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1

Development Finance in the Global Economy: The Road Ahead

Tony Addison and George Mavrotas

Introduction

Today, large volumes of global savings move through an increasingly integrated global capital market in search of investment opportunities. Capital is abundant. The developing world is receiving an increasing share of these flows, to the benefit of private investment – in production, trade and infrastructure – as well as to the balance of payments (with foreign direct investment (FDI) providing the most stable form of capital flow). Running alongside this story of private capital flow is one of increased official flows, official development assistance (ODA) having rebounded since its mid-1990s slump. And the flows of private and official capital run together at times, as with the international finance facility (IFF) which aims to leverage and front-load ODA by borrowing from international capital markets. The IFF, together with the French airline tax and proposals for global environmental taxes, the currency transaction tax (CTT) and the Global Premium Bond, constitute the new class of innovative financing mechanisms. Last, but certainly not least, the new philanthropy (increasingly in partnership with development agencies) is adding considerably to already well-established and growing flows from the charitable sector – and this source of capital has an especially close relationship with the goal of reducing poverty.

After many years of stagnation in the availability of finance for the developing world, the *aggregate* picture is brighter. But caution is also necessary. FDI is concentrated on a narrow range of countries (with China dominating), and while FDI into the smaller economies of Sub-Saharan Africa (SSA) is rising, it remains confined mainly to its traditional destination – the mining sector (which benefits growth but leaves economies undiversified). Private portfolio flows into equities and bonds are still concentrated on a narrow range of emerging markets, and while such flows into the so-called 'frontier markets' have risen in recent years – as investors' appetite for risk has increased – this is from a small base, especially in SSA. The good news on ODA is tempered by the fact that a significant part of the recent growth consists of debt relief.

Reducing the debt overhang of the heavily indebted poor countries (HIPCs) has been important to restoring their attractiveness to investors (Nigeria's international credit rating is now the same as Ukraine's) but many observers (including many poor countries) question whether debt relief represents a true net addition to their resources (and part of the jump in aid consists of cancelling the bad loans given to Saddam Hussein's Iraq). OECD-DAC warns that ODA could dip over the next few years, and this will imperil achievement of the Millennium Development Goals (MDGs) by 2015. And the effectiveness of aid is continually contested, most forcibly and recently by Bill Easterly (2006). Even among those favourably disposed to aid there are widely different views over the ability of poor countries to absorb and make good use of substantially larger flows (Mavrotas 2002; Killick 2005; Riddell 2007).

In summary, there is much to be positive about (especially when compared to the dismal decades of the 1980s and 1990s) but we are far from claiming victory in the battle to obtain more and better finance for the developing world, especially for the smaller and more vulnerable economies. There are ideas aplenty, and intellectual creativity in this area is certainly not confined to economists. The new international financial architecture raises many political and foreign-policy issues: finding the finance to tackle global environmental and health problems is recognized increasingly as being in everyone's interest; foreign aid is now viewed as an important part of the post-9/11 international security framework; and the balance of power in setting the international finance agenda is shifting, not only within the group of rich countries (as between the United States, Europe and Japan) but also between rich and poor countries, as China and India become increasingly important global actors. Political scientists and international relations specialists are now busy debating the implications of these trends both for the international financial architecture and for the global economy more widely.

This book aims to provide an overview and assessment of where we stand in the debate, and where we need to go from here in constructing a system of international finance that serves the needs of poor countries and especially of poor people. It contains contributions by specialists in economics, international relations, and political science; and a number of the authors have been at the centre of the international policy debate. The book is part of a stream of UNU-WIDER work in this area since 2000, including the study by Griffith-Jones *et al.* (2001) on short-term capital flows; the 2001 conference on debt relief (Addison *et al.* 2004); the 2003 conference 'Sharing Global Prosperity'; the study led by Sir Anthony Atkinson on new sources of development finance undertaken for the UN General Assembly (Atkinson 2004); and the 2006 conference on aid policy. This stream of research activity was stimulated by the lead-up to the 2002 UN Financing for Development summit held in Monterrey (Mexico) and its aftermath, the associated (and intense) activity around the MDGs, and the desire to continue UNU-WIDER's long-standing work on the global economy and the developing world that has,

since the 1980s, sought to understand the implications of rapid economic change (Calvo *et al*. 1989; Wyplosz 2001; Nayyar 2002).

This chapter provides an introduction to the main issues raised by the volume. The next two sections provide a short overview of development financing in order to place the individual chapters in an overall context, first discussing the changing picture for private financial flows and then official development finance as well as the new class of (innovative) sources of development finance. The penultimate section introduces the chapters in this collection, summarizing the main points of each, linking them together and to the earlier contextual discussion. In the concluding section we note that, while the development finance picture is now brighter than it was just a few years ago, much more action is necessary if this is not to be yet another false dawn.

Private development financing

Demographics shape global capital flows through the global savings rate and, since the population shares of the working young and the retired old vary across countries, the pattern of cross-border capital flows. Financing the pension and health costs of ageing societies, notably Europe and Japan but also increasingly China, is having powerful effects on international capital markets. For Northern-based pension funds this has led to a somewhat desperate search for yield as returns on the North's sovereign debt (which has the least risk of default) have fallen since the early 1990s, and particularly since the start of the 2000s, because of a strong growth in demand (amplified by a shift from equities to bonds by investors following the 1999–2001 sell-off in equity markets). A scenario is emerging in which ageing societies increasingly invest in the equity and bond markets of youthful developing countries, a potentially 'win–win' outcome for both; Northern investors get higher returns and the South gets more (and cheaper) capital. If this works well, it will create bigger and more liquid Southern markets for sovereign debt, equities, corporate debt and, eventually, municipal debt and property as asset classes for Northern (and Southern) investors. India's capital markets are already benefiting from this effect, although it is not without its costs (the speculation in these markets will no doubt lead to some booms and busts along the way). Optimists speak of a new era in which the need for concessional loans and grants from development agencies will decline rapidly, with ODA possibly becoming extinct (much to the satisfaction of those who question aid's effectiveness).

