to harmonize their programmes and practices, and work with country "partners" in a framework of mutual accountability. Blanket liberalization and privatization policies are to give way to

"liberalization, regulation, and industrial policy to match state capability"(p.2). The new approach is holistic in the sense that "it has to go beyond macroeconomic management and incorporate governance, human, and social development objectives". This multiplication of objectives echoes the general tendency in donors' thinking during the 1990s where a multiplicity of issues such as poverty, environment, gender and governance are mentioned alongside economic growth (see, for example, OECD, 1999).

2. Some central assumptions

Whether or not the new vision will lead to improved aid effectiveness depends on the extent to which it is based on a realistic diagnosis of the problems of the existing aid institutions and practices. Perhaps the central proposition of the new approach is that aid *will* be effective under "sound" economic policies by recipient Governments.[2] In other words, other things being equal, "sound" economic policy in the recipient country is not only *necessary* but also *sufficient* for aid effectiveness. This is also echoed by the following quotation from USAID (1991: ix) in the context of aid to Africa: "AID should put its time and energy into the development of analytically sound reform programme and worry less about the type of reform assistance it provides". But this view rests on a number of important implicit assumptions about the international aid delivery system.

Whether or not the new vision will lead to improved aid effectiveness depends on the extent to which it is based on a realistic diagnosis of the problems of the existing aid institutions and practices.

The first is that there are no major negative externalities associated with the "type of assistance provided" which can overshadow the possible returns. For example, if foreign assistance leads to the creaming off of scarce skilled personnel from the civil service and the private sector, and engages them in activities with a low social rate of return, there would be cause to be concerned about the type of assistance. However, if the total size of foreign aid relative to the domestic economy were small, there would be perhaps less cause to "worry" about the "type of assistance".

The second implicit assumption, therefore, is that the size of aid flows relative to domestic macroeconomic magnitudes is small. While this is normally the case for individual projects, it may not be true at a more aggregate level. In the case of the LDC economies in particular, as observed in chapters 1 and 2, aid flows overshadow the domestic sources of finance. Indeed, given the large size of the aid flows relative to government budget and external trade flows in the LDCs, macroeconomic stability as well as the efficiency of investment in most of these countries would be themselves largely dependent on the nature of the aid delivery system.

The third implicit assumption is that aid is well coordinated with the policies and priorities of the recipient countries. This is the case, for example, in the common pool approach to aid, in which aid is deposited by donors in a common pool for utilization by the host Government according to some mutually agreed development plan.[3] But in the era of adjustment and liberalization, government-led coordination withered. Donors were able to coordinate their policy conditionality around IMF and World Bank adjustment programmes. But at the same time, the donor community was, and is, by no means a homogeneous entity. On the contrary, as pointed out by Kanbur, Sandler, and Morrisson (1999), donors have contrasting histories, experiences, and ideas, and these influence the projects and programs they are willing to support. Thus, relatively strong coordination of policy conditionality has coexisted with great diversity in terms of aid delivery. This tension between the

commonality of policy conditionality and the fragmentation of the aid delivery system has played a significant part in reducing aid effectiveness and in disrupting the developmental processes in the LDCs during the past two decades.

C. The diversity of the aid delivery system and the "coordination problem"

Currently, in most Asian and African LDCs between 30 and 50 bilateral and multilateral official aid agencies are engaged in aid projects, which number at least a few hundred in each country. To this should be added hundreds of foreign NGOs and aid charities with their own aid delivery channels and a variety of objectives and work practices. Although most of the recorded official aid flows are reflected in the recipient countries' government budgets mainly as development expenditure, the magnitude, allocation and utilization of aid moneys are by and large outside centralized and coherent government decision-making processes in these countries. The various outside aid agencies play a dominant role in the design and implementation of aid projects, partly in conjunction with local ministries and agencies and partly by setting up parallel management frameworks – and increasingly through NGOs.

Currently, in most Asian and African LDCs between 30 and 50 bilateral and multilateral official aid agencies are engaged in aid projects, which number at least a few hundred in each country.

This diverse and fragmented aid delivery system is well characterized in a recent joint report by OECD and UNDP on Mali, which is one of the rare studies of the aid system largely from the viewpoint of the recipient country and in a comprehensive national framework (see OECD/UNDP, 1999). A summary of the main findings of the Mali report can give a picture of the aid delivery system that is not atypical of the prevailing situation in other LDCs. Mali is a typical LDC economy in that foreign aid plays a dominant role in macroeconomic aggregates. According to World Bank figures, foreign aid has constituted about 80 per cent of government expenditure, about 20 per cent of GNP, and between 90 and 200 per cent of gross domestic investment, and on average has financed over 50 per cent of imports in Mali over the past two decades (World Bank, 2000b).[4] The case of Mali is also instructive in that, having had a representative and democratically elected Government since the early 1990s, it represents the current aid delivery system at its best, least diluted by corrupt practices of aid-dependent autocratic rulers. Mali has also been one of the countries in sub-Saharan Africa which according to the World Bank has had a relatively successful policy reform record (World Bank, 2000a).

The diversity of the aid delivery system in Mali is highlighted by the fact that, for example, in 1996 the donor community comprised about 30 bilateral agencies and 20 multilateral agencies and a very large number of NGOs, "each with its own strategies, values, culture and customs, and work procedures" (OECD/UNDP 1999: 22). The fragmentation of the aid delivery system and its lack of integration in the national management structures and economy also stand out. According to the Mali aid report (p. 22):

> Frequently, national institutions and procedures and sometimes also national managers are not called upon in the first instance to manage aid operations, which in large part are conducted by parallel structures and expatriate staff using donors' procedures. This is illustrated by a large number of projects conducted outside the Three year Investment Programme (TIP) and the Special Investment Budget (SIB)… A similar lack of integration is found with the country's economy. Aid is not integrated into public and private economic channels. Tied aid and tax-exemptions

for aid-related imports generate parallel channels and procedures. Similarly, donors' remuneration practices are not in line with local conditions and create distortions in government's pay policy.

The difficulties of aid coordination, and integration into the national economy, are further exacerbated by lack of information. "The national authorities are often unable to state exactly the amount of aid flows that have been negotiated, and some [aid] agencies have difficulty keeping track of their own operations (commitments, disbursements, actual expenditure as compared with budgeted expenditure, the cost of consultants in staff months, projects in preparation, etc.)" (p.12). A consequence of this is that the aid flows given in Malian statistics represent only between one and two thirds of the official figures published by OECD and UNDP in their development co-operation reports (p. 21). Although formal government institutions in charge of coordination of foreign aid exist, these are normally bypassed by the donors and the line ministries. "In practice, sectoral ministries often submit requests to the donors themselves; in other cases, the donors may even indicate the requests they would like to see submitted to them" (p. 21). This, according to the report, has led to a proliferation and duplication of projects, disregard of national priorities in project choice, and a general breakdown of aid coordination.

Although formal government institutions in charge of coordination of foreign aid exist, these are normally bypassed by the donors and the line ministries. This has led to a proliferation and duplication of projects, disregard of national priorities in project choice, and a general breakdown of aid coordination.

Although comprehensive economy-wide surveys of the aid delivery system for many other LDCs are not available, the existing evidence does not suggest any better coordination than the Malian case for most countries, and perhaps even worse in the case of some.[5] The following observation by one of the long time observers of the international aid scene paints a picture similar to the Malian case for the sub-Saharan African LDCs in general:

> A remarkably high percentage of bilateral development assistance to low-income Africa goes directly to overseas contractors' foreign personnel, or to local suppliers, non-governmental organizations, or even local government officials (topping-up their inadequate salaries), without going through any local government budgetary system. The local governments frequently have no information on these flows or on the projects they support. Indeed most donors cannot or will not supply information on these flows to the local government even when they are asked to do so. Externally-supported projects frequently exist as "islands" within the local economy and society, supplying certain services to a select few but otherwise unconnected in any way to indigenous development processes (Helleiner, 1997).

This has been recognized as a general problem by the donor agencies themselves for some time; as, for example, a recent aid evaluation report by the World Bank indicates, "the development assistance system is too fragmented and onerous, particularly for the poor and weak countries" (World Bank/OED, 1999: 3).[6] However, the operation of this "fragmented and onerous" system for such a long period of time has had important implications for aid effectiveness both at the micro and macro levels.

D. Consequences for aid effectiveness

One of the well-known paradoxes of the aid system is that the evaluation of the individual aid projects at the point of exit, assessed by donors, often indicates "satisfactory" outcomes with high rates of return, but at the macro level the results are much less satisfactory. For example, a recent World Bank evaluation shows that over 70 per cent of its projects during the 1990s were

evaluated at the point of exit as satisfactory (World Bank/OED, 1999a). The same document at the macro level, however, maintains that "the fight against poverty is being lost, and the efficacy of the development assistance system is being questioned" (p. 1). High rates of "satisfactory" evaluation of projects are also common amongst the bilateral and other multilateral donors, which are difficult to reconcile with poor economic performance at the aggregate macro level.[7]

There are a number of reasons which may explain this apparent discrepancy between the assessed micro and macro impact of foreign aid, some relating to the nature of assessment itself and others to the negative feedbacks between aid projects and other developmental processes in the recipient countries. One reason for over-optimistic evaluation of projects by the donors can be that the assessments are based on donors' objectives and criteria, which may not necessarily be in tune with the long-term developmental needs of the recipient countries. The project managers in donor agencies are accountable to their own governments rather than to those who are affected by foreign aid in the recipient countries.

The agencies' incentive structures are hence such that short-term objectives, such as timely disbursement of aid moneys and satisfactory evaluation at the point of exit, may overshadow the longer-term and broader developmental impact of their projects. For this reason the evaluation of the sustainability of the aid projects normally produces much poorer results than spot evaluations at the point of exit. For example, only about 30 per cent of the World Bank projects in Africa during the 1990s were assessed as likely to sustain their "satisfactory" performance after delivery (World Bank/OED, 1999a, p. 37). And this 30 per cent success rate has itself been based on prospective assessment of sustainability by the donor at the point of exit rather than on observed long-term performance of the projects.

The poor integration with the domestic economy and national management structures often leads to the projects losing direction and finance once the donor agency exits after the completion of the project.

The apparently low rates of sustainability of the aid projects are not due solely to the incentive structures of the donor agencies at the design and implementation stage of the projects, i.e. the focus on short-term donor-centred results. An even more important reason is that the poor integration with the domestic economy and national management structures often leads to the projects losing direction and finance once the donor agency exits after the completion of the project. According to the Mali aid review, less than 20 per cent of the projects in Mali received counterpart financing by the recipient Government or other local beneficiaries, and because of this, "the probability of projects being sustained beyond the period of external financing is often diminished" (p. 22). This is, of course, only one of the implications of the fact that aid-funded projects are increasingly taking the form of islands amidst an increasingly impoverished public sector.

The poor integration with the domestic economy poses even more serious problems for the macro effectiveness of aid. But before these problems are examined, a number of points concerning the measurement of what constitutes aid and aid effectiveness are in order. First, what the donors regard as aid, i.e. the net official loans and grants registered in the international financial statistics, are normally largely at variance with the official statistics on aid in the recipient countries. For example, the aid flows given in Malian statistics represent only between one and two thirds of the official figures published by the OECD and UNDP in their development cooperation reports (p.21). Secondly, not all aid has or is meant to have a developmental impact. For example, a growing proportion of aid over the past two decades has been allocated to emergency

and humanitarian causes without direct developmental impact (see chapter 2). Thirdly, to the extent that aid is tied to the purchase of possibly inappropriate and expensive goods and services from the donor country, the return to investment financed by such aid is accordingly less. This effect, however, will be to a large extent captured by low returns to individual projects reflected in the micro effectiveness of aid discussed above.

Technical cooperation is a form of aid that epitomizes the debilitating effects of a combination of the above factors on aid effectiveness. It forms a substantial part of aid to the LDCs. Technical cooperation is tied aid in more than one sense of that term. First, it is tied in the sense that often “its provision is a condition associated with the provision of finance and other forms of assistance” (Helleiner, 1997: 3). Secondly, it is tied in the sense that it takes the form of direct, and often unsolicited, provision of experts, instructors or educational services by the donor. Much of the funds allocated under technical cooperation accrue directly to the individuals and institutions in the donor country without being reflected in the balance of payments or government accounts of the recipient country. This may be part of the explanation of the large discrepancy in registered aid funds in the donor and recipient accounts. The evaluation of the impact of technical cooperation in the LDCs particularly in sub-Saharan Africa, either in terms of its role in technology transfer or in capacity building, also indicates quite abysmal results (see, for example, the UNDP study by Berg, 1993). According to the UNDP study, the elements enumerated above, i.e. multiplicity and duplication, wrong incentive structures, and lack of integration with domestic structures, have all played their role in the failure of technical cooperation. In addition, there have been important negative externalities associated with technical assistance, ranging from distorting government pay structures, discouraging learning and capacity building in public institutions, to additional monetary costs for the recipient governments. As pointed out by Helleiner (1997: 3), technical assistance “typically has carried enormous costs not only in terms of the opportunity cost of the donor funds but also in local costs associated with ‘servicing’ inexperienced and expensive foreigners”. Such negative externalities, however, form an important part of the explanation of the poor macro effectiveness of foreign aid in general, to which we shall now turn.

