

# THE ARCHITECTURE OF FINANCIAL FLOWS TO DEVELOPING COUNTRIES

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## 1. Introduction

It is once in a while claimed that provision of Official Development Assistance (ODA) is not important for development, as especially Direct Investment (DI), remittances and trade flows are of a much greater size than ODA. Some extends this argument even further by saying that ODA should be abolished altogether, and only humanitarian aid should be provided when needed.

This paper discusses the financial flows to developing countries including ODA grants and loans, Other Official Flows (OOF), DI, Bonds, Equities and Export credits (BEE), remittances as well as contributions from Philanthropic Foundations (PF). The aim is to make an overall presentation of the relative size of the different flows. However, the paper does not engage into a discussion of the arguments against ODA, as there is a general consensus among practitioners, that aid is a requirement for development, but also that aid is not sufficient. The issue is therefore how aid enters into the architecture of financial flows to developing countries, and how it can complement the other official financial flows.

## 2. The data

This paper draws on data from primarily the Organisation for Economic Co-operation and Development (OECD) but uses other sources where necessary. The data is net flows.

ODA is subdivided into grants and loans, with statistics from OECD's Development Assistance Committee (DAC) as the source.

OOF covers transactions, which are not primarily aimed at development or have a grant element of less than 25 per cent. OOF could for instance be grants to developing countries for essentially commercial purposes, official direct export credits, or military debt relief. The source used is statistics from DAC.

DI covers direct investments made in an economy other than that of the investor with a long-term relationship between the investor and the recipient company. DI covers both initial investments and all subsequent investments - also among affiliated enterprises, both incorporated and unincorporated. The data used are from OECD<sup>1</sup>.

The data for BEE are DAC figures covering both bank and non-bank bonds, equities and export credits.

World Bank data for remittances are used<sup>2</sup>. These have been collected through the balance of payments framework covering worker's remittances, compensation of employees and migrant transfers. Many transactions of remittances are made unofficially through private channels, for instance visits. Gifts and goods are not included. The World Bank estimates that the figures could be 40 to 60 % higher if unofficial remittances were included. Others expect the unofficial remittances to make up more than 70 % of the total remittances<sup>3</sup>. Consequently, the official data on remittances used in this paper should be considered as a rough estimate only.

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<sup>1</sup> OECD, 2006/2008: 'Geographical Distribution of Financial Flows to Developing Countries'

<sup>2</sup> World Bank, 2006: 'Global Economic Prospects 2006'

<sup>3</sup> Peter Hansen and Trine Rask Thygesen, 2007: 'Remitter – Finansiering af udvikling in Afrika?', DIIS

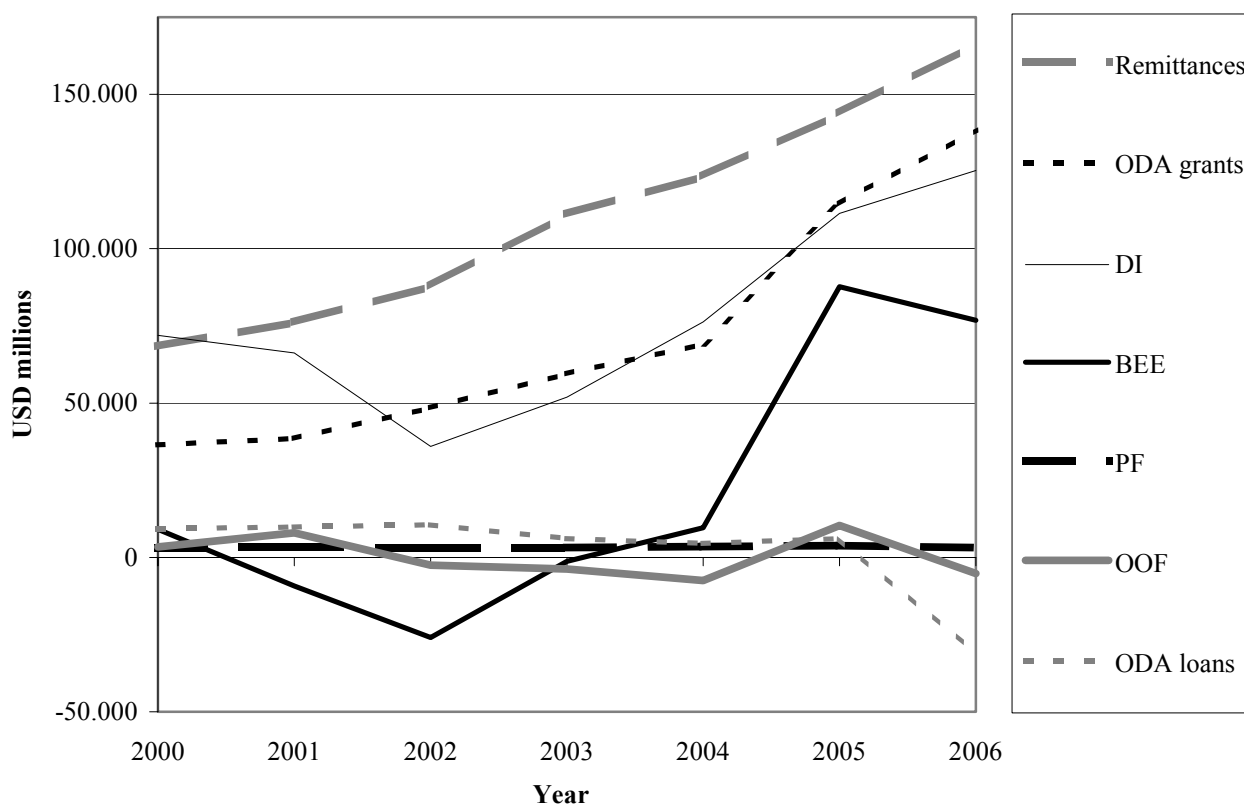
World-wide data on PFs' contributions to development does not exist, but the World Bank estimates that the amount is around USD 4 – 4.5 billion annually. This paper uses data from the World Bank<sup>4</sup>, and it covers U.S. foundations only, i.e. data on the size of contributions from PF is therefore likely to be underestimated. It should be noted that only a smaller proportion – about 10% - of the total granted amounts are for activities outside the country in which the foundations are based. The figures used in this paper only include estimated donations to developing countries. There are no data on the regional distribution of the contributions from PF.