This mutually beneficial scenario is not, however, a done deal, and some very fundamental problems remain that are more difficult to overcome than the optimists allow. Perhaps the most important of all is that the recipients of increased private capital flows need effectively to turn these into investments that generate higher economic growth, and therefore deliver

the higher returns global investors expect. Otherwise, they will go elsewhere in their search for yield. Global investors must also be sufficiently risk-taking to allocate a large enough share of their portfolio to the relevant asset categories to benefit significantly from any superior returns; for the moment they are willing to take on such increased risk, for reasons we discuss shortly (but this is far from being a given and the decision is much affected by the easing of global monetary policy since the start of the 2000s). Southern recipients must also improve corporate governance substantially to protect shareholder rights (otherwise equity investment will not be sustained), build better sovereign-debt management (a tough challenge for the poorer countries), and improve their macroeconomic management to cope with the real-economy effects of the capital inflows (thereby ensuring that they facilitate rather than undermine economic development). We can expect more use of derivative instruments by global investors to hedge currency and political risks; and innovation to reduce the costs of such hedging could do much to stimulate flows to the lesser-known and riskier countries.

But not all risks can be hedged (or are indeed observable, since many are asymmetric – as between lender and borrower). The political risks of investing in poor countries remain high (giving rise to insecure property rights) and to a degree unpredictable – including those associated with adverse global climate changes. So the world's capital markets are unlikely ever to achieve textbook perfection in which every investment need of poor countries is matched by willing global investors. Consequently there will remain considerable space for official flows. And the need for ODA could actually rise much further (even beyond that projected to meet MDG requirements) as the effects of global warming take their toll on the South (in particular, a greater variance of rainfall in Africa's agricultural margins, and increased flooding in the many densely populated and low-lying lands of Asia).

Alongside financial globalization, and interacting with it, are geopolitical changes of immense importance to everyone. China is in an especially interesting position. China is both a recipient of portfolio flows (its sovereign bond issues are regularly over-subscribed by Northern pension funds) as well as an increasing source, since it must cope with its own rapidly ageing population, including the effect on the ratio of workers-to-pensioners of the 'one-child' policy adopted in Maoist times (which in part explains China's very high personal savings rate). China is now attempting to invest its massive reserves through a specially created investment authority (initiated in 2007), and the country will no doubt become a big investor in the equity markets of the rest of the developing world. This will accentuate the decline in yields now occurring on emerging market investments, requiring all investors (including those in the North) to devote more of their portfolio to these markets (that is, to take on more risk) if they are to meet their overall targets for asset growth to match their liabilities. The growth in the latter greatly exceeds the projections made just a decade ago in the mid-1990s because the rate of

improvement in life expectancy is rising every year (not just in the North but also in China), imposing on pension funds a 'longevity risk' (pension payments will go on much longer); a typical large or medium-sized company in the UK has a pension scheme with liabilities that are a quarter of its market capitalization.[1]

Not far behind China is India (a country that one of the chapters in this volume assesses in detail; see further discussion below). Both China and India now borrow very little (as a share of their total financing) from the World Bank, and nothing at all from the IMF (making India a net creditor of the Fund). Brazil has also stepped back from borrowing from the Bretton Woods institutions (BWIs). The fact that the world's three largest emerging economies have moved in this direction has further reduced the IMF's role (one borrower, Turkey, now accounts for much of the IMF's outstanding lending). This is not to say that the BWIs are unnecessary: the World Bank's financing of health and social protection in India provides much-needed sector support, for example. But it is to say that we have shifted rapidly from the world of just twenty years ago (or indeed ten, if we recall the Asian financial crisis) when the BWIs called the shots.

The present strength of the sovereign debt market is the result of abundant global liquidity (with real interest rates at historically very low levels in recent years). Consequently there is a danger that as the interest-rate cycle turns, and liquidity contracts, emerging markets will turn down as they did in the past (Addison 2007). The US Federal Reserve, the Bank of England, and the European Central Bank have all begun to tighten over 2006–7. Yet, despite some strains (a wobble in Ecuador's sovereign debt market and a sharp sell-off in Chinese equities in 2007) there is not as yet any sign of major trouble, and the compression in spreads of emerging market over developed country debt that has marked recent years is continuing. In some cases the fundamentals in emerging markets have improved sufficiently to attract further inflows even as US monetary policy tightens with, perhaps, the search for yield by investors from ageing societies putting some kind of floor under the market. Still, we should not be too sanguine: financial crises are twice as prevalent today as they were in that other era (pre-1914) of financial globalization (Eichengreen and Bordo 2001).

The financial services industry is, not surprisingly, in a golden era; it will constitute 10 per cent of global GDP by 2020 and the emerging economies are its fastest-growing markets (Goldman Sachs 2003). Financial services are also showing modest but respectable growth in the poorer countries, with more direct investment by foreign banks in joint ventures with local partners (thereby helping to recapitalize banking systems) propelled in part by an expanding middle-class demanding more insurance, banking and housing finance (with, in some countries, increased efforts to provide formal financial products to poor people as well; Mexico has several interesting initiatives). This offers more scope for connecting domestic and international capital

markets to the benefit of poorer countries in securing a larger share of global portfolio flows (and perhaps to poor people, but this will not be accomplished without much institutional innovation and a large measure of private or public subsidy, at least initially). It also requires heavy investment in financial regulation to ensure that the increasing sophistication of financial sectors in poor countries does not undermine their macroeconomic stability when new financial institutions engage in imprudent borrowing and lending (see Brownbridge and Kirkpatrick 1999; Stiglitz 1999; Guha-Khasnobis and Mavrotas 2008; Mavrotas 2008).