There have been important negative externalities associated with technical assistance, ranging from distorting government pay structures, discouraging learning and capacity building in public institutions, to additional monetary costs for the recipient governments.

E. Macro effectiveness of foreign aid: (1) aid and economic volatility

The aid delivery system can influence the macro effectiveness of aid, and the overall efficiency of resource use in the recipient country, in various ways. A first question is whether foreign aid flows are reliable. Since aid flows are large relative to other macroeconomic aggregates in the LDCs, their instability can lead to macroeconomic instability with obvious negative consequences for the efficiency of resource use. Such instability would in addition make the task of investment planning difficult and lead to lower rates of both private and public investment. The second related question is whether the volatility of aid flows has been covariant with other sources of foreign exchange and government revenues in the LDCs, and if so, in which direction. Depending on the responsiveness of aid to the short-term liquidity problems of the LDCs arising from external shocks, it can influence the vulnerability of the LDC economies in a negative or positive way. For a number of reasons this role of foreign aid, namely its liquidity provision role, can be critical in the case of the LDCs. As discussed in chapter 1, the LDCs have been extremely vulnerable to short-term external shocks arising from natural causes or the vagaries of the international

economy. Furthermore, lack of recourse to international capital markets makes these economies almost totally dependent on foreign aid to alleviate or smooth out the consequences of external shocks for their foreign exchange and government revenues. The alternative would be to carry large foreign exchange reserves, which would be too costly for the LDCs. Whether foreign aid has intensified or compensated for the instability resulting from external shocks is therefore of paramount significance.

Foreign aid seems to have been more volatile than government current revenue in almost all the LDCs.

In order to examine the relative volatility of aid flows, we have measured in table 40 the coefficient of variation of annual changes in aid flows, government revenues excluding grants, and export revenues. The volatility of aid is measured both in domestic currency, for comparison with government revenue, and in dollar terms to be compared with exports. As shown in table 40, foreign aid seems to have been more volatile than government current revenue in almost all the LDCs, and it has shown higher annual variations even with respect to the extremely volatile export revenues in the majority of countries listed in the table.[8] Apart from the relative volatility of aid, what matters from the point of view of overall economic stability is whether the short-term variations in aid have alleviated or intensified the effect of external shocks. To determine this, the correlation coefficients between annual variations of aid and government

TABLE 40: VARIABILITY AND CO-MOVEMENT OF AID, GOVERNMENT REVENUE, AND EXPORTS IN LDCS, 1970–1998

	Coefficient of variation of annual growth rates				Correlation coefficient between Annual variations in aid and[a]	
	Aid in domestic currency	*Government revenue*	*Aid in $*	*Export revenue $[b]*	*Government revenue*	*Export revenue*
Bangladesh	3.71	0.88	2.90	1.37	0.671	-0.076
Burkina Faso	1.57	1.38	1.86	2.23	0.425	0.452
Burundi	1.71	1.14	2.68	13.70	0.288	-0.099
Dem. Rep. of the Congo	4.67	3.45	5.55	4.58	0.789	0.223
Ethiopia	1.75	1.53	2.24	2.12	-0.207	-0.237
Gambia	2.44	0.88	2.85	2.00	0.478	0.002
Lesotho	1.44	0.79	2.93	2.10	0.112	0.635
Liberia	3.27	1.74	3.27	2.79	0.369	0.377
Madagascar	1.61	1.40	2.69	2.32	-0.326	0.149
Malawi	1.30	0.46	2.05	2.88	0.131	0.241
Maldives	2.57	1.23	2.43	1.95	0.656	0.001
Mali	2.05	0.73	2.12	1.73	0.048	0.191
Myanmar	3.71	1.03	4.05	2.23	-0.250	-0.099
Nepal	1.16	0.48	1.77	1.25	0.046	0.341
Rwanda	2.02	0.87	2.08	6.53	-0.078	-0.408
Sierra Leone	1.42	1.33	2.51	15.07	0.567	0.163
Solomon Islands	2.14	0.63	3.24	1.77	-0.283	-0.095
Sudan	1.93	0.71	3.35	4.22	0.425	0.148
Togo	2.48	1.66	2.66	3.26	0.460	0.385
Uganda	1.66	2.25	2.66	4.60	-0.065	-0.376
United Rep. of Tanzania	1.21	0.53	1.79	3.95	0.455	-0.117
Vanuatu	2.74	0.61	2.79	1.61	0.135	0.144
Zambia	1.40	1.30	2.49	7.61	0.543	0.256
Mean	**2.17**	**1.18**	**2.74**	**4.00**	**0.234**	**0.096**
Median	**1.93**	**1.03**	**2.66**	**2.32**	**0.288**	**0.148**

Sources: World Bank, *2000b; World Bank, 2000c*, UNCTAD calculations.

a Measured in domestic currency for government revenue and in United States dollars for export revenues (including factor incomes). Official exchange rate is used for conversion.

b Export revenues include income from abroad.

revenue, and aid and exports, are shown in the last two columns of table 40. Also, the histogram of the estimated correlation coefficients for the two series are reported in charts 47 and 48. As can be seen, the correlation between short-term variations of aid and the other two variables is rather weak, and in the

CHART 47: HISTOGRAM OF THE CORRELATION COEFFICIENTS BETWEEN AID AND GOVERNMENT REVENUE VARIATIONS IN THE LDCS, 1970–1998

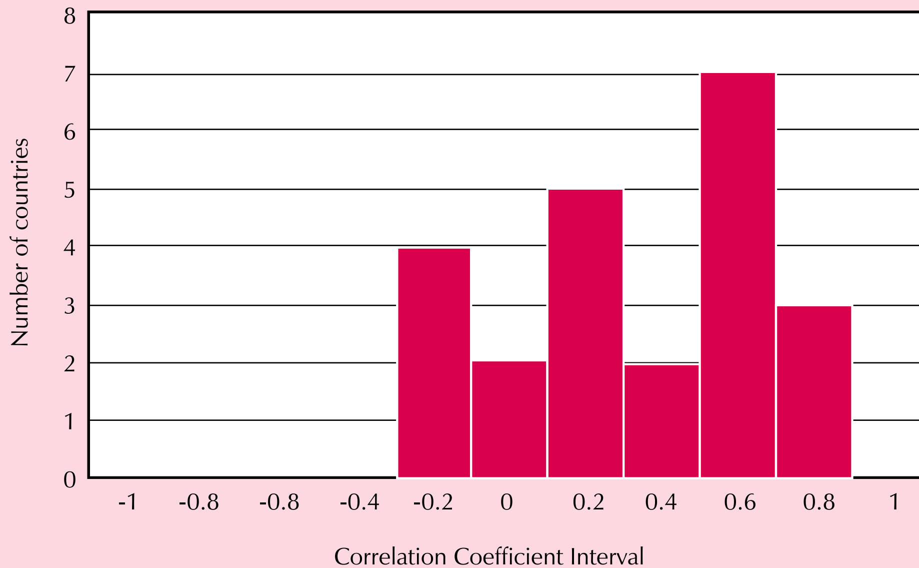
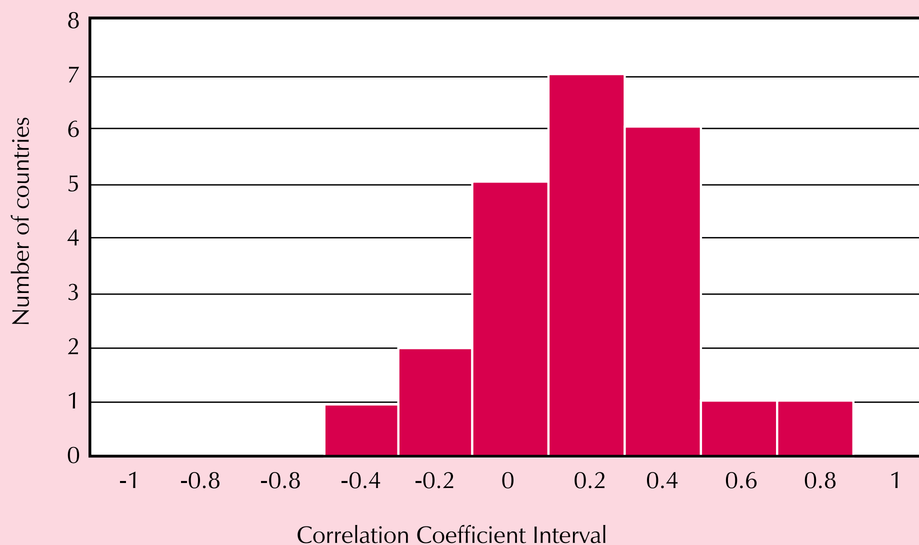


CHART 48: HISTOGRAM OF THE CORRELATION COEFFICIENTS BETWEEN AID AND EXPORT REVENUE VARIATIONS IN THE LDCS, 1970–1998



Source: As table 40.

majority of cases, there seems to be, if anything, a positive correlation between aid and the other two variables. It appears, therefore, that foreign aid by and large has not alleviated the effect of short-term external shocks in the LDCs, and has, if anything, reinforced the effect of such external shocks.

These results, which are in conformity with other findings in the literature, are not unexpected.[9] There is no reason why the multi-donor-driven and uncoordinated aid delivery system should particularly generate a stable and predictable flow of funds. Even if the overall committed aid budgets of the donor countries are relatively stable, disbursements to individual recipients can be quite volatile as a result of changing economic and political conditions, unexpected humanitarian emergencies in other recipient countries, and administrative delays. With regard to the covariance of the aid flows and other macro variables, there seem to be in fact a number of in-built mechanisms in the aid delivery system which are likely to generate a pro-cyclical variation in aid flows. Despite the growing emphasis on programme aid during the past two decades, the logic of the international aid delivery system has essentially worked against the potential role of aid in short-term liquidity provision. Bilateral donor agencies are more concerned with the stability of aid disbursements from the point of view of the overall commitments of the donor country than with unexpected external shocks in the recipient country. This also applies to programme aid, which apart from being a small part of bilateral aid often committed to specific programmes, is also subject to stop-go short-term conditionalities that essentially preclude it from playing its "quick disbursement" role. Furthermore, the IMF has failed to fulfil its function as the provider of contingency funding in the case of the LDCs, as its funding has been subject to conditionalities involving delays and large transaction costs, and the net resources provided have been in any case well short of the requirements to deal with the LDC shocks (Helleiner, 2000). On the contrary, in cases where the negative external shocks have caused the LDC Government to be unable to fulfil the IMF conditionality, the negative signal to the donor "community" at large has often caused a partial withdrawal or delay of funds at a time of need (Sachs et al., 1999). Furthermore, the complementarity of much of bilateral aid with the domestic currency resources of the recipient Government introduces an additional pro-cyclical tendency in the aid delivery system; negative external shocks lead to the recipient Government not being able to provide domestic counterpart financing and hence delaying the disbursement of aid. The overall logic of the aid delivery system, therefore, entails aid's pro-cyclical behaviour vis-à-vis external shocks rather than a compensatory role.

Despite the growing emphasis on programme aid during the past two decades, the logic of the international aid delivery system has essentially worked against the potential role of aid in short-term liquidity provision.

This phenomenon has had profound implications for aid effectiveness, and for investment and growth and the overall efficiency of resource use in the LDCs. The volatility of the aid flows has contributed to macroeconomic instability. Ironically, the community of donors has treated macroeconomic stability as a key component of policy reform conditionality since the early 1980s. This may be one reason why as soon as measures such as overall volatility or aid uncertainty are introduced into cross-country regressions of aid effectiveness the macro-policy index loses its significance (see, for example, Lensink and Morrissey, 1999, and Guillaumont and Chauvet, 1999). As pointed out by Lensink and Morrissey, "It appears reasonable to claim that aid will be more effective under certain policy environments, notably those that are themselves conducive to growth. It is less clear that conditional aid promotes such policy environments. If conditionality leads to greater uncertainty (and/or lower investment), and there are reasons to believe it does, then it may actually reduce the effectiveness of aid. The links between aid, policy and growth are more complex than simply stating that aid works if the right policies are present"

The volatility of the aid flows has contributed to macroeconomic instability.

