

Private Finance

Are Private Loans and Charitable Giving Replacing Aid?

Private financial flows to developing countries, such as debt, equity, remittances, and private charitable giving, have increased dramatically over the past 20 years. One commentator has even trumpeted “the privatization of foreign aid.” Since private charitable giving remains small and developing country governments are borrowing more, not less, from official sources, this claim is misleading. But unprecedented sums are indeed flowing to the private sector in developing countries.

Private financial flows are having a huge development impact in the countries receiving them, and the momentum seems to be picking up. Gross unofficial flows—foreign direct investment, migrant workers’ remittances, portfolio equity flows, grants from nongovernmental organizations (NGOs), and loans without a sovereign guarantee—increased sixfold between 1970 and 1985, and nearly tenfold between 1985 and 2002, to exceed US\$380 billion (figure 1). Official flows—loans, grants, export credits, and publicly guaranteed debt—were less than half this level in 2002, at less than US\$180 billion. As recently as 1985 official flows had been three times as large as private flows.

Net flows give an alternative picture, because large repayments or profit repatriations can make gross flows huge even while net flows are small or negative. Net flows to the private sector in developing countries display clear patterns.

Net debt and portfolio equity flows are trivial compared with foreign direct investment and gross remittances; private flows go mostly to middle-income countries (figure 2).

Foreign direct investment flows go largely to lower-middle-income countries—notably China, with 30 percent of the developing world’s population and 39 percent of these flows. Remittances, though smaller, have already outpaced official development assistance and would exceed foreign direct investment flows if the data excluded China. (For a skeptical discussion of the data, see OECD n.d.) And while direct investment flows to developing countries are roughly proportional to the size of their economies—with lower-middle-income countries overrepresented—remittances to low-income countries are large relative to their economies (figure 3).

Remittances also are important because they go directly to households, often for

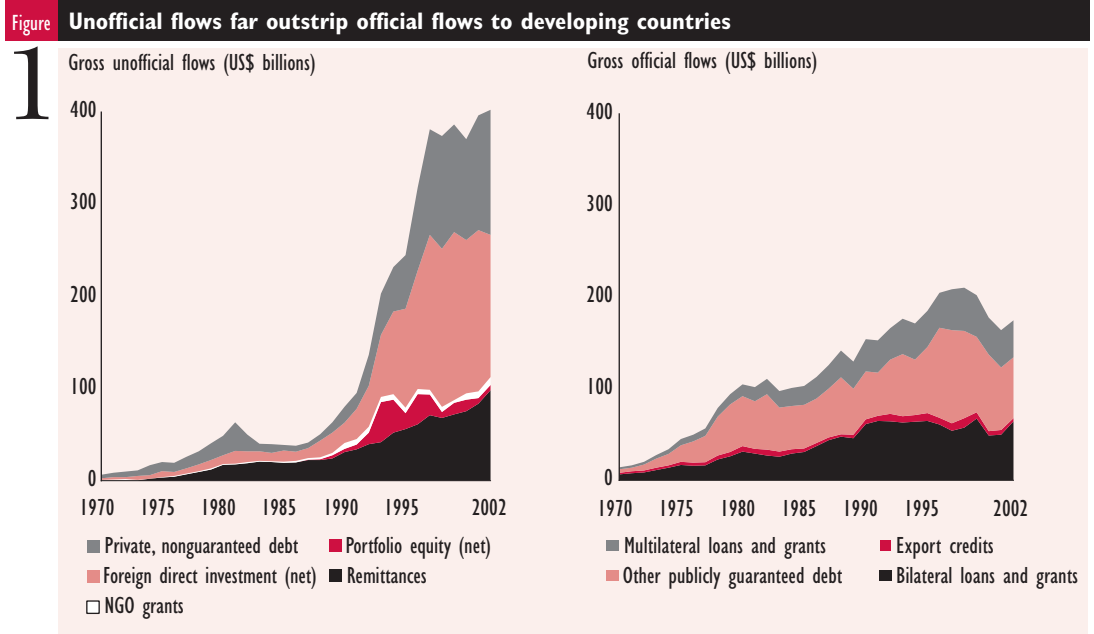
Tim Harford, Bitá Hadjimichael, and Michael Klein

Tim Harford (tharford@ifc.org) is an economist, and Bitá Hadjimichael (bhadjimichael@worldbank.org) a senior economist, at the World Bank and International Finance Corporation (IFC). Michael Klein (mklein@worldbank.org) is chief economist at IFC and joint World Bank–IFC vice president, private sector development.