The poorer and smaller countries are becoming better known to international investors since declining yields on emerging market debt – the consequence of large inflows in recent years and a reduction in the supply of such debt – have encouraged investors into 'frontier markets' (Addison 2007). This is paralleled by increased investment in equities in these countries as well. Traditionally, these markets were bypassed in favour of the bigger, better-known and deeper financial markets of countries such as Brazil, China, India and South Africa. Information asymmetries and high transactions costs have made it difficult for small, poor countries to tap into global capital markets, but this is starting to change. The large write-offs of HIPC debt have helped Ghana and Nigeria to raise their sovereign credit ratings (an effect we discuss further below). At the time of writing, twenty SSA countries have a sovereign credit rating (compared to only one in 1997), and many can now borrow commercially at interest rates less than half those of the past. And they have access to the international capital market on a scale unimaginable only a few years ago.

Their underdeveloped capital markets do, however, lack liquidity, and large flows can potentially destabilize poor economies (causing large changes in exchange rates that could undermine growth, for example); so, again, careful macroeconomic management – including, at times, the judicious use of capital controls – is necessary (Stiglitz *et al.* 2006). This must temper recent optimism, and there are dangers ahead that require careful navigation, not least re-running 'that '70s show' in which countries borrowed recklessly on the back of the 1970s commodity boom – only to see themselves saddled subsequently with enormous foreign debts (Collier and Gunning 1999). These had to be serviced on the back of meagre export earnings when commodity prices collapsed again in the recession of the 1980s.

So it is imperative that, this time round, the borrowed funds are used to fund infrastructure to diversify economies away from their traditional dependence on commodity exports. Getting the right infrastructure in place is no easy task, and one priority must be transport and communications infrastructure that facilitates more intra-Africa trade; the transport costs that countries face in trading with each other remain absurdly high, a problem that has been emphasized repeatedly for decades, but one for which there has been too little finance available.

At least today's financial markets offer more tools for hedging commodity price and exchange rate risks, and governments would be well-advised to use these, as the bonanza of cheap world capital cannot last for ever. At some point before 2012 global inflation will rise (perhaps as a result of China's seemingly insatiable demand for steel, copper and oil), requiring the major central banks to tighten interest rates: easy credit will then come to an end, risk premiums will jump (including those on emerging market debt), and countries that have not used their borrowing productively will be exposed to the chill winds of expensive credit again.

It is therefore worrying that, despite all the chatter about a 'new international financial architecture' over the last few years, we are no closer to its realization. There is still no institutional mechanism to manage private debt default, since the IMF's proposal for a sovereign debt restructuring mechanism fell by the wayside in 2003. And there are some very good ideas – such as GDP-indexed bonds and linking debt-service to commodity prices – that remain on the drawing board (Griffith-Jones and Sharma 2006). It is in the good times, when credit is easy and commodity prices are high, that we should be building a financial architecture that is robust for the bad times that inevitably arise.

Official development assistance

At the 2005 G8 summit in Gleneagles (Scotland) the UK extracted pledges from heads of state to add US$50 billion to annual aid flows up to 2010, with at least half the increase going to SSA. Moreover, the traditional mechanisms of ODA are now starting to connect to the debate around 'new' or 'innovative' sources of finance (discussed in the next section) specifically through the UK's IFF proposal promoted by HM Treasury (with the heavyweight political backing of Gordon Brown, UK Chancellor of the Exchequer at the time). The IFF will leverage additional money from the international capital markets (through a securitization process) to achieve a flow of US$50 billion from 2010 to the MDG target date of 2015 (Mavrotas 2004; Moore and Hulme 2004). Given the novel nature of its borrowing, one major issue has been how well the IFF fits into the fiscal frameworks of donor countries themselves; Eurostat has ruled that IFF borrowing need not be included in the government borrowing of EU member states (an important decision, since the latter is limited by the EU's stability and growth pact) but the IFF does not appear to be compatible with the budgetary procedures of Canada and the United States. An International Finance Facility for Immunization (IFFIm) is now in place and, aside from its inherent desirability, it also constitutes a pilot for an eventual IFF.

Two years on from Gleneagles, however, the promises were only half-delivered. ODA in fact fell by 1.8 per cent in real terms in 2005–6 (excluding debt relief to Iraq and Nigeria, which boosted the 2006 total: including this

debt relief yields a fall of 5.1 per cent in real terms over 2005–6). Far from rising to meet the MDG goals, aid to SSA from OECD-DAC donors was constant in 2006, once debt relief to Nigeria is excluded out (OECD-DAC 2007). The UK, Spain and Sweden have increased their aid sharply, with the UK moving up to become the world's second-largest bilateral donor. But aid from many European countries is stagnant or has fallen (notably from Finland and Italy), while US and Japanese aid has also fallen. It seems that the predictions made during Gleneagles that donors were fudging their commitments have proved all too true, and the donor community has come in for some sharp criticism. Richard Manning, chair of OECD-DAC, made it clear that the problem is one of supply rather than demand: 'the promises will not be credible unless we begin to see substantial rises in 2007 and 2008. The shortfall reflected a lack of will in the rich nations, rather than Africa's inability to absorb more aid'.[2] Aid absorption itself remains a thorny issue, with wide differences of view (Killick 2005; Gupta *et al*. 2005; Easterly 2006; Guillaumont and Guillaumont-Jeanneney 2006; Heller *et al*. 2006; Bourguignon and Sundberg 2007; Riddell 2007). But one key dimension is the quality of fiscal management and the ability of countries to translate additional resources into effective pro-development (and pro-poor) infrastructure and services; this is at the core of questions over whether aid can be scaled up by shifting from traditional project aid to budgetary support (McGillivray and Morrissey 2004; Mavrotas 2005; Koeberk *et al*. 2007).