(p. 22). As appears from the above discussion, not only conditionality but also, and perhaps more importantly, the diversity of the aid delivery system seem to have undermined macroeconomic stability and hence aid effectiveness.[10]

F. Macro effectiveness of foreign aid: (2) the erosion of state capacities

There are, however, other more important factors associated with the diversity of the aid delivery system which have contributed to the undermining of the macro effectiveness of aid in the LDCs. These factors can be grouped under the generic title of externalities arising from lack of coordination and integration of the aid delivery system. Foreign aid provides additional resources for the recipient countries, which can lead to the generation of new capacities and better utilization of the existing capacities in those countries. The productive use of aid funds, however, always requires complementary domestic resources in various forms, e.g. manpower, local government funds and public services, and services from other local institutions. Where the return on aid-related projects is higher than the return on the uses to which these complementary domestic resources were hitherto applied, the overall productivity in the economy will rise. In addition, aid-funded projects, when well coordinated and integrated into the domestic economy, can produce additional positive synergies in the economy through the transfer of new technology and know-how, learning and other positive externalities, which could bring about additional productivity increases. Even if the immediate returns on aid-funded investments are relatively low, they can still help increase overall productivity in the economy through their technological and learning effects.

The productive use of aid funds always requires complementary domestic resources in various forms, e.g. manpower, local government funds and public services, and services from other local institutions.

During this process, along with productivity growth the wages and prices of the local services rise relative to the prices of internationally traded goods. This process of productivity growth with its attendant real-wage and relative-price changes, which is the very essence of economic development, is sometimes mistaken for the so-called "Dutch Disease" phenomenon. This phenomenon, however, is relevant to the situation of developing countries subject to sudden capital inflows or temporary export booms. It is of little relevance to the analysis of the impact of aid in the case of LDC economies with their severe capital shortages, to the extent that aid funds are productively employed in developmental activities.[11]

However, when the activities of the various donors are not coordinated and the aid delivery system is not integrated into the domestic economic processes, aid would not only fail to generate the expected positive externalities, but might also give rise to considerable negative effects. Under these circumstances, aid can swamp the capacities of the local institutions, weaken the ability of recipient Governments in the provision of vital public services, and distort the overall allocation of resources away from the strategic priorities of development. While each aid project may be well designed and well implemented, and address some vital economic need from the micro perspective, the aggregate outcome would be much less than the sum of the parts. The problem here is not the size of foreign aid per se, or what in the classic aid literature has been referred to as the lack of absorptive capacity in the recipient countries. On the contrary, as pointed out in other chapters of this report and as is almost unanimously agreed by analysts, economic development in the LDCs in fact requires much higher amounts of foreign aid than they currently receive (see, for example, ESCAP, 1999; Collier, 1999; UNCTAD, 2000; World Bank, 2000a: 243). The main

problem is rather the lack of coordination of the aid delivery system, and the low degree of integration of the aid system into the local economic and administrative structures.

This lack of coordination and integration of the aid system can lead to a fragmentation of decision-making and a proliferation of projects and procedures which put increasing pressure on the meagre resources of the recipient Governments. Over time it can lead to a gradual erosion of the capacity of the recipient Government even to meet its basic recurrent expenditures – a situation which can be referred to as extreme "aid dependence". There are normally various mechanisms at work to bring about this situation. Foreign aid projects in the LDCs, though nominally in the public sector, have been controlled by the donors, at least until the completion or the "exit" date when the projects are expected to be handed over to the recipient Government. Wages and salaries in these projects are also usually set by the donors, often not in conformity with public sector pay scales. A prolonged adverse external shock, as for example happened in the late 1970s and early 1980s, followed by a relatively large increase in aid and at the same time a tightening of the recipient government's resources, can set the process going. There would be a proliferation of donor projects, increasing the demand for professional staff at a time when the tightening government budget is leading to increasing wage erosion in the government sector. Those parts of the Government that do not receive donor funds gradually lose their key staff as they lose the ability to pay competitive salaries. The gradual decline in public services leads to the erosion of its ability and capacity to raise revenues.

Those parts of the Government that do not receive donor funds gradually lose their key staff as they lose the ability to pay competitive salaries. The gradual decline in public services leads to the erosion of its ability and capacity to raise revenues.

A number of other factors, in-built in the international aid delivery system, further contribute to the implosion of State finances. The increasing GDP share of donors' expenditures, which normally benefit from various tax and duty exemptions, further reduces the capacity of the Government to raise revenue. Over time the government budget may be also increasingly burdened by the debt service obligations on foreign aid. While the projects and programmes being implemented are by and large controlled by the donors, the debt service on aid funds is very much "owned" by the central government budget.[12] A growing proportion of the meagre government resources is also increasingly spent on negotiations with various donor agencies with a variety of procedures and principles, and on debt rescheduling negotiations (see, for example, Killick, 1993, and Wuyts, 1996).

Furthermore, the currency devaluations accompanying the adjustment policies substantially increase the command of the aid funds in domestic currency, while at the same time increasing the domestic currency denomination of the debt service obligations for the recipient government. The governments' room for maneuver can be particularly restricted under the IMF ESAF-funded programmes where budget deficit targets are set with the exclusion of grants. In addition, the problems can be magnified when the bias of such programmes is towards cutting the recurrent expenditure (mainly the wage and salary bill) rather than the capital expenditure, as has been the case in the ESAF programmes. And even more so when the outcome of the programmes is by and large to reduce the wage and salary rate rather than public sector employment, as has also been the case in the ESAF programmes (see IMF, 1998: 4-5).

The downward spiral is complete when the donors increasingly realize that the national governments are no longer in a position to run the completed aid projects – the well-known recurrent cost problem. For the projects to survive, the donors find themselves increasingly enmeshed in continued support of

recurrent costs, and the cash-strapped recipient Governments, in order to comply with the terms of policy conditionalities, increasingly resort to imaginative accounting procedures whereby recurrent expenses are allocated under development finance (Wuyts 1996). Ironically, the recurrent cost problem has become particularly acute not during the investment support era of the 1960s, but during the programme aid era of the 1980s and the 1990s.

Most of the above processes have been at work in most LDC economies, albeit with differing degrees of intensity. The most intense cases are perhaps to be found amongst the sub-Saharan African LDCs, where the initial conditions in terms of the government administrative capacities and aid coordination capabilities were most fragile. The following excerpt from a recent study of aid and capacity building in sub-Saharan Africa paints a graphic picture:

> Many of the institutions [that] donors have supported in Africa cannot continue to operate without external support. Most African states lack the resources to run the institutions on their own – they cannot, or do not want to allocate scarce state funds to them. In some cases the 'output' from the organizations is, however, so valuable to the country that donors and recipients agree to run the institutions – i.e. to provide for their recurrent costs – for some time. During the 1990s this has increasingly been the case when the state finances have imploded in country after country. A number of roundabout ways have been invented to hide the fact that payments are for salaries, but donors and recipients have rarely admitted that topping-up allowances etc. are in fact carried out just because normal salaries are too low to keep the organization together… The financial collapse of the states has eroded the real value of the salaries to a fraction of what they were ten years ago. The institutions are deserted, not in the number of staff, but in capacity and knowledge. Professional staff are forced to have several occupations, and they spend less and less time at the institutions… A catastrophic destruction of knowledge and competence is occurring in Africa (Hesselmark, 1999: 2-3).

This picture is not very different from what individual country studies in the case of some sub-Saharan African LDCs portray (see, for example, Wuyts, 1995, 1996; OECD/UNDP, 1999; Helleiner et al., 1995; ESCAP, 1999). For example, the OECD/UNDP Mali aid review has the following to say on the links between aid and the system of governance in that country:

> In particular, the civil service underwent a marked decline in the 1980s, which still does not seem to have been really reversed. Handicapped by a failure to renew structures and an aging, de-motivated workforce, the public sector is withering away, while its managers grasp job opportunities in the development projects and programmes financed by donors. The root cause seems to be the lack of effective human resource management in the public service, rather than a lack of competencies. The on-going emergence of civil society and the decentralization process under way make the challenges facing the civil service all the greater. Increasingly it is required to behave as a partner in, rather than a manager of, development. Also, some of the development partner practices, especially overuse of conditionality and the creation of parallel management structures for projects, have helped to exacerbate the decline of Malian civil service (p. 20).

The above quotation points to a very important fact about the role of the LDCs and other young post-colonial States which is often forgotten in some of the more technocratic and economistic approaches to development policy. The role and the position of the State in such societies are different from what they

are in advanced industrialized States, where centuries of modern economic development has created a well-integrated web of appropriate institutions, rules, laws and strong civil society organizations, within which the markets play an important integrating social function. In many post-colonial LDCs such institutions did not exist, markets were not all-encompassing and integrative on a national scale, and in some countries even the basic institutions of private property were not yet in place in a large part of the economy. In such societies the States themselves play an important integrative and institution-building role. The move to the more market-based strategy of development, since the early 1980s particularly, actually involved *additional* administrative and organizational functions for these States in order to create the preconditions for the proper functioning of the markets and the strengthening of civil society organizations and institutions. During such reform periods, an increase rather than a decline in the financial and administrative resources of the Government is required. The erosion of those resources of Governments during this critical period would affect not only aid effectiveness but also the efficiency of resource use in the economy as a whole, and in extreme cases could lead to the unraveling of the social cohesion and national integrity of the country. It is not surprising that more than a quarter of LDCs during the 1990s have been subject to disruptive civil wars or serious armed conflicts, and an increasing amount of aid to these countries has been absorbed by humanitarian, peacekeeping and post-conflict reconstruction assistance.[13]

G. Macro effectiveness of foreign aid: (3) aid and budgetary squeeze in the LDCs

Although the experience of different LDCs with regard to aid coordination and government budgetary procedures and developments has varied, it would nevertheless be instructive to examine some of the overall tendencies in the fiscal structures of those economies as compared with other developing countries during the past few decades. Table 41 compares the overall fiscal structure of the African and Asian LDCs with that of other developing countries, and of other low-income countries, for the period 1970-1998.[14] Due care must be taken in comparing the average figures for different variables, as the sample of countries varies depending on the availability of data for each variable. The table, however, highlights some interesting overall tendencies in the fiscal structure of the LDCs as a group in relation to the above discussion on aid dependence and fiscal squeeze.

The first outstanding feature of the fiscal structure of the LDCs is that the GDP share of tax revenues and current revenues (excluding grants) seems to be on average significantly lower than that of other developing countries, including the other low-income economies.

The first outstanding feature of the fiscal structure of the LDCs highlighted in Table 41 is that the GDP share of tax revenues and current revenues (excluding grants) seems to be on average significantly lower than that of other developing countries, including the other low-income economies. There appears to be some debate on the policy implications, particularly in the context of African LDCs. On the one hand, the IMF in the context of its ESAF programmes, by targeting the fiscal deficit excluding grants, maintains that government budgets cannot rely on the unstable flow of external grants, and hence in addition to current expenditure cuts, improved tax performance is essential. On the other hand, Collier (1999) and a number of papers emanating from the World Bank's research department maintain that higher taxes in such economies would be distortionary and hence in the medium term greater reliance should be placed on foreign aid to bridge the fiscal gap.

TABLE 41: COMPARATIVE ASPECTS OF FISCAL STRUCTURES IN THE ASIAN AND AFRICAN LDCS, 1970–1998

	Current revenue (% GDP)			Tax revenue (% GDP)			Total expenditure (% GDP)			Current expenditure (% GDP)		
	1970-80	*1980-90*	*1990-98*	*1970-80*	*1980-90*	*1990-98*	*1970-80*	*1980-90*	*1990-98*	*1970-80*	*1980-90*	*1990-98*
Group averages												
LDCs	14.6	14.9	15.0	11.3	12.1	12.3	18.2	22.4	22.3	13.5	14.8	14.6
Other developing[a]	21.9	23.0	22.5	16.6	18.5	18.5	24.5	27.7	26.8	18.2	20.5	20.7
Other low-Income[b]	20.6	22.3	20.7	15.9	17.6	15.9	24.5	28.4	25.3	18.3	21.4	20.9
t-test for the significance between the means												
LDC and other developing	-3.87*	-3.60*	-3.20*	-4.50*	-3.11*	-2.44*	-2.51*	-1.35	-1.25	-2.49*	-1.93*	-2.14*
LDC and other low-income	-2.25*	-2.32*	-1.97*	-2.34*	-2.10*	-1.18	-1.66	-1.18	-0.74	-1.58	-1.69*	-1.87*
Number of LDC observations	21	21	21	16	16	16	12	12	12	10	10	10

	Current education expenditure (% GDP)			Capital expenditure (% total exp.)			GNP per capita, PPP, 1980-90
	1970-80	*1980-90*	*1990-99*	*1970-79*	*1980-90*	*1990-98*	*current international $*
Group averages							
LDCs	2.8	3.0	2.8	23.7	34.9	32.3	1 034
Other developing	3.3	3.6	3.8	24.4	21.1	18.4	2 800
Other low-income	3.2	3.3	3.4	22.5	23.6	18.3	1 172
t-test for the significance between the means							
LDC and other developing	-1.59	-1.69*	-2.59*	-0.28	3.57*	3.69*	-7.62*
LDC and other low-income	-1.59	-1.66	-1.98*	0.32	2.16*	3.25*	-1.05
Number of LDC observations	24	24	24	15	15	15	38

Source: World Bank, *2000b*; UNCTAD calculations.