Depending on the source, different figures for financial flows are provided, especially for DI. The following presentation of financial flows should be read with the above data uncertainties in mind.

### 3. Financial flows to all developing countries

The figure below compares the different types of financial flows to all developing countries.

**Figure 1. Financial Flows to All Developing Countries, 2000 – 2006**



The largest single flow of finance to all developing countries has since mid-2000 been remittances.

DI was the second largest flow until 2002. Since then ODA grants and DI have been at the same size. ODA grants grew with almost USD 70 billion from 2004 to 2006. This could be explained by the fact that ODA in 2005 and 2006 covered large amounts of debt relief to Nigeria and Iraq, reported to DAC as aid<sup>5</sup>.

The other types of financial inflows (OOF, ODA loans, BEE as well as PF) have in the years been significantly lower, except for BEE, which were important inflows in 2005 and 2006. Before 2004 the BEE flow was an outflow, i.e. a drain on financial resources available for development in the

<sup>4</sup> World Bank, 2006: 'Philanthropic Foundations – Actual Versus Potential Role in International Development Assistance'

<sup>5</sup> Total ODA from DAC countries dropped from 2006 to 2007 by 8,4 % (OECD, 4 April, 2008: 'Net Official Development Assistance 2007')

countries. Latin America/Caribbean account for half of the total growth of BEE from 2004 to 2005, while the BEE inflow to Asia/Pacific and Europe/Central Asia make up respectively 27 and 20 % of the total growth of BEE.

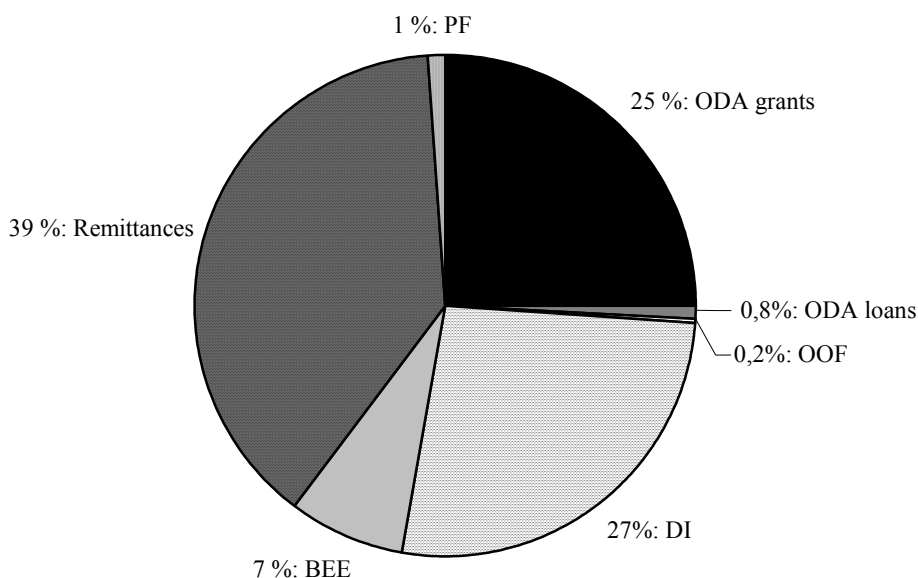
ODA loans constituted only a relatively small net inflow until 2006, in which year it turned to a negative amount of USD 30 billion, i.e. repayments and interests on old loans were higher than new loans provided. Sub Saharan Africa is the region that has the largest ODA loan outflow.

