

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.

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

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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.

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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 Tourtelotte (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.

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

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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).

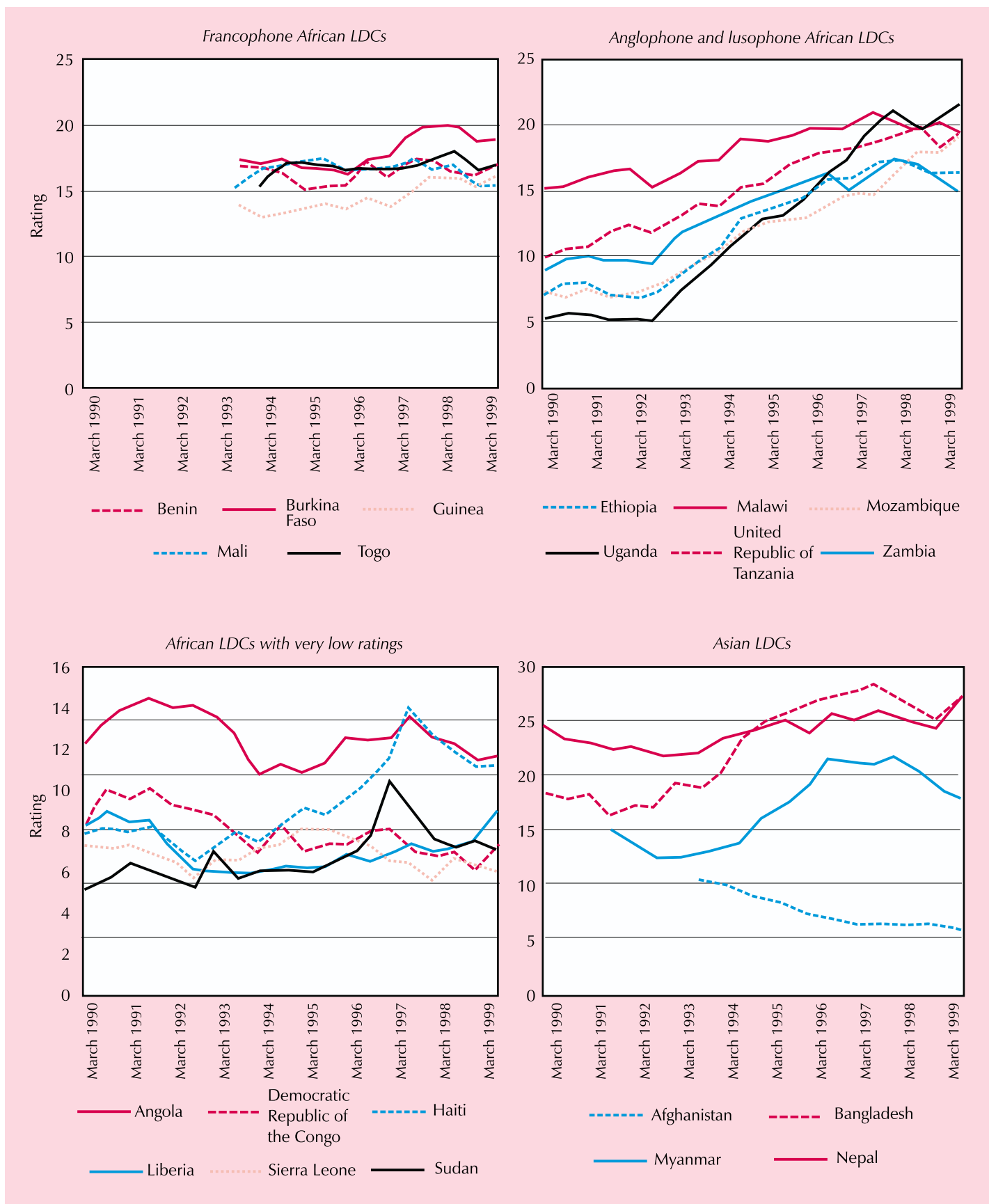
TABLE 20: RATES OF RETURN ON UNITED STATES DIRECT INVESTMENT ABROAD IN SELECTED LDCs, 1995–1998^a
(per cent)

| | 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 undervaluation 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.

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

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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 Vyrinen, 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.

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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

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.

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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 re-start 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 Príncipe, 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.

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.

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

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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. 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

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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.

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.

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.

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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