Meanwhile, as many of Africa's traditional Western donors stall, new players have come into the arena, buoyed up by their large-scale accumulation of foreign-exchange reserves. Once itself a large net recipient of aid, China is becoming a major aid donor in Central Asia, the poorer countries of South-East Asia and especially in Africa; at its 2006 Africa summit (attended by forty-eight African leaders) China pledged US$5.5 billion in aid to the region, and could be Africa's largest bilateral donor by 2010. Not surprisingly, China's new prominence as a donor is receiving mixed reviews. Optimists look to the large-scale infrastructure projects that China's aid is capable of funding, especially in easing the transportation of Africa's commodity exports which are now in high demand (a return to China's donor role in the 1970s when, in a very different political context, it funded the Tanzam railway linking Zambia to Dar es Salaam's port). China's funding of African infrastructure rose from US$700 million in 2003 to US$2–3 billion per year over 2005–6 (Naím 2007: 96). Pessimists go so far as to claim that China's aid represents a threat to Africa's healthy sustainable development. China could use its enormous reserves to contribute to the next replenishment of the International Development Association (it gave nothing to the last IDA replenishment in 2005) thereby dispelling some of the accusations that it is following the well-trodden path of Western donors in using its aid largely for commercial and diplomatic gain. As Richard Manning emphasizes, what is needed is a constructive dialogue between DAC and China, and other 'emerging'

donors, to encourage their take-up of DAC procedures and norms (Manning 2006). As a permanent member of the UN Security Council, China has a duty to set an example in ensuring that *all* aid is used for development purposes.

Debt relief constitutes a significant part of the recent ODA increase following the HIPC Initiative (later 'Enhanced') and then the Multilateral Debt Relief Initiative (MDRI) arising out of the Gleneagles decision to cut debt further. Whether much of this debt would ever have been repaid, and therefore whether it actually represents a true addition to ODA, remains a contested point (for a critique, see Eurodad 2006). Nigeria has also cut its commercial debt. In March 2007, Nigeria redeemed most of the debt owed to its commercial creditors (the London Club) in a deal that Nenadi Usman, the finance minister, said would 'free Nigeria from its historic debt overhang' (which in the late 1990s amounted to US$35 billion, equivalent to 60 per cent of GDP).[3] The last US$500 million has been bought back, and there are high hopes that Nigeria's sovereign bonds can now achieve an investment-grade rating. Although a politically unpopular decision at home (much of the debt was incurred by Nigeria's feckless military rulers with little thought to the future), recent debt buy-backs will lower the country's risk premium and make it easier to finance the budget – including much needed spending on basic health services, primary education, and pro-poor infrastructure (all of which are needed to haul Nigeria out of deep poverty).

Similarly, at the time of writing, Ghana is expected to raise up to US$750 million in 2007 from the international capital market, and overall the prospects for the region's poorer borrowers have improved significantly after completion of relief under the Enhanced HIPC Initiative and the MDRI. While eight African countries continue to languish at pre-decision point status under the HIPC Initiative (Central African Republic and Sudan, for example) debt relief is unlikely to do much to resolve their urgent political problems (the genocide in Sudan's Darfur region, in particular).

Having only just eliminated their HIPC debt (largely the legacy of past concessional aid loans to fund structural adjustment), why are countries in a hurry to borrow commercially? One reason is that aid is an uncertain way of funding the public budget, and the time since Gleneagles has not inspired confidence that aid is anything but a fickle friend.[4] And so African countries are turning to commercial borrowing, taking advantage of a world that is, at least for the moment, abundant in capital looking for a return. This provides an excellent opportunity to finance Africa's enormous investment backlog not only in 'hard' infrastructure but also in human capital. With the midpoint of the MDGs now upon us (as at June 2007) Africa is far behind on the education and health-care investments it needs to get close to the 2015 targets, and borrowing to achieve these targets is all too necessary, given the many broken promises of the aid 'community'.

New sources of development finance

What are now called 'new' or 'innovative' sources of development finance have attracted increasing attention since the start of the 2000s, following initial work done around the time of the 2002 UN Financing for Development Summit in Monterrey (Clunies-Ross 2004) and in part stimulated by frustration at the fall in ODA in the 1990s and the need to finance the MDGs as set out at the 2000 UN Millennium Summit. At the start of the decade, a panel chaired by President Ernesto Zedillo of Mexico calculated that roughly US$50 billion was necessary in addition to existing annual ODA flows to achieve the international development goals (subsequently the MDGs) (UN 2001). Interest in these new sources of development finance has also grown in response to the pressing need for more global public goods, especially in peacekeeping (reflecting the intense pressure on the peacekeeping resources of the UN and regional bodies such as the African Union), health (in the light of new pandemics such as SARS and avian influenza as well as the continuing HIV/AIDS crisis) and global climate change – concern for the latter accelerating in 2005–6 especially (on global public goods, see Kaul *et al*. 2003). In 2000, the UN General Assembly called for a rigorous follow-up study to the Zedillo report, and this was undertaken by UNU-WIDER in association with the UN Department of Economic and Social Affairs, and led by Sir Anthony Atkinson of Oxford University (Atkinson 2004). A study by the French government (Landau 2004) considered additional proposals, including a tax on airline fuel that has become a cornerstone of French action in innovative finance. Innovative finance has also become an issue for political co-operation between Europe and the larger emerging economies; thus in September 2004, the Governments of Brazil, Chile, France and Spain convened a heads of state meeting at the UN on an 'Action Against Hunger and Poverty Initiative'.

One 'old-new' source – and still in many ways the best known – is the currency transactions tax (CTT), originally known as the 'Tobin tax' after the economist James Tobin (who argued for the tax as a way to stabilize the extreme fluctuations in exchange rates that followed the breakdown of the Bretton Woods system in the 1970s). Tobin himself rejected the use of the tax in its modern financing-for-development guise, but it has proved to be a remarkably resilient idea within global civil society (see, for example, Pätomaki and Sehm-Pätomaki 1999) despite intense criticism from many economists. The CTT would be applied to foreign exchange transactions including the spot, forward and future markets as well as swaps and other derivatives. Countries that host major centres of international finance (notably New York, London and Frankfurt) do not favour the CTT, and even France has been lukewarm.