This Note is part of a series exploring trends in the aid industry, including patterns of aid flows, competition, and the effectiveness of different types of aid.



2



Source: World Bank, Global Development Finance database; Organisation for Economic Co-operation and Development (OECD), Development Assistance Committee.

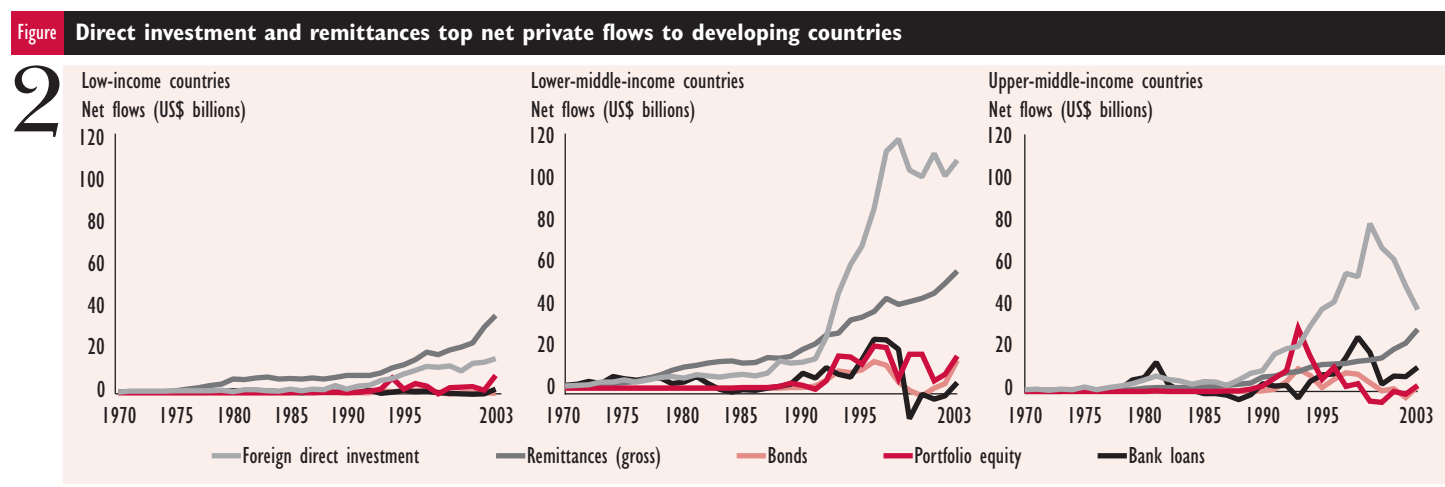
spending on essentials or investing in a new house or business. The total flow is much more stable than foreign aid or foreign investment (Ratha 2003), because the income and number of migrant workers change slowly. Even recent money laundering laws have not dampened remittances, as many feared they would.

Other private cross-border giving—from foundations, corporations, religious groups, and membership-based NGOs—is apparently substantial, yet far smaller than remittances and other sources of development finance. While

this private charitable giving is poorly measured (box 1), figures on donations from the largest foundations (OECD 2003) suggest that annual private giving from rich countries is probably more than US\$10 billion and less than US\$25 billion. Compare these numbers with around US\$70 billion of official development assistance and US\$98 billion of remittances in 2002.

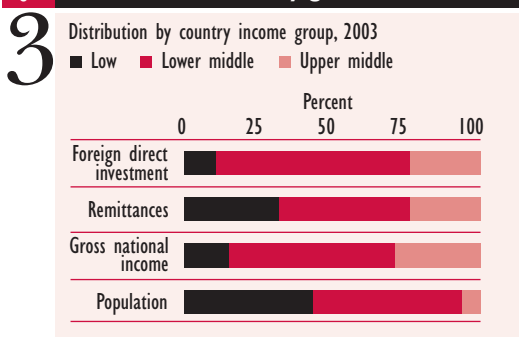
Changing patterns of commercial finance

What trends have emerged in investment flows—bonds, bank loans, and foreign direct



Source: World Bank, Global Development Finance database.