PFs' contributions to developing countries have during the period stayed around USD 3,5 billion annually and is relative low by comparison to the other financial flows. In relative terms OOF inflow is not significant either, on average around USD 6 billion annually, alternating between positive and negative figures.

Trade figures (export and import) have not been included in the above comparisons. Considering the relative size of the above financial flows to e.g. export from all developing countries - USD 2 trillion in 2000 gradually increasing to about USD 4.4 trillion in 2006<sup>6</sup> – there is no doubt that trade matters and that an improved trade regime which can increase the net export from developing countries can make a significant positive change for these countries taken as a joint group. The total of all financial flows to developing countries shown in figure 1 increased from USD 202 billion in 2000 to USD 474 billion in 2006, i.e. these flows were just below 10 % of the size of developing countries' export.

The next figure summarises the relative size of the different financial flows to all developing countries, taken as average of each of the years 2000 to 2006.

**Figure 2. Average Distribution of Financial Inflows to Developing Countries (2000-2006)**



<sup>6</sup> UN, 2007: 'UN Handbook of Statistics 2006-2007'

Remittances make up almost 2/5 of total financial flows to developing countries. It should be noted that China, the Philippines and India constitute 37 % of the total flow of remittances to developing countries.

While both ODA grants and DI cover around ¼, ODA net loans only come to less than 1 %. Thus the total ODA (grants plus loans) is at the relative size as DI. On average BEE has been 7 %, having increased from 4,5 % in 2000 to 16 % in 2006. PFs total only 1 % of the financial flows to developing countries. OOF amount to just 0,2 %.

#### 4. Regional distribution of financial flows

The following table presents the regional distribution of the different financial flows based on the average figures of the period 2000 to 2006.

**Table 1. Distribution (%) of ODA, DI, Remittances and Other Flows to each region**

REGION	ODA GRANT AND LOAN (%)	DI (%)	REMITTANCES (%)	BEE AND OOF (%)	TOTAL FLOW (USD MILLION S)	TOTAL FLOW PER CAPITA (USD)
Latin America and Caribbean	7.6	43.3	43.3	5.8	78,691	147
Asia and the Pacific	24.8	24.8	47.7	2.7	103,361	29
Northern Africa and Middle East	32.4	14.2	40.1	13.3	34,283	113
Europe and Central Asia	14.5	20.2	34.6	30.7	27,854	284
Sub Saharan Africa	66.6	19.1	12	2.3	35,762	50

Remittances are important financial flows in all regions, except Sub Saharan Africa where it only come to less than 1/8 of the total inflows. In Sub Saharan Africa ODA grants and loans is the distinctly primary flow. DI only makes up less than 1/5 of the total flows to Sub Saharan Africa.

In Latin America/Caribbean on the contrary, DI is one of the two equal main flows. Together with the flow of remittances, DI total 86,6% of all the flows to the region. ODA only plays a marginal role making up just 7,6 %.

Remittances amount to almost half of all the financial inflows in Asia/Pacific. DI and ODA make up ¼ each.

Europe/Central Asia is the region where the flow of BEE/OOF is most significant amounting to over 30 % of the total flows.

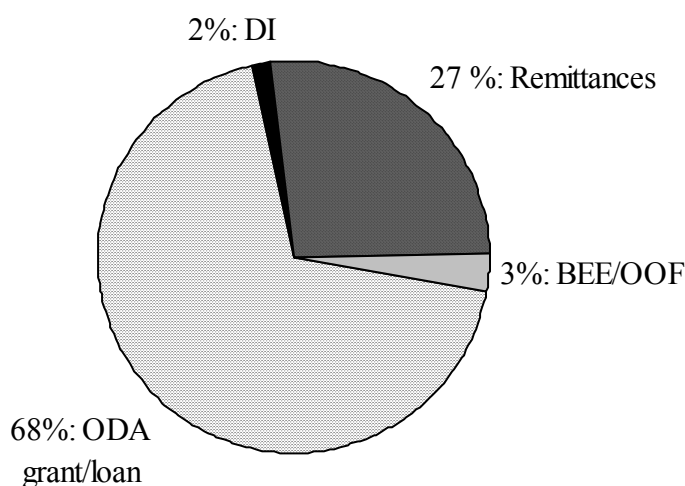
The largest portion of the financial flows is to Asia and Latin America. However, on a per capita basis, Europe and Latin America receives the highest and Asia the lowest financial inflows.

