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The challenge of financing development in LDCs

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, official development assistance.

Most least developed countries are caught in a low-income economic trap which is undermining their best efforts to improve policy and reduce poverty. On the one hand, there are massive investment needs. Private sector enterprises, mainly in small-scale agriculture and the urban informal sector, are undercapitalized. There is also gross underinvestment in physical infrastructure, human capital formation and health, the maintenance of an efficient civil service and enforcement of law and order. On the other hand, there is very limited scope to meet these multiple development finance requirements through domestic resources because of widespread poverty, with many people living hand to mouth, a weak domestic corporate sector, and limited sources of tax revenue.

External finance is essential to break out of the trap. But aid flows are declining, and even after widespread trade and capital account liberalization – which has often been pursued further than in other developing countries in the 1990s -- most LDCs remain unattractive to private capital inflows. External debt, owed mostly to official creditors, also continued to rise for LDCs as a whole in the 1990s, despite debt relief measures of expanding scope. This is undermining aid effectiveness, as a part of total aid resources are employed to service external debt rather than to promote economic and social development. Private investment and lending from abroad is also deterred by the debt overhang, and the costs of domestic borrowing mean that it is unprofitable for many promising local enterprises to invest in building the capabilities they need to compete in international markets.

Some least developed countries have been able to achieve spurts of economic growth, and evidence shows that when income levels rise in LDCs there is a strong domestic savings effort. But because of very low income per capita in most LDCs and their sluggish or negative per capita growth rates, the potential for creating a virtuous circle between rising domestic savings and investment is not generally being realized. Moreover, the economic size of terms-of-trade shocks and natural disasters is often many times the size of the domestic resources that LDCs can muster internally to cope with such situations. This is a fundamental source of vulnerability of LDC economies which renders growth, when it does occur, fragile.

Some key facts

- In per capita terms, real long-term capital inflows into LDCs fell by 39 per cent between 1990 and 1997 while rising sharply in other developing countries. Capital inflows to most LDCs were less affected by the Asian financial crisis than were flows to other developing countries, but the steady downward trend in long-term capital inflows has continued in the LDCs. In 1998, the least developed countries received less than 4 per cent of long-term capital inflows going to all developing countries, down from a peak of 18 per cent in 1987.
- Underlying the downward trend is falling official financial flows. Official finance constituted about 89 per cent of total long-term capital inflows for LDCs as a whole over the period 1990-1998. In only nine LDCs for which data are available did private inflows constitute more than 20 per cent of total long-term capital inflows over this period. They were: Myanmar, Vanuatu, Angola, Equatorial Guinea, Solomon Islands, Maldives, Cambodia, Lesotho, and Lao People's Democratic Republic.

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- Aid inflows to LDCs, as measured by the share of net official development assistance (ODA) disbursements in donors' GNP, have almost halved in the 1990s. In 1990, the net ODA from OECD Development Assistance Committee (DAC) members to LDCs stood at 0.09 per cent of their combined GNP, while in 1998 it was down to 0.05 per cent. In nominal terms net ODA from DAC countries to LDCs is estimated to have been $12.1 billion in 1998. This was the third successive year of uninterrupted declines, representing a reduction of $4.5 billion since 1995. In real per capita terms, net ODA to LDCs has dropped by 45 per cent in the 1990s.
- In 29 out of 45 LDCs for which data are available, private capital inflows were higher in the late 1990s than in the early 1990s. But 75 per cent of net FDI inflows, which were the leading component of rising private inflows to LDCs, was absorbed by just eight countries during the period 1995-98 (Angola, Bangladesh, Cambodia, Equatorial Guinea, Myanmar, Lao People's Democratic Republic, Uganda, and United Republic of Tanzania). There are only three LDCs in which the increase in private capital inflows has been sufficient to offset declining net official finance.
- For LDCs as a whole, the nominal value of the total debt stock rose from $121.2 billion in 1990 to $150.4 billion in 1998. In 1998, the external debt stock of LDCs was equivalent to 101 per cent of their combined GNP. Total debt service paid by LDCs in the same year was equivalent to $4.4 billion. But even then, 27 of 45 LDCs were unable to acquit themselves of their debt service obligations. Accumulated arrears constituted 30.4 per cent of total debt stocks of LDCs as a whole that year.