Notes: * Significant at 5 per cent level, one-tailed test. t-tests are based on non-pooled group variances.
a Other developing countries consist of all developing countries excluding oil-exporting countries and former centrally planned economies in Eastern Europe and the Soviet Union.
b Other low-income developing countries consist of all developing countries whose average per capita GDP over the 1980s did not exceed maximum LDC per capita GDP.

Both these positions are in some respects correct and in other respects mistaken. The IMF's position is correct in that the flow of aid is indeed very volatile and in some cases pro-cyclical, as noted above. There appears also to be much room for improving the tax performance of the LDCs, where tax rates at the average level of 12 per cent of GDP for the 16 countries shown in table 41 are significantly below the prevailing levels even in other low-income countries. However, in order to improve tax performance, there is a critical need for reconstruction and rationalization of public administration in these economies, not only with regard to their tax and customs administration but also with a view to better provision of public services. More efficient and effective taxation requires not only improved taxation capacities resulting from a more effective and better-designed taxation machinery, but also better provision of public services in order to make the "institution" of taxation socially acceptable and, so to speak, to "legitimize" higher taxes. This is the reason why those who criticize the IMF's position are correct in pointing out that the LDCs need to rely on substantially increased foreign aid in the medium term in order to bolster State finances. This is necessary in order to rebuild the public sector administration, and improve the morale of civil servants and the quality of public services, all of which are important preconditions for more effective and efficient taxation. But where these critiques are mistaken is in maintaining that aid is less volatile and negatively covariant with government revenue and that increased aid within the current delivery system will be effective in alleviating the fiscal bind of the LDCs. As argued above, the assumption about aid volatility is not supported by the existing evidence, and the effectiveness of increased aid is not guaranteed under the current delivery system. To see this more clearly, we need to examine the expenditure side of the LDCs fiscal structure.

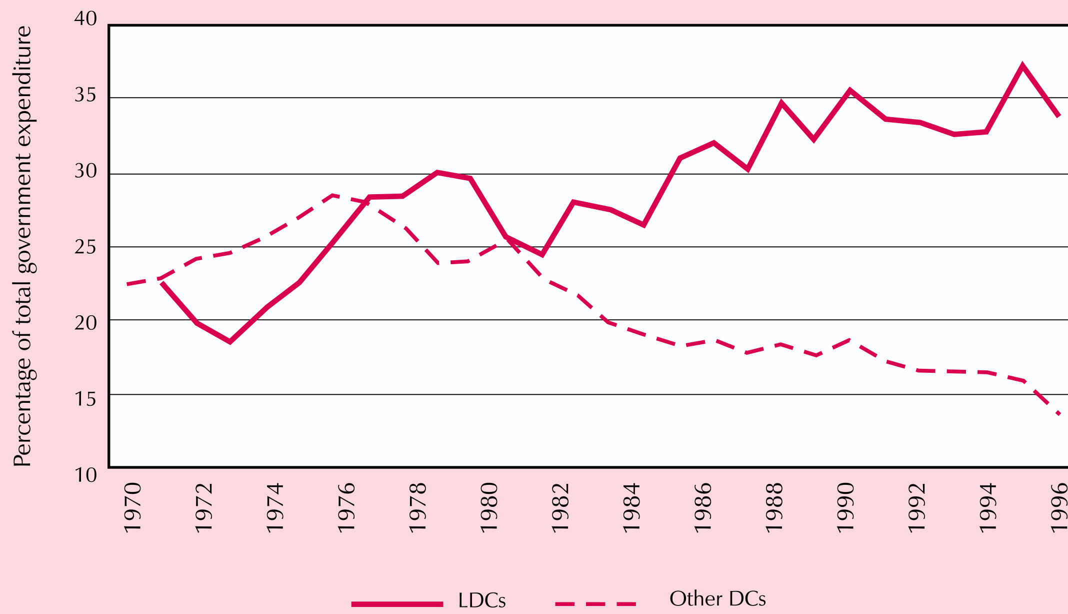
In order to improve tax performance, there is a critical need for reconstruction and rationalization of public administration in these economies, not only with regard to their tax and customs administration but also with a view to better provision of public services.

As can be seen from table 41, the total government expenditure share of GDP in the LDCs does not on average seem to be significantly different from that of other developing countries or other low-income countries. But the current expenditure share is considerably and significantly below that of other developing countries, even when one controls for the level of per capita income. This anomaly is even more starkly evident when one compares the share of capital expenditure in total between the LDCs and other country groupings. As can be seen from table 41, the average share of capital expenditure in the LDCs increased from about 24 per cent during the 1970s to over 30 per cent during the 1980s and the 1990s as foreign aid as a share of GDP increased in these countries. This is in sharp contrast with the declining capital expenditure share in other developing country groupings. To have a clearer picture of the trends in capital expenditure shares we have plotted the median of capital expenditure shares for the LDCs and other developing countries in chart 49. The capital expenditure share of the LDCs, starting from levels more or less similar to those of the other developing countries in the early 1980s, follow a steep upward trend, sharply diverging from trends in other countries, with the proliferation of aid projects in the 1980s and the 1990s. By the late 1990s, the gap between the LDCs and other developing countries in the share of capital expenditure reaches about 20 per cent.

With the proliferation of aid projects the share of capital expenditure in total government expenditure increases beyond any rational bounds.

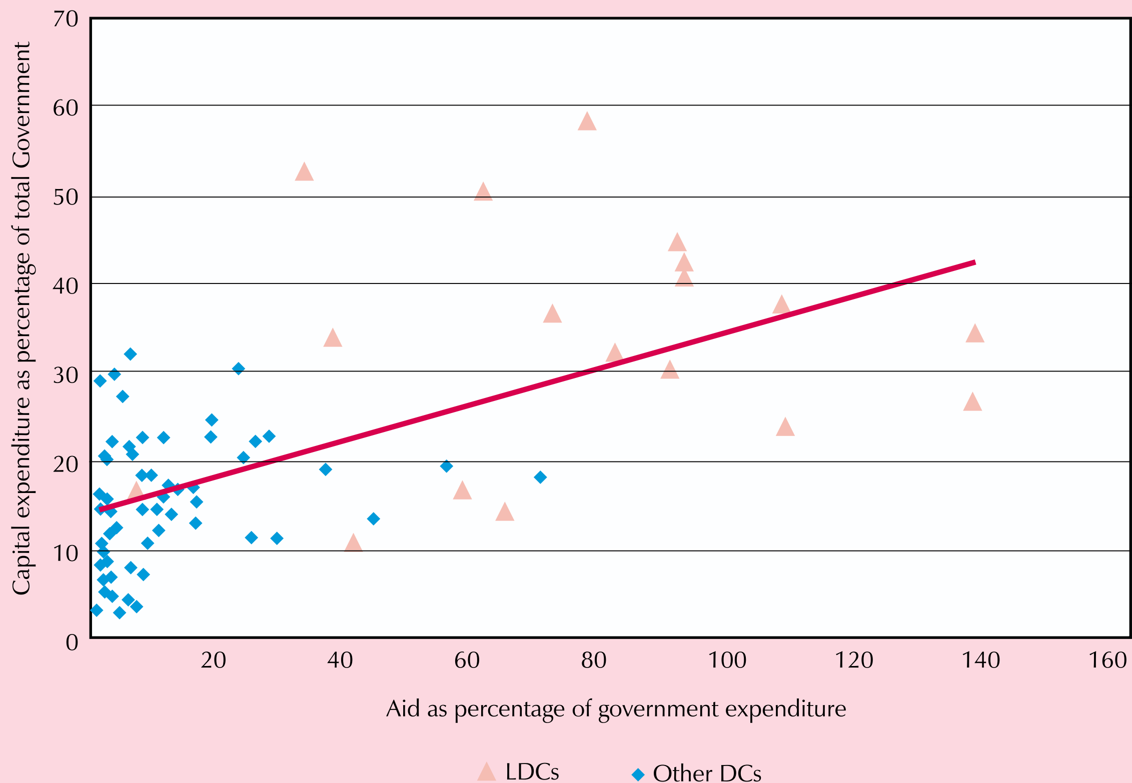
To see more clearly the link between the capital expenditure share and foreign aid, we have also plotted the capital expenditure share against the ratio of foreign aid to government expenditure in chart 50. The figure clearly shows the divergent behaviour of the LDCs as compared with other developing countries with respect both to the capital expenditure share and to the aid ratio. With the proliferation of aid projects the share of capital expenditure in total government expenditure increases beyond any rational bounds. Of course, one should be careful in interpreting what is meant by capital expenditure in LDC

CHART 49: CAPITAL EXPENDITURE SHARE OF TOTAL GOVERNMENT EXPENDITURE IN LDCS AND OTHER DCS, 1970–1997



Sources: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 1999*.

CHART 50: THE RELATIONSHIP BETWEEN AID AND GOVERNMENT CAPITAL EXPENDITURE, 1990–1995



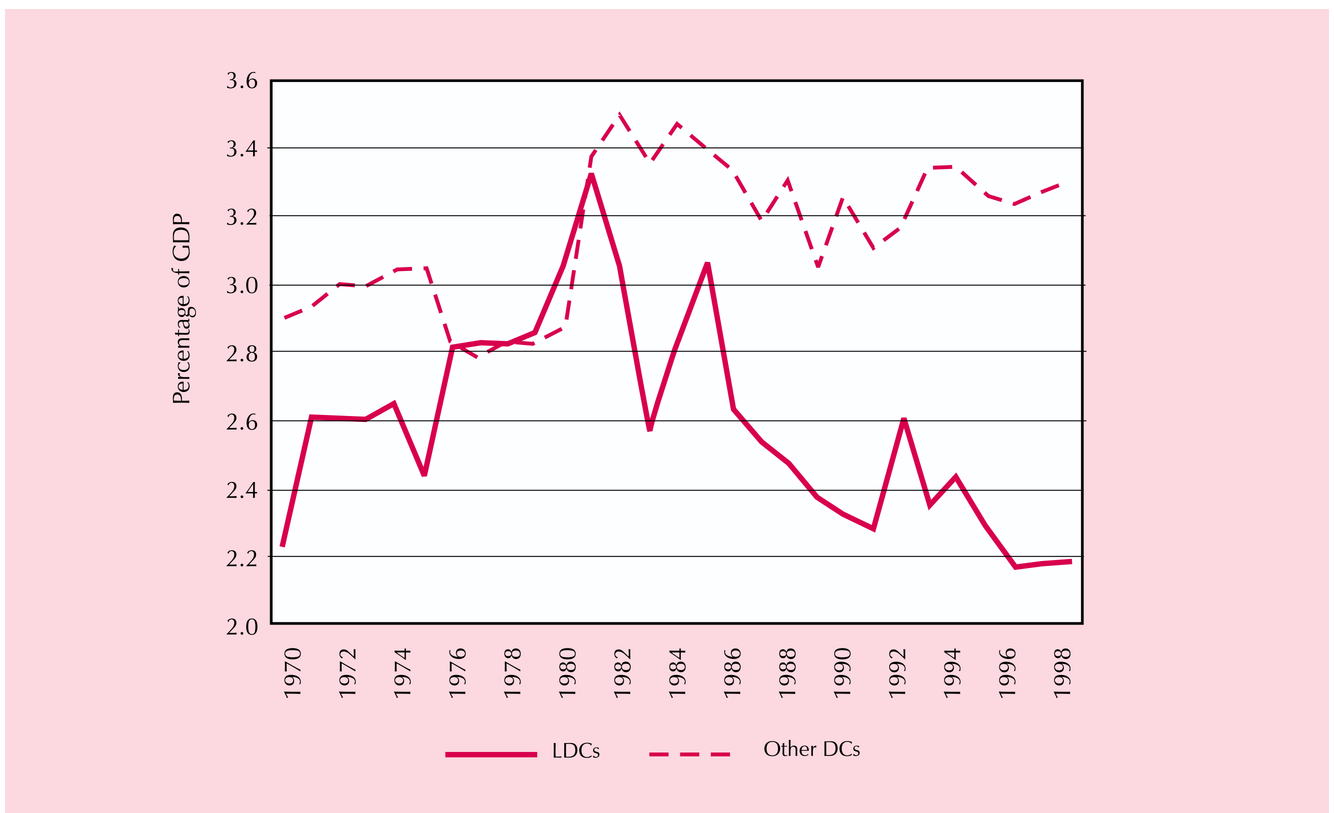
Sources: Same as chart 49.

budgets. Expenditures associated with aid projects are by and large regarded as development expenditure, which is likely to give an inflated figure for what is recorded as capital expenditure in the budgets.[15] As pointed out in chapter 1, this is one reason why the investment data in the case of these countries may contain a large overestimation error.