How much the CTT and other such sources of finance could raise remains an open question, depending as it does on the tax rates used, compliance, and the willingness (or otherwise) of national authorities to sign on. The

UNU-WIDER study assessed the relative merits of global environmental taxes (specifically, a carbon-use tax) and the CTT, as well as frameworks for international taxation more generally, and found that comparatively low tax rates could mobilize large revenues (Atkinson 2004). The CTT could generate US$15–28 billion per year (Nissanke 2004), and taxing hydrocarbon fuels could generate another US$50 billion (Sandmo 2004). Note that, to make an effective dent in global carbon emissions, the tax rates would have to be significantly higher than those used in the UNU-WIDER calculations, and while such taxes do have 'double dividends' – reducing adverse global climate change in the case of carbon taxes as well as raising revenue – they remain controversial, as the recent 'Stern Report' points out (Stern 2006).

The UNU-WIDER assessment informed the report of the French government (Landau 2004) as well as the 2004 'Action Against Hunger and Poverty Initiative' of the governments of Brazil, Chile, France and Spain. UNU-WIDER's findings were well received by the developing-country and European members of the UN General Assembly (although the developing countries did affirm that innovative sources of finance need to be *additional* to ODA) but the United States remains opposed to global taxes, arguing that they infringe national sovereignty (Addison *et al*. 2005a, 2005b). The present US administration's position is in part bound up with its reluctance to be swayed by scientific evidence on global warming, and therefore its extreme reluctance to sign up to any comprehensive action, be it the Kyoto protocol or global environmental taxes. But this reluctance is steadily being chipped away, not least by the state government of California, which is now taking global climate change very seriously. More fundamentally, global taxes raise issues of who will run the necessary tax authority; the UN would seem to offer the best home, but if the UN took on this role it would represent a large shift of power from its constituent (nation-state) members. Innovative finance in synergy with action on global climate change could become an avenue for recasting the UN's global role, although the practical and political issues that must be overcome remain formidable, but it is hoped not insurmountable.

Aside from global taxes, the remaining ideas in the innovative finance area are a mixed bag. The UK's IFF (a blend of ODA leveraged by private capital markets), which we have already discussed; the creation of Special Drawing Rights (SDRs) for development purposes (donor countries making their SDR allocation available for poorer countries) a long-standing idea but one that has been given a recent boost; innovations using IT to scale up charitable donations for development, especially for micro-enterprises; the Finnish proposal for a global lottery; and a global premium (prize) bond for poverty reduction. Others have looked to remittances, which now amount to US$80 billion per annum (matching annual aid flows), and while this is a very old flow there are new proposals to reduce transaction costs for poorer households and communities by creating new financial services for

them to bypass the reliance on traditional (but high-cost) money-transfer services (Solimano 2004). One of the chapters in this volume focuses on the development impact of remittances.

One important side-effect of the boom in information technology businesses and global financial services is the creation of new wealth, a portion of which is going into global philanthropy, with the Bill and Melinda Gates Foundation and the Google Foundation being the largest of the new players. Innovation in service delivery is central to these new philanthropic models, as is public and private partnership. A good example is the current effort to supply cheap Coartem (a highly effective malaria drug) to Africa. Novartis, which makes Coartem, has waived the patent restriction and supplies it at cost price to public health authorities in Africa, the Global Fund to Fight AIDS, Tuberculosis and Malaria (GFATM), and other donors. The Gates Foundation is working with GFATM and the World Bank to cut the cost further by subsidizing the supply chain by some US$300 million per year. This, together with Novartis's production subsidy, constitutes a major external resource transfer straight into an area of key priority, since at least a million Africans die of malaria every year (many of them under five years old).

Development philanthropy by individuals and corporations can be increased by tax incentives and matching private donations with public funds: the UK's Treasury offers a range of tax incentives for corporate and private giving, including a Payroll Giving scheme, for example (HM Treasury 2003; Micklewright and Wright 2004). Being voluntary, private and corporate philanthropy is one area where the present US administration is supportive, and the United States has a long and fine philanthropic tradition. Microfinance is now increasingly internationalized through the work of NGOs such as the Microloan Foundation and Five Talents, building on the much-deserved success of the Grameen Bank. The market for ethical financial products is also growing, as more individuals and companies seek to incorporate ethical investments into their portfolios. Ideas for hybrid products – those that appeal to both self-interest and altruism – are also around. Addison and Chowdhury (2004) assess the prospects for a global development lottery that could perhaps mobilize US$6 billion per annum by taking a portion of the world gambling market (a US$1 trillion per year business). While some might (reasonably) question the ethics of financing development in this way, the urgency of meeting the MDGs (and the shortfall in ODA) may overcome such qualms. One alternative, is a global premium (prize) bond, which has the characteristics of a lottery but where investors do not lose their stake, making it an attractive ethical investment product in a way that a pure lottery is not (Addison and Chowdhury 2004). In summary, global philanthropy (both large and small) – often exploiting the enormous leverage available from global financial markets – could take the centre stage of development finance into the 2010s.

The worlds of finance and environmental change also intersect increasingly; 2007 saw the first debt-for-carbon swap when the United States agreed to exchange US$12.6 million of Costa Rica's US$93 million debt for carbon certificates (covering some 10 per cent of the country's debt to the US). This looks promising for a future with more capital flows to poor countries as rich countries seek to offset their carbon footprints by investing in sustainable forestry and alternative energy. Africa could benefit from this, given its great tropical forests with their rich biodiversity – a global public good that needs preserving for the benefit of all humanity.