Figure Where does the money go?



Source: World Bank, Global Development Finance database.

investment? One way of interpreting the pattern of these resource flows to developing countries is as a shift from debt to equity finance (figure 4). This shift occurred in two stages: In the early 1980s net flows of debt collapsed because outflows rose sharply and (perhaps as a result) gross inflows fell. Then throughout the 1990s equity flows grew very quickly, mostly in the form of foreign direct investment.

Although net flows of private debt today are tiny compared with net foreign direct investment, gross flows of private debt remain quite large: US\$247 billion in 2003, compared with net foreign direct investment of US\$152 billion.

These gross disbursements of debt have undergone big shifts in composition over the past two decades. In the mid-1980s most debt flows from banks and bond markets to developing countries were publicly guaranteed. Now governments prefer to borrow from multilateral agencies (see Note 289 in this series). Meanwhile, commercial banks have found no shortage of customers in the private sector (figure 5).

What explains trends in private finance?

So the major developments in private for-profit finance are a shift from debt to equity and a shift away from private debt with a sovereign guarantee. What might explain these trends?

As Note 289 in this series argues, the shift in sovereign borrowing from private sources to multilaterals seems to reflect responsible debt management: developing countries are seeking longer maturities and paying off debt. This implies that the decline in private, publicly guaranteed debt is a demand-side phenomenon. Private banks and bond markets could supply

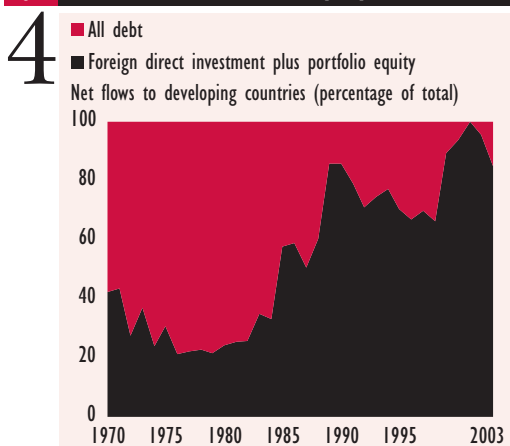
Box How well is private charitable giving measured?

1 Data on private charitable giving reported to the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD) are patchy. For example, France, reported by DAC to be the fifth largest source of private giving in 1992, reports no data from 1996 on. Ireland's NGOs are implausibly reported to have given US\$56 million, US\$0, US\$5.7 million, and US\$90 million in a series of four years in the late 1990s.

Private giving also is vulnerable to double counting (Radelet 2005). NGOs receive funding from foundations and corporations and often substantial funding from governments too—all of which might be counted once when transferred to an NGO and again when disbursed by the NGO.

Recent estimates of U.S. private giving show big disparities. Adelman (2003) puts U.S. private giving at US\$17 billion annually, arguing that the OECD figure of around US\$6 billion underestimates the amount because most private donations are not reported. While Adelman has been criticized for lack of documentation, her estimate seems likely to be more accurate than the OECD figure.

Figure The shift from debt to equity



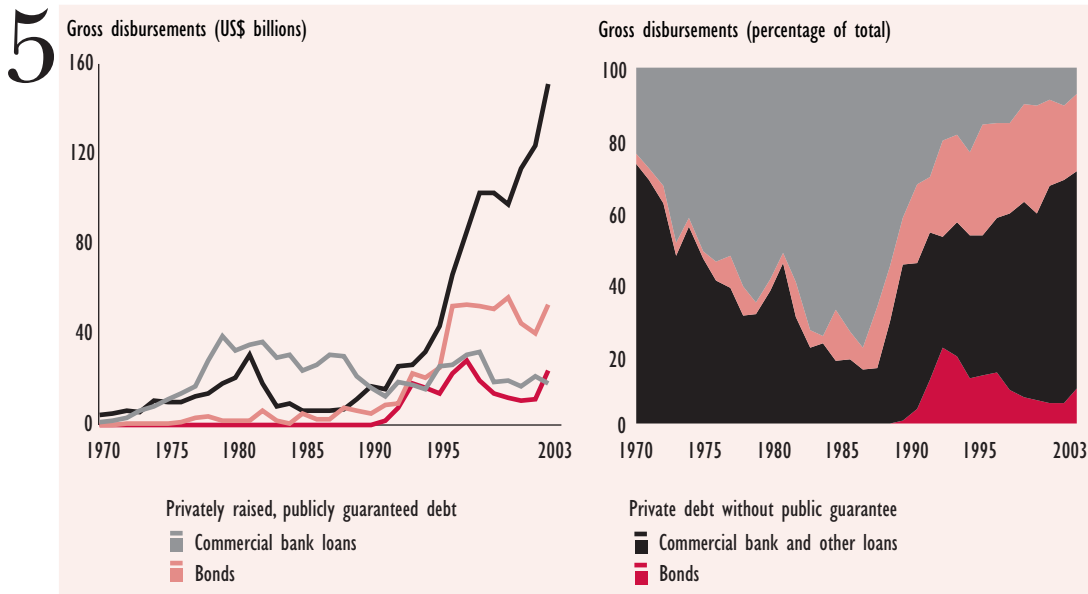
Source: World Bank, Global Development Finance database.