It should be emphasised that polarisation is widespread in the developing world<sup>7</sup>. The average amounts of financial inflows per capita therefore cover large differences among countries. The figures are however helpful for the purpose of indicating the distribution of the financial flows among regions.

## 5. Distribution of financial flows to the Least Developed Countries

The following considers financial flows to the Least Developed Countries (LDC), among which are both Sub Saharan Africa countries as well as a number of countries in Asia/Pacific. A country is classified as a LDC if it meets three criteria based on low-income<sup>8</sup>, human resource weakness<sup>9</sup> and economic vulnerability<sup>10</sup>.

**Figure 4: Average Distribution of Financial Inflows to Least Developed Countries (2000-2006)**



ODA is the most significant flow to LDCs making up above 2/3 of the total flows - the same proportion as in Sub Saharan Africa. The relative sizes of BEE/OOF are the same in LDCs and Sub Saharan Africa (2-3 %).

The distribution of the financial flows between LDCs and Sub Saharan Africa differ, when it comes to remittances and DI. The total of remittances and DI amounts to about 30 % in both Sub Saharan Africa and LDC. However, while DI accounts for 19 % in Sub Saharan Africa, it only amount to 2% in LDCs. To the contrary, the flow of remittances make up 27 % in LDCs, which is more than the double of the relative proportion of remittances in Sub Saharan Africa (12 %). The remittance flow to LDCs (27 %) is lower than the proportion (39 %) for all developing countries.

<sup>7</sup> UNESCO, 2008: 'Education For All Global Monitoring Report'

<sup>8</sup> The criteria of low-income is based on three-year average Gross National Income per capita of less than USD 750 (UN)

<sup>9</sup> The criteria of human resource weakness is based on nutrition, health, education and adult literacy (UN)

<sup>10</sup> The criteria of economic vulnerability is based on among others instability of agricultural production and exports of goods and services, merchandise export concentration and the percentage of population displaced (UN)

Sub Saharan Africa is the most represented region on the list of LDCs, but the major recipients of DI in Sub Saharan Africa are not LDCs: South Africa, Nigeria and Kenya together account for almost 75 % of the region's DI with South Africa alone getting more than 60 % of the DI. Thus, 75 % of Sub Saharan Africa's DI goes to a few countries, which explain the high inflow of DI into Sub Saharan Africa compared to the LDCs.

Flows as DI seem to decrease in times of conflict or crisis, while remittances increase when they are most needed<sup>11</sup>. This could explain the high proportion of remittances for LDCs as some of those are conflict and post conflict countries. The low share of DI is also a reflection of this, as investments in conflict or post-conflict countries are much more risky. LDCs are by the definition of the category countries that are economically vulnerable and low on human resources, which make them adverse for investments.

## **6. Conclusion and perspectives**

Although ODA seems as a relatively small inflow compared to remittances and furthermore equals DI on a global scale, ODA does account for a great part of the financial flows when it comes to Sub Saharan Africa and the LDCs. In other words, ODA matters as a source for development in many countries.

Remittances are important in all regions, although to a lesser extent in Sub Saharan Africa. Most studies show that remittances can play a role in poverty reduction. However, in many instances, remittances are mainly used for consumption and not for direct productive investments. Despite that, some regional African studies show that households, which receive remittances, have a higher living standard and a higher level of education. Other studies from Africa do however question this by suggesting that households that receive remittances are not better off than those households who do not receive remittances. In conflict and post-conflict countries, remittances could be used for non-developing purposes, including financing the conflict. Remittances are often sent from migrant workers, and as it takes some income to be able to go abroad, there are indications that better-off families have greater access to remittances.<sup>12</sup> Considering these analyses, a relevant question is in what way ODA could work on giving the existing high flow of remittances a greater development impact.

DI does not flow to Sub Saharan Africa and especially not to LDCs, but to middle income countries. It is believed by many that DI contribute to development while some point out that for investments to have a development impact it requires e.g. use of local sub suppliers and local labour<sup>13</sup>. If this is true it will point towards using ODA to a higher degree to activities that can help countries attract more DI – and along side of this, activities that strengthen the development impacts of DI and an equal distribution of the benefits.

ODA matters as a source for development in many countries – especially in Sub Saharan Africa and LDCs. Remittances and DI are significant flows, but cannot substitute for ODA.

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<sup>11</sup> Peter Hansen and Trine Rask Thygesen, 2007: 'Remitter – Finansiering af udvikling in Afrika?', DIIS

<sup>12</sup> Peter Hansen and Trine Rask Thygesen, 2007: 'Remitter – Finansiering af udvikling in Afrika?', DIIS

<sup>13</sup> Peter Kragelund, 2007: 'Udenlandske investeringer og udvikling i Afrika', DIIS