In summary, the various proposals in the innovative finance area involve varying combinations of private and public action: global philanthropy requires no government approval as such (although tax concessions can stimulate it further) and the IFF's implementation may be undertaken unilaterally or by a small subset of countries. A lottery for development purposes could be introduced by individual countries without co-ordination, as could a global premium bond. Creating SDRs for development purposes requires ratification by 100 IMF members (85 per cent of the voting power of the Fund), and global taxes would require a complete new institutional structure; hence these are the measures least likely to make progress in the current international political environment. There is a great deal of exciting talk about innovative sources of development finance, but it may just remain just that: talk. With the exception of the IFFIm and the French airline fuel tax, no further action has been taken. A cynic would say that some of the rich world's politicians advance bold new schemes in development finance when they are most keen to distract attention away from their lack of political success in the mundane (but vital) task of raising ODA.

Overview of this volume

This book addresses many of the most important issues in development finance. The discussion ranges from economics to politics to political economy, reflecting as it does the interaction of economic and political considerations in driving financial flows, both private and public, to developing countries. In this section we summarize briefly the main issues and approaches taken by each chapter.

Despite the promise of increased private capital flow, aid remains a major source of development finance for the poorest countries. But in framing aid policy it is crucial to understand the history of aid – that is, how we got to where we are today. Chapter 2, by Peter Burnell, provides the reader with a fascinating journey into the history of aid since the end of the Cold War, and its revival in recent years. The author explains the reasons why aid was down but definitely not out in the early 1990s following the collapse of the Soviet Union, and the changing perceptions about the importance of aid as an instrument of *realpolitik*.

The chapter then details the reasons why aid has staged something of a recovery in recent years, by focusing on two crucial factors and, at the same time, two potentially competing 'drivers', namely globalization and poverty, and security concerns following the events of 11 September 2001. Burnell argues that reports circulating in the 1990s claiming that foreign aid was in terminal crisis, were premature, and that while there is still a strong recognition that some countries continue to need aid because they are poor, traditional political factors play a large part in translating need into *effective* demand. Therefore, according to Burnell, the size and shape of the market for aid are political constructs. Furthermore, questions about whether economic progress, even if it does reduce poverty, will solve the kind of problems related to globalization and the post-9/11 era – and *how* aid might best contribute – continue to be controversial in development studies and among aid practitioners. This takes Burnell into the discussion of an important category of foreign aid that emerges from the new environment for aid – namely, democracy assistance or political development aid. The chapter concludes by arguing that aid for democratization considered in the 1990s to be an instrument for addressing indirectly socioeconomic weakness and improving development aid's effectiveness – making it a positive feature in a bleak decade – is increasingly seen as problematic. The author concludes by arguing that, for now, aid's resurgence should target pro-poor development rather than democratic reform, although the likelihood is that old-fashioned determinants of *realpolitik* will continue to get in the way, so that 'notwithstanding all the new spirit informing an increase of support for aid to both development and democracy, there could still follow a very familiar hangover'.

One of the central debates in the area of development aid is related to the developmental role of multilateral aid as compared to the bilateral assistance. Mark McGillivray, Simon Feeny and Howard White argue in Chapter 3 that from a development perspective, bilateral aid was often seen as bad (or just plain ugly) during the years of the Cold War. Multilateral aid, on the other hand, had a better reputation in the sense that it went to countries in greatest need, was generally of better quality and was more orientated towards development. Since the end of the Cold War, bilateral aid has recovered some of its reputation and is perceived to have become more developmental. But are these common perceptions in fact correct? The chapter provides a quantitative assessment of whether multilateral aid is more developmental than bilateral aid, and whether bilateral aid has become more developmental, relative to multilateral aid, since 1990. The authors employ a range of indicators of the development orientation of the two types of aid, including the degree of support for low-income countries, the division between grants and loans, the extent of concentration and indices of donor performance with respect to inter-country allocation. They find that, contrary to common wisdom, it is difficult to conclude that multilateral aid is more developmental than

bilateral aid, or that the relative degrees of orientation to development of these broad categories of aid have changed appreciably since the early 1990s.

There are now many ideas on the table of ways to raise additional resources from new ('innovative') sources of development finance. But getting these ideas implemented is in many ways a much tougher process than thinking them up, and our earlier discussion indicated that each measure requires very different levels of political support and co-ordination among countries; some can be introduced by small coalitions of countries (or indeed unilaterally) while others need considerable international unanimity. In Chapter 4, Anthony Clunies-Ross and John Langmore discuss strategies to move forward, in particular the importance of developing-country governments building effective alliances with each other, and with campaigning NGOs and sympathetic research organizations, to press the case for innovative finance. They emphasize that, for such alliances to work, they must be sufficiently institutionalized (preferably with a high-level secretariat) to negotiate forcefully with the rich world regarding development finance, and to forge common ground with groups in the rich world over areas of common global concern. They note a considerable degree of consensus within the European Union and between this and the larger developing-country governments. While the process is subject to frequent stalling, the chapter concludes that measures seen as visionary at the time of the Monterrey summit are now debated in terms of possibilities for their practical implementation. At least some progress has therefore been made.

One factor that is changing the global political landscape is rising international concern over adverse global climate changes (Stern 2006). The need to increase spending on goods with wide social effects that transcend national boundaries has therefore become more urgent since the start of the millennium. Yet there is also a continuing need for aid to fund traditional development projects and programmes, and for this aid to rise to meet the MDGs (Sachs 2005). But how much needs to be allocated to funding 'new' global public goods and how much for 'traditional' ODA? Chapter 5 by Helmut Reisen, Marcelo Soto and Thomas Weithöner organizes its analysis around three classes of public goods based on a taxonomy from the theory of public finance. An international public good (IPG) is a public good that provides benefits that cross the national borders of the producing country; a regional public good (RPG) is an international public good that displays spillover benefits to countries in the neighbourhood of the producing country; and a global public good (GPG) is an international public good that benefits consumers across the world (although not all necessarily to the same extent). Using data from the OECD Creditor Reporting System (CRS) the chapter then attributes ODA to the provision of global public goods, regional public goods and traditional aid over the period 1997–2001, and models donors' interest in the provision of international public goods. The authors find a strong empirical relationship between the provision of international

public goods, and donors' income and budget balances. They also discuss and assess empirically possible crowding-out between international public goods and ODA, concluding that an increase in spending on such goods is unlikely to reduce the flow of aid to the poorest countries.