debt with long maturities but presumably feel it is too risky to do so, especially at interest rates that could compete with those of official sources.

Yet the demand for nonguaranteed private debt remains strong. The most likely explanation is the growing importance of the private sector in developing countries after the privatization and deregulation of the 1980s and 1990s.

Still, equity finance, usually in the form of foreign direct investment, is much more popular than private debt finance. One important reason is that equity finance shares risks in a way more likely to align the incentives of investor and recipient. Equity finance gives investors an upside risk and so encourages them to transfer technology and expertise. Direct investment also is less foot-loose than portfolio capital or short-term debt and thus attractive to recipient countries.

Figure The rise of nonsovereign debt



Source: World Bank, Global Development Finance database.

Moreover, the risk of expropriation for foreign direct investment is arguably lower than the risk of repudiation for long-term debt. This calculation depends on the investment climate and must be set against currency risk, which affects foreign direct investment but not dollar-denominated debt. This tradeoff has presumably swung in the direction of direct investment as typical (median) inflation rates have fallen in developing countries. As long as the investment climate in developing countries continues to improve, large flows of direct investment can be expected to persist.

Conclusion

Private finance is now the biggest show in town. But to speak of a privatization of foreign aid, as a provocative *Foreign Affairs* article (Adelman 2003) recently did, is going too far: developing country governments continue to borrow most of their debt from official sources, and private charitable giving is substantially smaller than official development assistance. But money from overseas is reaching the private sector in far greater amounts than a couple of decades ago, a large share of it remittances from migrant workers. Also very large are investment flows, which increasingly take the form of equity finance rather than debt

finance, probably because direct investment has more attractive risk-sharing properties. And while much of this investment is bypassing the poorest countries, remittances are flowing in large quantities even there.

References

Adelman, Carol. 2003. "The Privatization of Foreign Aid." *Foreign Affairs* 82 (6): 9–14.

OECD (Organisation for Economic Co-operation and Development). 2003. "Philanthropic Foundations and Development Cooperation." *DAC Journal* 2003 4(3).

———. n.d. "Remittances as Development Finance." <http://www.oecd.org/dataoecd/62/17/34306846.pdf>.

Radelet, Steve. 2005. Comments in debate, U.S. Aid: Generous or Stingy? Center for Global Development, Washington, D.C., January 13. (Transcript at http://www.cgdev.org/docs/0113aid_debatetranscript.pdf.)

Ratha, Dilip. 2003. "Workers' Remittances." In World Bank, *Global Development Finance 2003: Striving for Stability in Development Finance*. Washington, D.C.

viewpoint

is an open forum to encourage dissemination of public policy innovations for private sector-led and market-based solutions for development. The views published are those of the authors and should not be attributed to the World Bank or any other affiliated organizations. Nor do any of the conclusions represent official policy of the World Bank or of its Executive Directors or the countries they represent.

To order additional copies contact Suzanne Smith, managing editor, Room F 4K-206, The World Bank, 1818 H Street, NW, Washington, DC 20433.

Telephone: 001 202 458 7281
 Fax: 001 202 522 3480
 Email: ssmith7@worldbank.org

Produced by Grammarians, Inc.

Printed on recycled paper