A more appropriate interpretation of the picture emerging from charts 49 and 50 is that as aid projects proliferate, the share of the budget financed by donor-controlled aid funds increases at the expense of the share of the regular budget directly controlled by the recipient country. The outcome, as argued above, is the squeeze in the recipient Government's command over real resources and a declining quality of public services. This cannot be better demonstrated than in chart 51, which compares the trends in the median GDP share of current expenditure on education in the African and Asian LDCs with those in other developing countries. As can be seen, during the 1970s the median LDC, starting from expenditure shares below those of other developing countries, follows a steeper trend and catches up with the median developing country group by the end of the decade. During the programme aid and adjustment era of the 1980s and the 1990s, however, the current education expenditure share of the LDCs experiences a precipitous decline, while other developing countries on average manage to maintain their current expenditures as a share of GDP. It is remarkable that the picture revealed in chart 51 regarding educational expenditure looks like an exact mirror image of the behaviour of capital expenditure (i.e. aid-financed expenditure) shown in chart 49.

During the adjustment era of the 1980s and the 1990s, the current education expenditure share of the LDCs experiences a precipitous decline.

Chart 51: Current government expenditure on education, 1970–1998



Sources: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 2000*.

Of course, it may not be surprising if one finds that total educational expenditure (including capital expenditure on education) as a share of GDP has followed a different trend from that of current expenditure in some LDCs. However, what matters from the point of view of delivery of effective educational services is current expenditure. Aid-funded schools without teachers and books, or with low-paid, demoralized or badly trained teachers and dilapidated structures, do not deliver effective education. This is an important part of the explanation of why LDCs are rapidly falling behind other developing countries in education, health and other social aspects of development, as indicated by the data discussed in part I of this Report.[16]

It appears, therefore, that the government finances of the African and Asian LDCs have been adversely affected by the double squeeze of uncoordinated and non-integrated aid on one hand, and by policy conditionalities of adjustment programmes on the other. Rising debt service obligations, the increasing amount of time spent on aid coordination and debt negotiations, and a continuous haemorrhage of experienced personnel to rapidly proliferating aid projects formed the various elements of the squeeze resulting from the diversity of the aid delivery system. The targeting of the domestic budget deficit (excluding grants) and within that the current expenditure of the government by the Bretton Woods institutions formed the other side of the bind. This indicates that at least in the case of the African and Asian LDCs, the *lack* of fungibility of aid has been one of the reasons for reduced aid effectiveness, rather than the much discussed fungibility of aid.[17] Had the aid delivery system been more integrated into the budgetary processes, or in other words had the recipient governments exerted more control (ownership) over aid funds, the resulting fungibility might have helped alleviate the demise of public administration and public services in the African and Asian LDCs.[18]

The government finances of the African and Asian LDCs have been adversely affected by the double squeeze of uncoordinated and non-integrated aid on one hand, and by policy conditionalities of adjustment programmes on the other.

One strategy to increase the fungibility of aid, which the LDC Governments seem to have followed during the pre-adjustment era, was to resort to inflationary finance and highly overvalued currencies. Although these proved to be distortionary and self-defeating policies in the long run, in the short run they boosted State finances at the expense of the command of the donors' funds over domestic resources and, of course, also at the expense of the rest of the economy. With the strengthening of stabilization programmes, this option became by and large closed to Governments, while at the same time the large currency devaluations further tilted the balance by squeezing the part of the regular budget under the Governments' direct control and increasing the domestic currency value of the donor-controlled funds. The proliferation of unsustainable aid projects was almost an inevitable outcome of this situation, as the cash-starved line ministries scrambled for new aid projects and the disbursement-driven donor agencies competed to download their funds, with little time to worry about the recurrent cost quagmire they were creating. One of the enigmas of this whole situation is why under these circumstances, and with the admittedly low rates of sustainability of aid-funded projects, the IMF insisted on increasing the share of government investment expenditure in this period and cutting the current budget. It was precisely at this time of economic reform that the donors needed to address the problem of lack of coordination and integration of the aid delivery system in order to prevent the demise of public finances and the deterioration in public services in the reforming countries. The failure to address this problem adequately and effectively has played an important part in the lack of success of reform programmes in a large number of Asian and particularly African LDCs.

A good deal of effort has, of course, been expended on public sector management reform under the World Bank adjustment lending programmes. The Bank's public sector reform programmes have addressed issues such as public expenditure management, civil service reform, capacity building, public enterprise reform and, more recently, general governance issues. According to the World Bank's own evaluations, these attempts at least in the case of low-income countries have remained by and large unsuccessful. In a recent review of such evaluations, Berg (2000) concludes, "The substantial donor efforts to reform public sector management in low-income countries during the past 15-20 years can justifiably be called failures. And a significant share of the responsibility for these dismal results has to be attributed to donor deficiencies as reformers" (p. 493). One cannot but agree with Berg's assessment because, although it may be tempting to try to explain this lack of success in terms of the administrative deficiencies and political peculiarities of the low-income countries, it is precisely because of such deficiencies and pecularities that public management reform programmes are called for in the first place. In this respect, Berg points out that in general the donors failed to adapt programmes and practices to the circumstances of low-income countries with weak administrative institutions, and that their response to implementation problems has been generally inadequate. "In these senses they [the donors] have been unimpressive architects and implementers of public sector management reforms" (p. 493).

With regard to the deficiencies of the public sector reform programmes proposed and implemented by the World Bank, Berg's study (pp. 495-498) makes the following observations:

> One factor is the well-known organizational inclination in the World Bank to give much greater weight to analytic issues than to the softer matters of process such as concern with ownership and nurturing of local capacity… Related to this is the World Bank staff discomfort with institutional matters. Awareness of institutional weakness should permeate all reform activities in low-income countries. But sensitivity to country specific institutional constraints has never been a strong point in World Bank operations. The 1998 evaluation of PER [public expenditure reviews]… found neglect of institutional issues to be a major failing… Another factor is the natural tendency to resort to off-the-shelf solutions. Confronted with extremely difficult and complex problems, crafters of reform almost never have the time or the specialized skills and experience needed to develop customized approaches. They rely on what is available – 'best practices' or what other countries are doing… Then there is the inadequacy of communication, learning failures, within the World Bank…

Local ownership is necessary for the design of correct policies in the first place.

The above points, of course, are known to the World Bank (since Berg's study largely relies on the World Bank's own evaluations), and the second-generation reform programmes since the latter part of the 1990s have apparently moved on to emphasize institutional issues as well as the question of "ownership" of policy reform within the new Comprehensive Development Framework. What the above quotation helps to highlight however, are the intricate inter-relationships between institutional specificity, ownership, design, and implementation of aid policy. Institutional specificity necessitates policy ownership, not just because policies that are not locally owned are unlikely to be implemented effectively. More importantly, in the context of institutional specificity, local ownership is necessary for the design of correct policies in the first place. In the absence of local ownership, inappropriate "off-the-shelf-solutions" are imposed by the force of conditionality, and when these solutions inevitably fail, the recipient country is doubly punished by the cutting off the

assistance. This has the additional effect of killing off learning, both in the recipient country institutions and in the donor agency.

H. Ownership, partnership and selectivity

1. Ownership and partnership

This analysis of aid effectiveness has important implications for the rethinking of international aid which is currently underway. It is widely agreed that the conditionality paradigm has failed and that new ideas and systemic changes in the old way of thinking are urgently needed. But the current position, as noted earlier, is that aid will work if the national policies are right and when these policies are truly domestically "owned". From this perspective, Governments should not have policies in which they do not believe foisted on them from outside. Aid effectiveness can be increased by putting the Government, in tandem with domestic civil society, in the driving seat in the preparation and implementation of policies. Creditor-donors should key their assistance in their respective areas of comparative advantage to a strategy document produced by the Government, and performance conditions, which must be achieved in order to justify continued assistance, should be drawn from this and monitored by creditor-donors. Donors should practise selectivity, targeting their aid flows at countries in which the right policies are in place and are domestically owned.

Effective "ownership" of policies, therefore, in the case of LDCs requires not simply preparation of the strategies, but also effective control over the allocation of aid funds within a coherent and integrated budgetary process.

The analysis in this chapter shows that the multi-donor-driven resource allocation processes in the LDCs interfere with effective policy-making in these countries in various ways. The problem with the policy conditionality during the adjustment period was not that conditionality invariably failed to influence policies. In many instances the policies were implemented, but the main problem was that the policies were inappropriate for the contexts in which they were applied, and they were combined with the uncoordinated and the largely donor-driven resource flows. As a consequence, the outcomes were contrary to what was expected.[19] Effective "ownership" of policies, therefore, in the case of LDCs requires not simply preparation of the strategies, but also effective control over the allocation of aid funds within a coherent and integrated budgetary process.

As the example of Botswana shows, once aid is integrated in such a coherent national framework, there is no reason why the LDCs cannot make effective use of aid (see box 10). What distinguishes the management of aid in Botswana, which is in fact the only country to have graduated from LDC status, from the case of other LDCs discussed in the previous section is that in Botswana the management of aid and relations with donors has been an integral part of the national planning process. Projects that were not included in the National Development Plan as approved by the Parliament were not accepted, all aid funds and local revenues were integrated into a unified national budget, and technical assistance personnel were under strict national control.[20] Most other LDCs, particularly in sub-Saharan Africa, relaxed their control over aid flows in the latter half of the 1970s, and with the end of the planning era and the beginning of the adjustment era in the 1980s they became increasingly enmeshed in the uncoordinated, donor-driven system of resource allocation. While the loss of control in the sub-Saharan African LDCs looks most acute, aid effectiveness in all the LDCs is held back by the lack of coordination of the aid

Box 10: Aid management and economic performance in Botswana

Botswana is a country that has applied principles consistent with national priorities for efficient aid administration for over 20 years. After the establishment of a budget and planning system that operationalizes the national priorities in a transparent fashion within resource realistic ceilings, the country's public management system has both legitimacy and credibility.

Botswana has created a strong Ministry of Finance and Development Planning (MFDP), which draws up the country's six-year development plans, prepares projects as needed (together with the appropriate line ministry), and only then matches projects with appropriate donors. Line ministries do not negotiate directly with donors. All projects and programmes must be approved by the Parliament. All aid money and local revenues are integrated together into the budget. Most important of all, Botswana has the political will to reject donor proposals that are not part of national plans.

To reinforce the local ability to manage aid resources, the Government decided to make use of expatriate personnel in line positions in the ministries, replacing them only when local people were adequately trained to take over those positions. Expatriates generally occupy mid-level advisory and analytical positions, but not the high-level decision-making ones. Technical assistance is assessed and used not on a project-by-project basis, but according to manpower development plans prepared sector by sector for the economy as a whole.

Principles of Botswana's aid management:

- The management of aid and dealings with donors is an integral part of the national planning process. Only MFDP has the authority to negotiate and secure aid.
- No project will be accepted if it is not included in the National Development Plan as adopted by Parliament. New programmes can be included, but only with parliamentary approval.
- No separate procedures or standards are applied to aid-funded as opposed to nationally funded projects. Projects must be carried out by available staff, and the Government has consistently refused to create additional posts in order to implement donor-funded projects.
- Technical assistance personnel are placed under national control, often in line rather than in advisory positions.

As an LDC until 1995, Botswana has achieved impressive economic growth over the last 20 years and is now classified as an upper-middle-income country. It's real GDP per capita grew from US$ 1678 in 1980 to US$ 3611 in 1998, that is a 4.3% annual growth rate as compared with -1.3% for the group of African LDCs. Botswana's aid dependency ratio to GDP declined steadily from 7% in 1980 to less than 2% in 1995, whereas that of the African LDCs increased from 8% to over 15% during the same period. Following the sharp increase in diamond production from the mid-1970s onwards, Botswana has built up strong budgetary and current account surpluses. The authorities have invested part of the mineral revenues in domestic infrastructure and social services. Spending on education and health increased by 170% in real terms between 1980 and 1998.

Sources: Brautigam and Botchwey, 1998; ECON, 1999.

system with the national development processes. And this lies at the heart of the question of policy "ownership".

Three basic requirements have to be fulfilled for genuine policy ownership to become a reality in the LDCs. First, there must be a serious effort by the countries themselves to establish comprehensive and coherent budgets and medium-term expenditure plans which have the transparency, accountability and realism required in order for them to be taken seriously by the donors and their own domestic constituencies. Second, the donors need to provide the necessary information about their current activities and future plans in order to make the first task possible. They should be also prepared to coordinate their procedures with the local requirements and integrate their activities within the national budgets and expenditure plans – in other words, genuinely to put the recipient country in the "driver's seat". Third, a realistic assessment of the immediate financial requirements to jump-start the process needs to be made, and the necessary funds need to be made available in order to get the countries

out of the downward spiral discussed in the previous section. We shall discuss these three requirements briefly in turn.