If traditional forms of development finance are not enough, or it takes time to increase them substantially to meet the MDGs, then other sources of finance must be found; this is the focus of Chapter 6, by Jeremy Heimans. These have emerged as important and increasingly popular new mechanisms for financing development and other global priorities. Multi-actor Global Funds (MGFs), such as GFATM, are distinctive because they are administered and financed by multi-actor coalitions of governments, international organizations, the private sector and civil society. They also operate independently of any single institution and are tied to a particular issue or policy area. The author argues that, while MGFs have become increasingly popular in recent years, little is known about the way they operate, whether they are desirable as instruments for financing major international initiatives, and what implications they might have more broadly for global governance. The chapter assesses the desirability of MGFs as instruments for international financial mobilization, resource allocation, and as a form of experimentation in global governance. Heimans argues that MGFs hold considerable promise as focal points for generating additional public and private resources to address urgent global problems and to finance global public goods. They may be more operationally nimble than traditional mechanisms and capture some of the benefits of collaboration among different actors. However, he concludes that MGFs may also result in a less coherent response to global problems, duplicate existing structures, and may be only weakly accountable democratically.

Although official capital flows such as ODA remain the dominant type of development finance for many low-income countries, private capital flow in all its forms is becoming more important, especially for the fast growers in transition from low-income to middle-income status. Managing the macroeconomic effects of private capital flows is challenging, as we discussed earlier. In Chapter 7, Renu Kohli assesses India's sharp swing in external financing from ODA to private capital following the 1990 crisis and the subsequent economic liberalization. The chapter demonstrates that external resources have increased, and that the greater role of private capital flows has required more macroeconomic discipline to deal with the increased vulnerability of the economy to negative capital account shocks, volatility and other risks associated with private capital flows. Kohli's analysis also reveals that, in India's case, private capital flows are, in contrast to official flows, associated with a real exchange rate appreciation, expansion in the domestic money supply, and stock market growth, liquidity and volatility. Integrated financial markets also expose the economy to correlated risks (with different types of private flows having varying degrees of volatility and predictability)

requiring the development of sound and efficient domestic financial institutions with the capacity to intermediate private flows effectively. The author concludes that this transition points to the importance of developing 'self-protection' policies to mitigate the risks while at the same time extracting the static and dynamic gains that private capital flows can bring (the externalities arising from FDI, for example).

Issues related to the selectivity of foreign aid have attracted a lot of attention from researchers and policy-makers alike (see McGillivray 2003 for a comprehensive discussion). The World Bank study *Assessing Aid* (World Bank 1998) and the work of Burnside and Dollar (2000) and Collier and Dollar (2002) have been very influential in policy circles in recent years, and many donors have adopted the 'country selectivity' approach emanating from this work. Although the World Bank study, and in particular the aid–policies–growth empirics on which it is based, has received its fair share of criticism (see, for example, Guillaumont and Chauvet 2001; Hansen and Tarp 2001; Easterly *et al.* 2004; Antipin and Mavrotas 2006) many donors have none the less embraced the country selectivity argument in their aid policies.

A recent example is the Millennium Challenge Account (MCA) introduced in 2004 by the US administration of President Bush in 2004, and evaluated by Steve Radelet in Chapter 8. The MCA is designed to provide substantial new funding to a select group of low-income countries that, in the administration's view are 'ruling justly, investing in their people, and encouraging economic freedom'. Radelet argues that, while the MCA is a promising new programme, much work needs to be done to turn that promise into reality – and it is quite possible that the programme will never reach its potential. The chapter discusses the potential impact of the Millennium Challenge Corporation (MCC) that runs the MCA on USAID and the relationship between the two aid organizations in the United States. Radelet argues that there exist a number of important issues needing to be clearly addressed in this case and if not resolved carefully through planning and coordination, the difficulties in operating two foreign assistance programmes from two very different parts of the US government could significantly undermine both the MCA and USAID programmes. And this echoes similar concerns expressed by others on the MCC–USAID *modus operandi* with calls to merge the two aid agencies to improve the performance of US development aid.[5] Radelet stresses that the MCA's potential for success depends very much on its willingness to co-operate with recipient governments and other donors in reducing administrative burdens on countries. If the United States stridently insists on using its own unique proposal format and reporting systems, the MCA will set back recent efforts to improve co-ordination. If, however, there is a serious effort to establish rigorous procedural norms that a majority of donors can accept, the MCA will be a step in the right direction of improving donor harmonization and overall aid performance.

The legacy of the concessional lending that supported structural adjustment in the 1980s and the early 1990s was the HIPC debt problem that bedevilled the issue of financing for poor countries in the late 1990s; much energy was wasted denying the scale of the problem, thereby delaying the debt write-down that was inevitable. Tony Addison, in Chapter 9, discusses how the poor-country debt crisis arose as a result of low growth (policy mistakes, but also the big structural constraints of infrastructure and health that still impede Africa's take-off), uncoordinated donor-lending (no single lender would have lent as much as the myriad of uncoordinated donors), and the absence of a market that could mark down official debt's value (thereby recognizing the impossibility of paying it back).

