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Issue Paper

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External Financing for Poor Nations: Greater Commitments Needed from the North

Increasing Global Interdependence

At the global level, a new form of global economic interdependence is slowly taking form, primarily as a result of World Trade Organisation (WTO)-induced or inspired trade liberalisation undertaken by many developing countries. Until recently, many of them practiced inward-looking growth strategy. China and India are perfect examples of what can be done to increase countries' share in the global economy. Several other Asian and Latin American countries have also done reasonably well. At the global level, however, the international community still faces the challenge to manage the integration of a large number of LDCs, which are increasingly becoming marginalised in the global economy.

Complementarity

Today, South-South cooperation has become a new buzzword. But it would be a gross mistake on our part if we consider it a substitute of North-South cooperation. In this new age of global interdependence, North-South cooperation is as important as South-South cooperation. The integration of LDCs into the global economy can only be successfully managed if the two complement rather than substitute each other. While South-South cooperation is required to harness the growing markets of the South and reducing their dependence on Northern markets, North-South cooperation is needed to address developmental needs of the South through increased flow of external financing and technology.

The Three Critical Areas

External financing for poor developing countries is definitely one area where the North needs to step up efforts. In this context, three issues are critical: debt relief, increased aid and foreign direct investment (FDI). While debt relief releases additional resources for poor countries, greater flow of aid and FDI make an important addition to scarce domestic capital. Debt relief combined with increased aid and FDI flows can provide a much needed boost to the listless economies of many poor countries, provided they are channeled to the right places.

Presently, many Southern countries are grappling with an overwhelming debt burden, which is eating into their national income every year. The problem was compounded further by declining foreign aid in the 1990s, from about US$73bn in 1992 to US$57bn in 2002. And although the share of developing countries in global FDI inflows rose to 31 percent in 2003, the inflow was largely confined to ten larger developing countries. For the majority of LDCs, official development assistance still exceeds FDI flows.

Debt Relief

At the global level, debt relief for low-income countries has become an important political issue. Developing (including middle-income) country debt rose from US$500bn in 1980 to US$1tn in 1985 and around US$2tn in 2000. The 41 Highly Indebted Poor Countries (HIPC) – among the poorest of the poor – saw their total indebtedness increase from US$60bn in 1980 to US$105bn in 1985 and US$190bn in 1990, and would have been, without any debt reduction, nearly US$200bn in 2000. Poor countries owe these debts to either developed nations or international financial institutions, indirectly controlled by a few powerful nations.

The policy developments of the last two decades have made the world more integrated and interdependent. At the policy level (economic and trade), there is now a greater degree of coherence among a large number of countries, including developed, developing and least developed countries (LDCs). However, despite the rapid growth of the world economy and trade over the last one and a half decade, many Southern countries still have a tiny share in world trade and gross domestic product (GDP).

What caused this heavy debt overhang? Worldwide events in the 1970s and 1980s – particularly the oil price shocks, high interest rates and recessions in industrial countries, combined with weak commodity prices – were the major contributors to the debt build-up in the Heavily Indebted Poor Countries (HIPC). After rising by 12 percent per year from 1970 to 1980, commodity prices dropped sharply in the early eighties. Countries partly compensated for declining terms of trade with increased foreign borrowing.

Debt relief to poor countries makes lot of sense. Firstly, it provides predictable additional resources at the disposal of poor countries, which they could invest towards meeting the millennium development goals (MDGs). Secondly, it allows poor countries to access loans from private foreign investors. Private investors may be unwilling to lend to a highly indebted country for the fear of unrecoverable bad debts. Finally, the sums involved in debt relief are relatively modest – with the US, for example, expected to put in just US$175mn a year over 10 years. The debt deal is worth around US$1.5bn – critical sums to very poor countries, but only 3 percent of total aid flows of US$50bn per year.

Official Development Assistance

Foreign aid to poor countries through Official Development Assistance (ODA) has been in operation for the last several decades. In most poor countries with underdeveloped infrastructure and human capital, aid from developed countries is considered essential. Way back in early 1970s, the world's 22 rich countries were mandated by the UN General Assembly to provide 0.7 percent of their gross national product (GNP) as ODA to developing nations. However, only five countries so far have met this target. Most of the rich nations have not even come close to that target. Today, only 0.24 percent of donor countries' total GNP is delegated to ODA; the US finds itself at the bottom of the league with a mere 0.1 percent.

Developed countries needs to enhance their efforts to attain the 0.7 percent target of ODA. As already mentioned foreign aid actually declined in 1990s. What is most unfortunate is that this decline came on the heels of fresh promises made at the 1992 Rio Earth Summit. Donor governments once again made new commitments to increasing their ODA at the International Conference on Financing for Development in Monterrey, Mexico, in March 2002.

Imagine if the industrial world were to be successful in meeting its ODA targets, financial aid would increase to about US$175bn, slightly more than three times current levels. This will be of immense help to poor countries in achieving the MDGs by 2015. The World Bank (WB)-International Monetary Fund (IMF) Global Monitoring Report 2005, first in the planned series of annual reports assessing the implementation of policies and actions for achieving the MDGs and related outcomes, notes that, on current trends, most of the targets will not be met by the majority of poor countries, especially sub-Saharan Africa (SSA).

The IMF and the WB have initiated another joint initiative called 'Aid for Trade' at the call of G-8 countries in the year 2005. The main objective behind this initiative is to help poor countries overcome supply-side constraints to their participation in international markets and to cope with adjustment costs related to transition to liberalisation. Jagdish Bhagwati, an eminent trade economist, has supported this initiative, citing reasons of preference erosion and increased food import bills as a result of further trade liberalisation under the auspices of the WTO. However, many people are suspicious of this move of developed countries. They are of the opinion that this proposal only serves to divert attention from the real issue of agricultural trade liberalisation.

Foreign Direct Investment

In this new era of globalisation, FDI has become an important source of external financing. This has helped many developing countries from Asia and Latin America in the process of industrialisation and the achievement of a higher economic growth rate. Realising the crucial role FDI plays in helping domestic economies increasing their growth rates, many developing countries including LDCs have significantly liberalised their FDI regimes. This policy change has resulted in the increased flow of FDI to developing countries as a whole, but this has not been evenly distributed. The share of LDCs as a group is less than two percent of FDI flows to developing countries. And, as a percentage of total inflows worldwide, their share was a minute 0.5 percent.

The low inflow of FDI to LDCs illustrates the scale of the task ahead in mobilising capital, at a time of continuing declines in grant aid and for some – a heavy foreign debt overhang. Today, FDI has become the most preferred source of external financing. In order to increase their share of FDI, LDCs definitely need a greater degree of cooperation from their rich counterparts in the North. Despite rising FDI from the developing world, developed countries continue to account for over 90 percent of total outward FDI.

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