Specific issues

The potential for private capital inflows

LDCs have made major policy efforts in the 1990s to attract foreign capital. Within the context of World Bank and IMF economic reform programmes, many governments have undertaken widespread economic liberalization. As restrictions on foreign investment and free enterprise are removed, purely commercial considerations, as well as imperfections in the workings of international capital markets, have become increasingly important as deterrents of private capital inflows.

There are profitable investment and lending opportunities in the LDCs. But private capital inflows from abroad are particularly deterred by risks which are rooted in the vulnerability of LDCs to shocks and also high levels of external debt. The initial costs of asset development, lack of business support services, and the general underfunding of physical, social and administrative infrastructure within LDCs are also important factors negatively weighing on potential foreign investors.

But constraints are not simply at the national level. While business information services and risk-rating agencies have paid increased attention to emerging markets in recent years, coverage of LDCs remains very thin. In the absence of objective documentation of investment opportunities, stereotypes and negative assumptions hold sway, especially in the current atmosphere of global financial uneasiness. The volume and size of many potential business opportunities in LDCs are also often viewed as being too small to interest major global players.

Over the long term it is possible to envisage a transition from aid dependence to a situation in which development is increasingly financed by domestic resources and private capital inflows. But obstacles to investment in the LDCs cannot be removed by private sector activity per se, and not solely by the efforts of overwhelmed LDC governments. The international community must play a role.

> *"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. . . . National and international policy efforts to promote economic growth, poverty reduction and sustainable development in LDCs must start from the reality that not only are the central accumulation and budgetary processes of the LDCs dominated by external rather than domestically generated resources, but also long-term capital inflows are dominated by aid."*
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> *- The Least Developed Countries 2000 Report,* prepared by UNCTAD, Geneva.

The problem of aid effectiveness

A critical issue for both LDCs and their development partners is how to increase aid effectiveness. All agree that national ownership of policies is vital, and this has recently led to sweeping changes in the ways in which aid is provided to poor countries.

Donors are seeking to get away from donor-driven development cooperation modalities of the past in which "off-the-shelf" blueprints were imposed through policy conditionality on government officials who knew they were contextually inappropriate. National strategies should now be developed by the governments themselves through a participatory process with civil society.

Donors are also convinced that aid cannot work unless the right national policies are in place. They have thus resolved to enhance aid effectiveness by increasing the selectivity of aid flows, concentrating resources on those countries which have the right pro-poor development strategies in place.

From the aid recipients' viewpoint, the right national policies are certainly necessary, but changes in donor policies are also vital. Volatility of aid flows and disbursement delays constitute very serious problems for budget management in least developed countries. The lack of coordination among the activities of various aid agencies and the failure to integrate their programmes into domestic economic and managerial structures has undermined the sustainability of aid projects and the development of government capacities. The issue of untying aid to the least developed countries is unresolved, even though it inevitably increases import costs and reduces international competition. Tensions also still remain between national ownership and donor policy conditionality. It is unclear as yet what will happen if national participatory processes recommend national strategies which diverge from those regarded as acceptable by the IMF, World Bank and donor community.

All stakeholders agree that the principle of partnership is fundamental for increased aid effectiveness. But the degree to which the new aid regime will actually deliver genuine partnership remains to be proved.

The HIPC initiative and debt relief

An important initiative from which many LDCs are benefiting is the enhanced Highly Indebted Poor Countries (HIPC) Initiative. Three quarters of the HIPCs (31 of the 41 countries covered) are LDCs, and in 29 of the HIPC-LDCs, the external debt is considered unsustainable even after the application of traditional relief mechanisms.

The initiative is important, as it enables multilateral debt relief. It also provides a shining example of an innovative approach to financing debt relief. But current expectations regarding the benefits of the enhanced HIPC Initiative need to be carefully monitored.

The additional fiscal space which is being opened for LDC-HIPCs through HIPC assistance is not that significant. According to the OECD's Development Cooperation 1999 Report, the average reduction in annual debt service through 2005 under the enhanced HIPC Initiative compared with debt service paid during 1993-1998 for Burkina Faso, Mozambique and Uganda would be equivalent to just 6-8 per cent of net ODA in 1997. The export forecasts which underlie the expectation that the amount of debt relief provided is sufficient to ensure a durable exit from the debt overhang are overoptimistic, particularly in the light of recent commodity price declines. Finally, aid flows to LDC-HIPCs, including those not in conflict, are declining, thus offsetting the benefits of HIPC assistance.

It cannot therefore be assumed that external debt is an issue of the past which has now been effectively dealt with.

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