Meeting the first requirement for genuine policy ownership depends firstly on adequate human resources. By now many LDCs should have the necessary personnel and expertise to start putting the government accounts in order, producing credible and consistent expenditure plans within realistic macroeconomic frameworks, and introducing effective accounting and auditing systems. After all, when Botswana began its development planning process the country had only 22 college graduates (Brautigam and Botchwey, 1998). In any event, there is no dearth of technical experts that the countries can draw on if the need arises, as long as they are used judiciously, as in the case of Botswana. However, a major difference between Botswana and some of the less successful LDCs, particularly in sub-Saharan Africa, is that in the latter, low salaries and adverse working conditions in public administration have made it difficult to attract and retain well-qualified personnel.

The setting up of the necessary public sector auditing and accounting systems is a basic precondition for genuine policy ownership.

One important technical capacity for effective policy which requires strengthening in many LDCs is financial auditing and accounting. In many sub-Saharan African LDCs, technical capacity for auditing and accounting, which is the backbone of government accountability, is extremely weak (Schacter, 2000; Johnson, 1995, 1996). The setting up of the necessary public sector auditing and accounting systems in such countries is thus a basic precondition for genuine policy ownership.

The political processes underlying the formulation and implementation of the budgets are, however, at least as important as the financial and accounting technicalities. Due consultation with all the relevant line ministries, and open discussion by relevant stakeholders of the strategic development visions and the means to implement them, are essential preconditions for transparency, accountability and credibility of government efforts, which in turn are necessary in order to convince the donors to integrate the financial management of their projects and programmes within the government budget.

However, without simultaneous support by the donors, and without an effort by them to coordinate their aid with one another *and* with the domestic economic processes, the efforts by the recipient Governments in aid-dependent economies are likely to remain ineffective. This is the second precondition for genuine policy ownership. The internal processes of consultation, transparency and consensus building around the budget would be rendered futile without timely and accurate financial information from the donors. The lack of synchronization of donors' and recipients' budget cycles, the use of different accounting conventions and classifications, provision of incomplete data on aid disbursement, and lack of information on aid strategies and future expenditure plans of the donors are well-known deficiencies of the aid delivery system, which have made the task of financial management in the recipient countries difficult, if not impossible. As we have seen in the previous section, rather than alleviating the vulnerability of the LDCs, the prevailing aid delivery system appears to have added to the volatility of most of these economies. However, the most important impediment to comprehensive medium-term public sector expenditure planning and financial management in the LDCs, is that a large part of the donor-funded projects and programmes indeed bypass the central government budget.[21] Under these circumstances, it should not be surprising to find that over time some aid-dependent Governments have lost confidence in their own budgetary processes and also the capacity, discipline and institutions necessary for good public sector management.

The internal processes of consultation, transparency and consensus building around the budget would be rendered futile without timely and accurate financial information from the donors.

The lack of correspondence between policy conditionality and the aid delivery system, as discussed in the previous section, has had further debilitating effects by weakening governance and undermining public service delivery. The double squeeze on public sector funding through the proliferation of "stand-alone" donor-funded projects on the one hand, and the current spending controls imposed by policy conditionality and the debt service burden on the other, has created a demotivated and demoralized civil service and has undercut vital public services such as education. Under these circumstances, the imposition of practices such as cash budgeting in some LDCs has further undermined the institutions of good governance, for example respect for the budget document as a mutually agreed and binding document amongst different line ministries and public agencies. Naturally, cash starved central governments with a demotivated civil service suffering from a long process of "brain drain" to the more highly paid donor-supported institutions do not make good development "partners".

An important precondition for the much-discussed public sector reform in the LDCs is a more cooperative and trustful attitude on the part of the donors. During the process of reforming public sector pay structures, the donors need to end their prevalent practice of parallel staffing and remuneration arrangements on stand-alone projects, which has undermined recipient governments' ownership, accountability and capacity. Donor funds should increasingly take the form of budget support or collaborative sector-wide programmes administered by recipient governments in accordance with objectives and priorities agreed with the donors. New forms of aid which bypass the budgetary and monitoring scrutiny of reformed government administration, and are uncoordinated with national priorities, need to be restrained. Practices such as tied aid, tax exemptions, and restrictive import controls by donor countries, which work against the efficient operation of market forces in the reforming LDCs, should end.

Donor funds should increasingly take the form of budget support or collaborative sector-wide programmes administered by recipient governments in accordance with objectives and priorities agreed with the donors.

These reforms by the donors, which constitute the basic elements for the establishment of good "partnership", have of course been emphasized for a long time in various DAC reports on effective aid (see, for example, OECD/DAC, 1992, 1996, 1999).[22] The 11-point checklist for partnership by OECD/DAC, shown in box 11, is a good example of not only the principles but also the practicalities of establishing good partnership and effective local ownership. Although recent enthusiasm for recipient country ownership may hasten reform of the aid delivery system, this process of change is likely to take some time. Helleiner (2000) has also proposed a list of necessary reforms of the aid delivery system – similar to OECD/DAC's list – and an international monitoring scheme which may help hasten the pace of reform (see box 12). In the meantime the reform of public sector management in the LDCs is urgent. New challenges are putting the weak public sectors in these countries under increasing stress. Under the new ownership initiatives, not only are the existing weak structures supposed to function better, but also new tasks are being added (ECON, 1999).

This extended agenda, in addition to making a more focused and efficient use of the financial and human resources in the public sector essential, implies the need for additional aid in order to relax the financial bind on Governments, created by a dysfunctional aid system during the past two decades. That is the third requirement for effective domestic policy ownership. This should not be regarded as aid-funded current government consumption with an open-ended outlook, but rather as an initial investment needed to create a more trim and efficient, and better remunerated and motivated, civil service. This is necessary for the success of other reform programmes, which in due time would lead to increased government revenues and the gradual end of aid dependence.

Box 11. OECD/DAC: a working checklist for partnership

1. Donors should encourage recipient partners to formulate their own development strategies – setting out the local priorities, plans and instruments for implementing such strategies. This process should systematically involve civil society, as well as consultation with external partners. Where such locally owned strategies are compatible with internationally agreed goals, donors should work to implement their aid programmes in a coordinated manner on the basis of those strategies and accept their discipline.
2. Donors should stimulate and help strengthen recipient partner-led coordination of development cooperation. The capacity for local coordination (which can and should also strengthen the international process) may be improved by donors' own delegation of decision-making authority from headquarters to field missions. At the international level, the possible advantages and disadvantages of organizing consulting group (and Round Table) meetings in the capitals of the recipient partners concerned should be further tested in practice.
3. The transparency of donor and recipient partner interests and mutual trust should be increased through continuous dialogue, both informal and through systematic work on themes and sectors through standing sub-groups, preferably led by the host Government.
4. External partners should agree in principle to adjust more to local procedures, where necessary helping recipient countries to bring their procedures and management capacities up to international standards. There may be useful DAC roles in identifying best practices and helping organize pilot exercises to move towards the simplification and harmonization of procedures.
5. Practices involving tied aid are permanently identified among procedures that can impair local ownership and capacity building, with substantial economic and credibility costs. The proposal for a DAC recommendation to start with untying aid to least developed countries could be a step towards improved partnerships in this area, yielding additional tangible benefits for partners from competitive bidding and from local procurement.
6. Donors share the objective of ending the proliferation of projects and providing their aid increasingly in forms of programme and budget assistance to support country's strategic priorities for development. To this end, they need to help strengthen partner countries' capacities to manage such aid, and further test the various approaches and conditions under which they can pool their contributions in country funds for major sectors or key goals, e.g. poverty eradication. The integration of aid spending into the overall budget context may [encourage] donors to manage their own significant inputs differently to help strengthen local revenue pools.
7. There is a widely felt need to support local capacity building by changing the existing modalities for providing technical cooperation, which often appears expensive and excessive, hampering true ownership and the use and development of local capacities.
8. The practices of joint monitoring and evaluation of development programmes by donor and recipient partners should be further developed and applied, with a view to learning together the lessons of achievements and failures.
9. Improving the coherence between external partners' development cooperation policies and their other policies (such as those affecting trade and investment) affecting recipient partners is clearly seen as increasingly important to help the developing countries concerned move towards reduced dependence on aid.
10. Innovative ways of financing should be constructed so as to have ODA play a catalytic and leverage role in generating and attracting other forms of domestic and foreign investment. The roles of grants, loans, forms of support for the local private sector and "matching" contributions by beneficiaries merit further careful assessment and coherent policies.
11. External partners should continue to help lessen the debt burden of recipient partners; in this context, among others, the modality of various types of "debt swaps" should be considered.

Source: ECON, 1999.

Box 12. Recent suggestions for aid performance monitoring

1. *Recipient country specificity of data*. The most important consideration for aid recipients is that data and evaluation systems relate to their own budgeting and planning needs, as well as their own country-specific statistical categories and decision-making timetables. To be useful to the recipients, donor performance monitoring and evaluation must take place at the level of activities within the host countries, activities over which, at least in principle, they can have jurisdiction and exercise their sovereignty. Such recipient country-level systems do not exist.
2. *Compliance with recipient requests for information*. The economic decision-making in the more aid-dependent of the low-income countries is severely constrained in terms of critical data. The degree of donor compliance with recipient government requests for standardized and timely aid data should therefore be an important performance indicator for donors.
3. *ODA expenditures and recipient budgetary system*. A common misconception about ODA is that it is all passed through a recipient government system, even through its budget. This is typically not the case. In Mali and the United Republic of Tanzania, for example, only 20 to 30% of ODA is estimated to flow through the government budget. Needless to say, decisions as to the uses and recipients of the remaining part are made exclusively by the donors. The proportion of each donor's ODA expenditures that finds its way into the national budget is another good performance indicator for donors.
4. *Integration and coordination with national plans and priorities*. A related issue is the degree to which donor projects and expenditures are coordinated and integrated into national and sectoral plans and/or recognize the declared priorities of the recipient Government. The clearest manifestation of this is the degree to which donors are willing to contribute to sectoral or cross-sector "basket funds", administered by recipient Governments in accordance with objectives and priorities agreed with the contributing donors. Donors who may be constrained by their own national legislation from pooling their resources in basket funds should tailor their activities to recipient priorities, and attempt to coordinate their support, standardize their accounting and reporting systems, and reduce transaction costs to recipients. A quantitative donor performance indicator, where feasible, may be the percentage of funds allocated to stand-alone projects (as a "negative" indicator).
5. *Shortfalls from ODA promises*. Aid donor announcements and even formal commitments often bear little relationship to subsequent actual disbursements. For effective policy-making one must have reasonably accurate resource projections. There must be a presumption that where general macroeconomic management remains sound, and particularly in the case of sectoral or budget support, the primary responsibility for exceptionally large shortfalls rests with the relevant donors. Their actual disbursements should therefore be monitored in the context of their own prior commitments.
6. *Compensatory and contingency financing*. It is important to recognize the exceptional need for liquidity and contingency finance in the poorest and least developed countries, because of their high degree of vulnerability to external shocks. Because of the conditionalities attached to its lending to LDCs, the IMF can no longer be described as a source of increased "liquidity". Bilateral donors, who collectively disburse far greater amounts in support of poor countries than the IMF or the World Bank, could alter the time profile of their disbursements for budget or balance-of-payments support in response to an individual recipient's shock-generated need for liquidity. Those able to perform such a role should obviously be favourably recognized for doing so rather than recorded as offering unstable and unpredictable finance.
7. *Tying of procurement*. The tying of aid is very costly to the recipients, particularly when it relates both to its use and to its procurement source. Despite years of effort, DAC OECD members have still not been able to collectively agree to untie all aid to LDCs. Another obvious donor performance indicator, then, is the percentage of ODA which is provided on an untied basis with respect to country of procurement.
8. *Role of technical cooperation*. The emerging consensus among aid analysts is that, as great as the need for technical expertise may be in most of the poorest countries, traditional technical assistance/cooperation activities have been signally ineffective in sheer cost-benefit terms. One suitable donor performance indicator may be the percentage of aid spent on donor-country-tied technical assistance. One could also conceive some positive indicator of contributions to long-term capacity building as a complement to this "negative" indicator, but this would have to be somewhat subjective and hence would be more difficult to devise.
9. *Qualitative assessments of ownership*. On other dimensions of the aid relationship there might also have to be resort to more qualitative assessments, undertaken by independent evaluators, of individual and collective donor performance. In one recent such exercise, an independent assessor assigned letter grades to the collective performance of donors with respect to the variety of promises they had made regarding the transfer of "ownership" of development programmes (together with relevant commentary) (Helleiner, 1999).
10. *Time horizon for ODA commitments*. Some attempt must be made to record systematically the degree to which donors have been able to make longer-term commitments, e.g. within the framework of a medium-term expenditure plan.
11. *Individual and collective donor performance indicators*. All of these indicators should be recorded at the recipient country level both for individual donors, at least the more significant ones in the particular country, and for the donor community as a whole.
12. *Independence of monitoring authority*. Fundamental to the credibility and effectiveness of any performance monitoring is the independence of the evaluator. Neither the DAC OECD nor the Bretton Woods institutions can be trusted to be neutral and apolitical in their assessments of donor performance (there is room for doubt about their record of neutrality regarding the performance of recipients as well). Perhaps some more independent UN agency could serve as an appropriate financier and organizer of independent donor performance assessments via contracting with private individuals, teams of individuals (panels) or consulting firms to provide these services. Whoever the financiers/organizers are, it must be clear to all that the assessors retain absolute independence.
13. *Frequency of performance assessments*. Since change in aid relationships is likely to take some time, in any case, every effort should be made by donors to reduce recipient transaction costs and to take a longer view. The current one-year cycle for donor consultations and Consultative Group (CG) meetings is too short. The more balanced assessment of donor and recipient performance recommended here, and perhaps CG meetings themselves, need not take place so frequently. A two-year cycle might be most appropriate.