The chapter then assesses the state of play with the HIPC Initiative and MDRI; the HIPCs that have reached their completion points account for 64 per cent of the HIPC Initiative assistance to be delivered by creditors, so substantial progress has been made. The chapter then turns to the development and poverty impact of debt relief, discussing the debt over-hang and fiscal effects. Addison argues that the quality of the fiscal system is crucial; debt relief will not have its expected benefits unless we see an improvement in the ability of public expenditure management to transfer the resources released by debt relief into quality infrastructure and services for the poor, and to mobilize additional resources from equitable (fair) taxation. The chapter also discusses the respective roles of economics versus international politics in driving the amount of debt relief granted: what started out as a process in which economic considerations dominated (albeit that the debt sustainability criteria of HIPC were too constraining) turned very much into a process in which donor governments were pushed along by debt campaigners, culminating in the debt cancellation agreed at Gleneagles. This success notwithstanding, Addison argues that debt relief's development benefits will prove disappointing unless fiscal institutions (which are at the core of state-building itself) improve dramatically. The chapter concludes by emphasizing the importance of getting poor countries connected effectively to the international capital market, where they can share in the growth of global portfolio flows and FDI.

Away from the world of official flows, one of the most noteworthy developments is the accelerating pace of globalization and migration (both legal and illegal) that is boosting remittances. The growth in this financial flow looks firm for the future and likely to continue to outpace ODA (remittances are already much larger). Remittances are generally viewed as having many positive development dimensions: they support both consumption and capital investment (especially in small-scale projects) in receiving countries; the external transfer is not mediated through the potentially problematic fiscal institutions of governments (as in the case of ODA in the form of budget support or debt relief); and they are a less fickle form of capital flow (thereby inducing some stability in the current account). Chapter 10, by

Helen Toxopeus and Robert Lensink, sets out to examine one crucial additional effect, namely that they stimulate financial-sector development and thereby growth. This has been much discussed, but until now there has been little empirical investigation. From their econometric analysis, Toxopeus and Lensink find that financial inclusion is an important effect, and that remittances raise economic growth through this route. They point to the need for better databases on remittances (particularly on flows through informal financial channels) so that we can draw more robust conclusions on their development impact (and in particular their impact on poverty). And they also highlight the need to disaggregate the characteristics of migrants who send remittances to understand better who does not use the formal financial system and why; this is especially important for understanding the remittance behaviour of poorer migrants.

Conclusions

For much of the last thirty years or so – since the post-Second World War boom collapsed under the weight of the 1970s oil shocks – the global economy has not worked well for most poor countries, or for many poor people. China is the big exception, but China is large enough to take on the global economy on its own terms, deploying a combination of external orientation and state-led development (while at the same time enjoying the benefits of an enormous domestic market). This puts it in a different class from small and highly vulnerable economies such as Bolivia, Guinea-Bissau and Papua New Guinea (to name just three examples from the main regions of the developing world). So, despite the rapid and large increase in flows of trade, finance, and technology across the global economy, the very poorest countries have mainly had very low access to the finance necessary for development. Private portfolio flows into equities and bonds have been limited to a narrow range of emerging markets, and FDI is highly concentrated in a narrow range of countries (China, in particular). And while policies have to be 'right', a lack of finance has limited the ability of many countries to invest in diversifying their trade, to access new technologies, and to achieve poverty reduction. This has in turn diminished returns from policy reform.

This picture is starting to change. Global liquidity is ample at present, pushing investors into parts of the world they previously avoided, in their search for yield. High prices for many (but not all) commodities are raising the export earnings of primary producers, in Africa especially, thereby improving their debt sustainability, and this together with debt relief has improved their sovereign credit ratings. A new page has opened in Africa's debt history and, for once, it looks like a positive story – in which the region begins to access the international capital market in ways that could fund development and poverty reduction. After years of stagnation, aid flows have started to rise

again, and were given a political push by the 2002 Monterrey summit and the 2005 Gleneagles G8 meeting. There are now in addition plenty of innovatory ideas around to expand finance. These include the use of Global Funds, the US Millennium Challenge Account, the UK's International Finance Facility, and proposals for global taxation, the expansion of SDRs, and ways to encourage the flow of private finance (both FDI and portfolio flows). The separation between private and official flows is becoming much less marked, especially in initiatives involving the new philanthropy. So there are grounds for optimism.

Yet plenty can still go wrong. Eventually the credit cycle will turn, interest rates will rise, and global liquidity will contract. The risk tolerance of global investors for the bonds and equities of small and poor economies will turn down. Using borrowing to achieve development remains a tough job for many countries; careful choices must be made over the sectors in which to invest to achieve effective diversification away from dependence on only a few primary commodity exports. Fiscal systems must be overhauled so that sovereign borrowing as well as ODA is deployed effectively into public investments with the highest returns for growth and into the areas of human capital formation – primary education, basic health care, safe water and sanitation – that most benefit the poor. None of this can be taken for granted, as it involves building the state itself, with all the necessary institutions. And while there are many bright ideas for innovation in development finance, getting the political will together is another matter; the present US administration is far apart from Europe (and in denial over the human-made nature of climate change, which stymies proposals such as a carbon tax) and collective action by the developing world is far from assured. So while the development finance picture is now brighter than it was just a few years ago, much more effort is needed if this is not to be yet another false dawn.

Notes

1 'Everyone Wants a Solution to Longevity Risk', *Financial Times*, 1 May 2007.
2 'G8 Pledge on Aid to Africa Threatened as Spending Falls', *Financial Times*, 4 April 2007: 1.
3 Nenadi Usman cited in *Financial Times*, 2 March 2007.
4 On aid volatility, see Fielding and Mavrotas (2005).
5 See, for example, Carol Lancaster (2006), who concludes that: 'To make US foreign aid more effective in supporting development in poor countries, the two large aid agencies – USAID and the Millennium Challenge Corporation – should be merged into a new development agency. It is no secret that the MCC – set up by the Bush administration to provide aid to countries deemed 'good performers' – has struggled to get up and running.'

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Key: **bold**=extended discussion; b=box; f=figure; n=endnote/footnote; t=table.

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