Source: Helleiner, 2000.

The debt reduction strategies under the HIPC Initiative should also alleviate the immediate cash flow problems of the budgets in poor countries. It is telling in this regard that many observers argue that the relaxation of the criteria which are used to judge both eligibility for, and the extent of, debt relief should focus on fiscal indicators. This is not surprising, given that aid flows generally do not go into the government budget whilst debt service generally has to come out of it. For example, it is estimated that in Africa in 1998, donors' gross disbursements (including grants) for projects were about $13 billion, and for general budget support about $3 billion. Debt service paid from the budget was about $9 billion. Thus, including debt repayments, governments on average in Africa had to finance a net negative transfer from their budget of $7 billion (Birdsall, Claessens and Diwan, 2000: 6). Under these circumstances, to load the debt relief process with too strict policy outcome conditionalities would be both unfair and impractical. It would be unfair because, as we have seen, the debt situation is partly the outcome of two decades of donor-driven and dysfunctional aid strategy, during which, as pointed out by the World Bank, the donors "assumed to have all the answers". It would be impractical because, as we have argued above, government policies in the LDCs are very much constrained by the prevailing aid delivery system, and an important precondition for greater local ownership is an immediate reform of public sector management, which is made difficult by the severe financial constraints facing the governments, the most important element of which is the debt service obligations.

To load the debt relief process with too strict policy outcome conditionalities would be both unfair and impractical.

2. Inclusive ownership and selectivity[23]

Within the current rethinking of international cooperation, good policies are seen to lay the foundations for partnership, but they should ideally be made by Governments that are accountable to their citizens through some form of democratic governance. The quest for increasing government accountability and local choice has many merits. If successful, it can undoubtedly enlarge the stake of the public in economic policies through political checks and balances, a free press, and open debate on the costs and benefits of government policy. But the double accountability, whereby the recipient Government is accountable not just to donors for the use of aid finance but also to its own electorate, may create tensions.

This point may be analysed within the framework created by Ndulu (2000), based on partnership involving greater *inclusiveness* of local political processes. Rather than looking at the aid relation as a principal-agent problem involving one principal (the donor) and one agent (the recipient Government), he argues that there are in fact two principals: the donor community on the one hand, and the local electorate and civil society on the other.[24] Consequently, for the aid relation to be inclusive, the recipient Government has to be responsive to both these principals. Moreover, he argues, partnership is essential in order to prevent the preferences of one principal from being overridden by the other, or the recipient Government from finding itself in a position of multiple (and perhaps conflicting) structures of accountability. *Consensus building* through partnership, he argues, is necessary in order to arrive at a single structure of governance, transparency and accountability.

This argument provides an answer to one of the persistent stumbling blocks that prevent many donors from pooling aid resources under the control of the recipient Government rather than channelling them to project aid or to NGOs.[25] Consensus building, jointly with capacity building in development management,

can provide the foundations for enhancing accountability and transparency and hence reduce donors' objections to handing over control of finance to the recipient Government. As Helleiner (1999) has shown, for example, the recent Tanzanian experience with the move towards consensus building through inclusive partnership has produced significant advances in managing public expenditures in general, and aid finance in particular. But the process has not been without difficulties and setbacks. For example, one particular measure, taken in 1997, to improve the aid relationship between donors, recipient and beneficiaries was to move the Consultative Group meeting to Dar es Salaam rather than from Paris. The meeting took place in December 1997 and provided greater scope for wide-scale involvement not just of all members of the Tanzanian Government and government officials, but also of business, trade-union and NGO representatives. The next year, however, the donor community voted in favour – albeit by a small margin – of holding the next meeting in Paris so as to guarantee the attendance of senior officials from their national capitals. This example – trivial as it may be in terms of content, but not of process – shows that the aid relation is essentially asymmetrical and unequal in nature.

One aspect of this asymmetry is that it is up to the donor to decide which partners are eligible, or not. Adherence to "good policies" plays a key role in this respect. But this question is often seen as unproblematic – that is, as part of an already existing *international consensus* on development and structural adjustment policies. But this ignores the question whether the same set of good policies *fits all*, or whether context and specificity matters. As Mkandawire (1994: 165-169) has argued, there is no reason to believe that the policies adopted within democratic processes would, of necessity, converge with the views of the donor community at large, and of the multilateral financial institutions in particular. Unless, of course, the assumption is made, explicitly or implicitly, that there is only one "right" theory and practice around which a consensus can readily be built and no scope for conflict regarding what is desirable for society arises (p. 168).

Genuine partnership must allow for differences in perspectives and leave room for partners to learn from mistakes.

However, the question is whether policy does not have to address the concrete circumstances in which developing countries in general, and each country in particular, find themselves. History shows that successful experiences in economic growth, poverty alleviation and social development often pursued quite varied economic and social policies, which by no means always converged with present-day doctrine (Taylor, Mehrotra and Delamonica, 1998). Sen (1999), for example, contrasting Western Europe and the United States, points out that, while Western Europeans find it hard to accept the lack of social provisioning in the United States, the citizens of that country would find the double-digit levels of unemployment in Europe quite intolerable (p. 95). The interesting point here is the significant divergences in policies and in their effect on livelihoods that exist between Western European countries and the United States, reflecting clear path dependencies in their respective developments.

A critical issue, as noted in the last chapter, is whether there is room for manoeuvre left to less developed countries under structural adjustment for similar divergences in policy choices to tackle poverty alleviation and social development. Will divergence from the prescribed economic policies be acceptable, or will it be identified as manifestations of "distortionary" practices of a predatory State? Genuine partnership must allow for differences in perspectives and leave room for partners to learn from mistakes. It will be easy for selectivity, which functions as a threat of withdrawal of concessional finance if the policies are not right, to act as a mechanism which guides policies to those that fit the donors' preferences.

Monitoring of outcomes and setting appropriate performance criteria are likely to be best achieved if research, design, implementation, financing and evaluation of programmes and policies are not all combined within the same institutions, and if recipient countries have a greater voice in the formulation of the policy agenda and the monitoring of outcomes.

The argument put forward here is not that donors should not be selective with respect to which countries to support. Principles such as democracy, human rights, and pro-poor development are important. But the way in which the concept of partnership is used often leaves considerable vagueness about whether most donors merely see partnership as a disguised form of *ex-ante* conditionality inasmuch as recipient Governments should adhere to and own the policies prescribed by donors, or whether partnership actually provides scope for the recipient Government to develop its own responsible policies, based on democratic and inclusive principles. In the former case, the new aid paradigm may well become a variant of what Mkandawire (1994: 173) has described as "the usual meddlesome condescension", while in the latter case, it may signify a significant move towards establishing a less unequal and less asymmetrical relation between donors and recipients.

Finally, it is necessary to address the question of "outcome selectivity", or *ex-post* conditionality, which is being discussed as a new instrument for increasing aid effectiveness during the "partnership" era. Although monitoring of both government policies and outcomes is essential for aid effectiveness, simplistic approaches such as macroeconomic simulations or the use of *ex-post* growth regression models should be avoided.[26] Furthermore, it is important to keep in mind the lessons learned from experience – most notably, that as long as Governments are not in control of aid funds, in a fragmented and uncoordinated aid delivery system, they cannot be held totally responsible or accountable for the policy outcomes or even the success or failure of policy implementation. In this context, as suggested by Helleiner, independent monitoring of the donors as well as of the recipients is essential (box 12).

Selectivity also raises important but more general questions about the architecture of international development assistance. As indicated in point 12 in the list of Helleiner's recommendations, independent agencies other than the existing international donor agencies such as OECD/DAC, the World Bank and the IMF are necessary for effective monitoring of the donors. In the context of selectivity, however, this issue becomes even more critical and assumes wider dimensions. Selectivity involves not only monitoring of outcomes, but also setting performance criteria based on independent research which takes into account the constraints and institutional specificities of the recipient countries. This is likely to be best achieved if research, design, implementation, financing and evaluation of programmes and policies are not all combined within the same institutions, and if recipient countries have a greater voice in the formulation of the policy agenda and the monitoring of outcomes.

Another pitfall to be avoided as the idea of selectivity gains ground is the temptation to set three-year, or even worse, annual quantitative targets, and to try to achieve these under the threat of cutting off aid. This approach, apart from increasing uncertainty and creating a wait-and-see mentality for private sector investors, misses a key point regarding what the process of development is all about. As the experience of centrally planned economies over a good part of the last century showed, economic development is not about setting quantitative targets and trying to achieve them. It is rather a long and complex process of learning at the level of society and polity, strewn with social conflict and frequent reverses. It may not be inappropriate to conclude this brief discussion of "selectivity" with the following sobering thought:

> A difficult policy environment should not be taken as purely negative, as donors sometimes seem inclined to interpret it as. *Conflict* and *power* are key concepts to understanding priority setting in industrialized societies,

yet there seems to be a view that in emerging societies, "ideas matter" and that once good ideas have been presented, national consensus and harmony will emerge around them. Allowing a political system to work through the conflicts and contradictions is necessary if the overall system is going to develop and gain legitimacy, and stepping back and letting national politics work out the compromises necessary for coalition building may require time (ECON, 1999: 29).

I. Conclusions and policy implications

This chapter has argued that the lack of aid effectiveness in the LDCs is a consequence of the nature of the international aid delivery system and the impact of policy conditionality under this system. In common with OECD/DAC's own evaluations of how aid works, this chapter finds that the diversity and the fragmentation of the aid delivery system are a critical problem. Although the LDC economies clearly need foreign aid, the multi-donor-driven and fragmented aid delivery system has seriously disrupted the resource allocation mechanisms in these countries. Foreign aid flows are too volatile and unpredictable. Aid flows are also by and large non-covariant, or positively covariant, with exports and government revenues, thus adding to the economic vulnerability of most LDCs. Furthermore, the lack of coordination of the activities of various aid agencies and the lack of integration of their projects into domestic economic and managerial structures has undermined the sustainability of aid projects. The combination of these factors have substantially reduced aid effectiveness. More importantly, given the predominance of aid flows as major sources of development finance and foreign exchange revenue in the LDCs, this has had important consequences for economic management, the overall efficiency of resource use, and economic growth in general.

Although the LDC economies clearly need foreign aid, the multi-donor-driven and fragmented aid delivery system has seriously disrupted the resource allocation mechanisms in these countries.

The combination of this dysfunctional aid delivery system and policy conditionality since the early 1980s, during the adjustment era, has particularly undermined economic progress in the LDCs by eroding State capacities and undermining the quality and quantity of vital public services such as education and public administration. This has occurred because of a double squeeze of public finances by the uncoordinated and non-integrated aid delivery system on the one hand, and the policy conditionalities of adjustment programmes on the other. Rising debt service obligations, the increasing amount of time spent on aid coordination and debt negotiations, and a continuous haemorrhage of experienced personnel to the proliferating aid projects formed the various elements of the squeeze resulting from the diversity of the aid delivery system. Measures to reduce the domestic budget deficit and within that the current expenditure of the Government, which have been central elements of stabilization and structural adjustment policies, have formed the other side of the bind. According to most accounts, capacities in most of the LDCs in sub-Saharan Africa are now below the levels of two decades ago. As discussed in *The Least Developed Countries 1997 Report* (part three), the weakness of the State in many LDCs has become a major impediment to economic progress in these countries.

The combination of this dysfunctional aid delivery system and policy conditionality since the early 1980s has particularly undermined economic progress in the LDCs by eroding State capacities and undermining the quality and quantity of vital public services such as education and public administration.

The findings of this chapter have important policy implications at the national and international levels. In any discussion of development policy it is important to distinguish between policy *objectives*, and the ways and means of achieving these objectives under empirically given conditions in the countries concerned. For example, the desirability of most of the *objectives* that formed the components of policy conditionality during the adjustment period remain

undisputed - for example, the objectives of achieving macroeconomic stability, pursuit of internal and external balance, and creation of an efficient market economy. But the *policies* that have been advocated in the shape of ready-made blueprints to achieve these *objectives* are inadequate. Policy-making in the context of the LDCs is about finding the ways and means to develop sustainably, in conditions where economies are subject to large shocks in relation to domestic resources available to cope with them. Policy design needs to be specific to the circumstances of the country concerned, signifying the importance of the recipient country "ownership" of policies and programmes. The general policy implications of this chapter, as discussed below, are in effect some of the preconditions for the recipient country "ownership", rather than being a new set of blueprints.

A fundamental prerequisite for recipient country ownership is to reinstate countries' lost capacities, which is a particularly demanding task in the sub-Saharan African LDCs. In some of these countries public sector accounting and auditing capabilities, which are the essential ingredients of government accountability, have been seriously eroded. Low levels of remuneration in the public sector and the inability of the Governments to attract competent and motivated staff are a major obstacle to rebuilding these structures in most countries. A major constraint on the creation of a more effective public sector administration in these economies is the lack of funds. The possibilities of reliance on domestic sources of finance to mobilize sufficient resources for this task are, at least in the short run, very limited. This emphasizes the need for additional aid in the form of budget support or sector-wide programmes in order to relax the financial bind on the governments. This should be regarded as an initial investment, necessary for creating a more effective civil administration, rather than an open-ended commitment to financing government consumption expenditure. Such capacity-building measures are necessary for the functioning of an efficient market economy and improved economic growth, which in due course should increase government revenues and end aid dependence.

A major constraint on the creation of a more effective public sector administration in these economies is the lack of funds.

A mistake that is often made by economists not familiar with the LDC economies is to treat foreign aid and debt service obligations, together with other revenue and expenditure sources, as equivalent entries in a general government budget constraint. Aid funds under the current aid delivery system, however, are by and large non-fungible. It is therefore important that the flexibility which Governments have in the use of aid be increased, so that funds can be allocated in accordance with national developmental priorities, transcending the current artificial boundaries in the LDC context between what is regarded as developmental and what is seen as recurrent expenditure.

In this context, it should also be recognized that under the current aid delivery system, increases in net transfer from debt reduction play a developmental role that is different from that played by increases in new loans and grants. Debt service obligations are a direct burden on government budgets, while aid flows under the current system only marginally increase foreign exchange resources under the control of LDC Governments. As a consequence, the result of the prevailing aid-debt service system has been a substantial net drain on public sector resources. This needs to be an important consideration in the design of any debt reduction strategies in the case of the LDC economies, with the requirement that debt reduction be aimed at alleviating the immediate budgetary constraints in poor countries. Under these circumstances, to load the debt relief process with the type of conditionalities currently imposed under the HIPC Initiative would be counter-productive and self-defeating. As shown in this chapter, the objective of macroeconomic stability, for example, is likely to fall

beyond the capacity of the LDC Governments under the prevailing aid delivery system.

The policy implications of the findings of this chapter at the global level are by and large in line with OECD/DAC's recommendations on good partnership (box 11). A step towards the effective implementation of these recommendations may be taken by giving effect to the proposals for donor monitoring set out in box 12. As discussed in the last section, the issue of partnership, based on inclusive ownership, also raises serious questions not simply about national institutions but also about international institutions. New global goals in the era of partnership require new global institutions. Whether the new vision of "partnership" will lead to a genuine change in the aid relationship and improved aid effectiveness depends on the extent to which it can be transformed from a one-way dialogue between the donors and the recipients and enlist the genuine participation of the recipient countries in materializing the new vision.

In the LDC context, more aid is a precondition for effective aid, and effective aid is necessary for economic growth, poverty reduction and sustainable development.

It is important finally to stress that the present diagnosis of the ways in which the workings of the aid delivery system have undermined aid effectiveness should not lead to the conclusion that there is no need for more aid. The contrary is rather the case, for the current limits to domestic resource mobilization and to attractiveness to private capital inflows mean that aid is essential to LDC development. It implies that a proper analysis should be made of the constraints on effective aid and of ways of overcoming them. In the LDC context, more aid is a precondition for effective aid, and effective aid is necessary for economic growth, poverty reduction and sustainable development.

Notes

1. This discussion partly draws on Wuyts (2000).
2. This proposition is based on econometrics results of Burnside and Dollar (1997), who use a composite policy index based on government budget deficits, inflation and openness. Others have challenged the robustness of Burnside and Dollar's results (see, for example, Hansen and Tarp, 2000, and Lensink and Morrissey, 1999). In this chapter we are concerned with a more basic question - namely, to what extent these supposed policy variables in the LDCs are under the control of the Government, and how the aid delivery system constrains independent policy-making by recipient Governments.
3. Economists have conventionally assumed that aid is "fungible", that is, it relaxes the overall government budget constraint. Aid is "fungible" when the projects that it finances would have been undertaken by the Government in the absence of aid, hence releasing resources which are used by the Government to finance other activities. For example, with the assumption of fungibility, Mosely et.al. (1987: 617) maintain, "Our point of departure is that the government of a developing country will attempt to maximise its welfare in the face of budgetary constraints, and will use aid inflows from overseas as an instrument in the pursuit of that objective". When aid constitutes the entire development expenditure of a Government that is cash-starved even for its requirements for running its daily administration, as is the case for many LDCs, the idea of fungibility in this sense is difficult to support. This position is made more problematic by IMF conditionalities under ESAF, which impose restrictions on domestic budget excluding grants. This theme is elaborated below.
4. These figures are much higher than figures reported in Malian statistics on aid. According to the OECD/UNDP report (1999: 6), "The aid flows given in Malian statistics represent only between one- and two-thirds of the official figures published by the OECD and UNDP in their development co-operation reports."
5. See, for example, Helleiner et al. (1995), van de Walle and Johnston, (1996), and Bagachwa et al. (1998), for studies of the aid delivery system in the United Republic of Tanzania, and ESCAP (1999) for a discussion of aid delivery systems in the Asian LDCs.
6. It is interesting that this point is made by the World Bank's Operations Evaluation Department. Much work on aid effectiveness makes no mention of this important point

and starts from the basic premise of a benevolent donor versus a corrupt or rent-seeking recipient Government that is assumed to have total control over aid funds.

7. In the words of OECD/UNDP (1999: 11), "one of the most striking findings in the Mali aid review was the contrast between the relatively satisfactory results of project and programme evaluations and the far less encouraging overall assessment of aid activities, which for instance were said to have little noticeable impact on living conditions".
8. The countries included in Table 40 are those where data are available for all the variables for at least 10 years over the period 1970-1998. Export revenues in the table refer to total exports of goods and services, including net factor income from abroad in dollar terms at current prices as registered in balance-of payments-accounts. The exercise was repeated using other export revenue notions, e.g. exports of goods and services excluding factor incomes, and exports of goods and services deflated by the import price index. Other measurements of variability such as the standard deviation of annual growth rates and the coefficient of variation of annual absolute changes were also made. However, as the results were not different from those in the table, they are not reported here.
9. For example, Gemmell and McGillivray (1998) provide similar results regarding aid and the different categories of government revenue and expenditure with respect to a broader sample of 48 developing countries. The only exception in the literature seems to be Collier (1999), who claims that aid in the case of sub-Saharan Africa has been less volatile than, and negatively covariant with, government revenue. There are, however, some serious problems with Collier's statistical analysis, notably that it uses the variance and covariance of trended variables, such as aid and revenue levels, as indicators of annual variability and co-movement. Even so, the individual country estimates by Collier (table 1, p. 541) do not appear to support his conclusions made in the text.
10. This also may go some way in explaining two of the perhaps less spurious regression results from Burnside and Dollar (1997), namely, that (i), aid does not flow to countries with good policy environments, and (ii), aid does not cause good policy environments to emerge. Macroeconomic stability is a component of the policy environment index used by Burnside and Dollar. However the wide-ranging experience of countries with respect to correlation between aid and external shocks, as shown in figures 6.1 and 6.2, clearly shows one aspect of the problem of omitted heterogeneity in panel regressions of the type conducted by Burnside and Dollar.
11. Of course, when aid flows are subject to large short-term fluctuations and do not contribute to productivity growth in the economy they can also lead to similar Dutch Disease symptoms. However, in that case, as we shall argue, uncoordinated aid can give rise to much more serious problems than just an overvaluation of the exchange rate.
12. For example, it is estimated that in sub-Saharan Africa in 1998 debt service minus the amount of aid that took the form of budget support drained the government budgets by about $7 billion (Birdsall, Claessens and Diwan, 2000).
13. Among the LDC's, serious conflicts and civil wars occurred in Afghanistan, Liberia, Sierra Leone, Sudan, Eritrea, Ethiopia, Haiti, Somalia, the Democratic Republic of the Congo, Angola, Rwanda and Burundi in the 1990s.
14. Other developing country group in table 41 and elsewhere in this chapter encompasses all the developing countries listed in World Bank (2000b) as developing countries, excluding the former Soviet bloc countries in Central and Eastern Europe and Central Asia, and the OPEC member countries. The other low-income country group consists of all other developing countries whose per capita GDP in purchasing power parity terms (at current international dollars) during the 1980s was below the maximum per capita income in the LDC group in the same period. The sample of countries for different variables varies depending on the availability of data, but the numbers are consistent over time.
15. As mentioned earlier, there is also much evidence to suggest that donors have had increasingly to support the recurrent cost of some of the projects, and that the recipient Governments, in order to by-pass the IMF - imposed ceiling on current expenditures, and have labelled part of their recurrent expenditure as development expenditure. On estimates of the recurrent cost component of aid projects in Mozambique, see Wuyts (1996).
16. Considering that the LDCs have had higher population and school-age population growth rates, as well as lower per capita GDP growth, than other developing countries over the past two decades, in terms of real educational expenditure per student the widening gap between the LDCs and other developing countries is much worse than the situation revealed by expenditure shares in figure 5.5.
17. For a definition of the term "fungibility", see endnote 3.
18. On the revenue side, whether the low tax rates in the LDCs are due to "fungibility" of aid or structural and administrative shortcomings of the LDC economies depends on how far one is prepared to stretch the concept of fungibility, since it can be argued that

such structural and administrative shortcomings are themselves due to fungibility of aid. Standard fungibility tests, however, suggest that at least with respect to the sub-Saharan African economies aid is not fungible vis-à-vis government taxation (Devarajan, Rajkumar and Swaroop, 1998).

19. In the aid policy debate, outcomes and policies sometimes are confused. For example, various tax rates and government expenditures within the regular government budget can be regarded as policy variables, even within the constraints of underdeveloped structures of the LDCs. But the budget deficit, even when we exclude donor-funded investments and grants, though it can be a target of policy, is not in itself a policy variable. Fluctuations in aid funds can exert an overwhelming influence on the outcome even when they are excluded from the measurement of the deficit. Similar considerations apply to monetary policy, as compared with outcomes such as domestic credit expansion and inflation, and to exchange rate policy, as compared with real exchange rate outcomes.
20. This is not, of course, to deny that there have been with other important enabling conditions in the case of Botswana which are absent in many other LDCs.
21. For example, as Helleiner (1999: 3) points out, "in Tanzania, where efforts have been made to transfer 'ownership' of development programs from aid donors to the government, only 30 per cent of ODA was estimated to flow through the government budget in fiscal year 1999". And the figure for fiscal year 2000 is apparently unchanged (ibid).
22. In fact, the principles of partnership, i.e. the critical role of the recipient Governments in giving direction and strategic guidance to aid coordination, and the donors' roles in harmonizing their activities as *partners* in development, were set out more than 30 years ago in the Pearson commission's report on international development (Pearson et al., 1969: 127).
23. This discussion partly draws on Wuyts (2000).
24. An arguably more appropriate framework would be one where there are two principals, namely the voters and the tax-payers in the recipient and the donor countries, and two agents, namely the recipient country Government and the Government or aid agencies in the donor countries. As shown in this chapter, the reasons for lack of aid effectiveness have to do with agency problems on both sides. However, Ndulu's framework (Ndulu, 2000) is adequate and more parsimonious for the study of issue of inclusive ownership.
25. This preference for NGOs, however, is not always clearly spelt out since many NGOs (particularly international NGOs relying on co-financing out of aid funds) are by no means accountable to the ultimate beneficiaries.
26. This may appear too superficial a point, but there are a number of influential advocates of this type of selectivity (see, for example, Collier, Guillaumont and Gunning, 1997, and Gunning, 2000), proposing the use of cross-country growth accounting regressions. The latest topical issue in this debate is whether to include policy variables in the regression equation and, if so, how to adjust the error term in order to find the right formula for effective aid allocation (see Gunning, 2000). But too much confidence should not be placed in the residuals from cross-country panel regressions, owing to various statistical problems, notably those arising from omitted heterogenity..

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