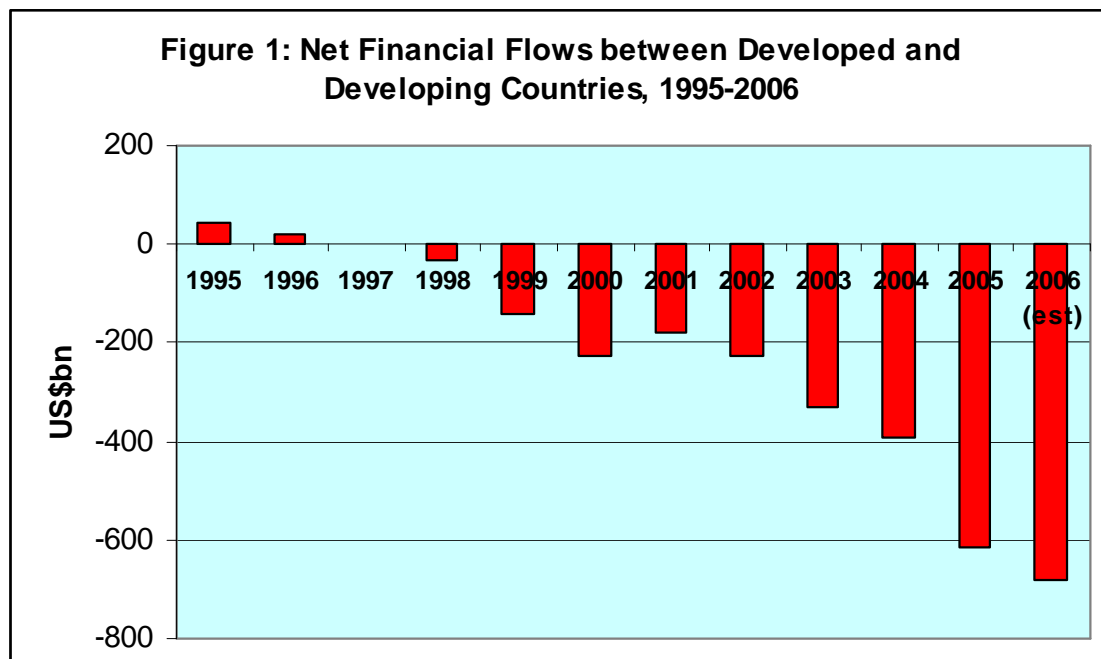


## Water flowing uphill – why South-North financial flows defy conventional economic logic

International capital flows are generally seen as increasing economic efficiency by allowing capital flow (broadly) from developed countries, where capital is relatively plentiful and therefore has a lower rate of return, to developing countries, where capital is scarcer and therefore more expensive. Developing countries, taken as a whole, are indeed receiving more capital inflows from developed countries (in aid, borrowing, foreign investment, cross-border bank deposits, etc) than they send to developed countries. However, this net capital inflow is more than outweighed by the costs of servicing the stock of foreign liabilities – primarily interest payments and profit remittances. Thus, while there is a small net *capital* flow from developed to developing countries, there is a much larger net *financial* transfer (including interest and profit payments) in the opposite direction.

The net financial transfer between developing<sup>1</sup> and developed countries has shifted from a balance of \$46bn in favour of developing countries in 1995 to an estimated outflow of \$683bn (in the order of 5% of their gross national income) in 2006, becoming substantially more negative in every year during this period. (See Figure 1.)



Source: UN DESA (2007) *World Economic Situation and Prospects, 2007*. New York: United Nations Department of Economic and Social Affairs.

<http://www.un.org/esa/policy/wess/wesp2007files/wesp2007.pdf>

<sup>1</sup> Including “transition” economies.

It is important to note that the aggregation of financial flows to and from developing countries as a whole is potentially misleading. In this context, developing countries can be broadly divided into three categories.

- Most *low-income* countries have enjoyed inward transfers for much of this period, primarily as a result of aid flows.
- Many *middle-income countries*, typified by Latin America, experience net outward resource transfers primarily as a result of interest payments and profit remittances on their liabilities.
- Some “*emerging market*” *economies* (most notably China) experience outflows largely through the accumulation of foreign assets – particularly the accumulation of foreign exchange reserves.

For countries in the first two categories, the perverse financial flows arise because North-South capital flows create an ever-increasing stock of liabilities in the South, which in turn give rise to an ever-increasing flow of service (interest and profit) payments. As liabilities accumulate over time, the latter increasingly outweigh the former. In effect, *current* North-South flows are off-set by the legacy of *past* flows.

This can be resolved in one of three ways:

- increasing inflows above the level of outflows through the provision of sufficient non-liability creating capital flows (ie aid grants);
- reducing outflows below the level of inflows through the cancellation of existing liabilities (eg through debt cancellation); or
- reducing the rate of return on cross-border liabilities sufficiently to have a similar effect.

However, the scope for the last option is limited, as rates of return on (most) liabilities are determined primarily by market forces. Increasing liability-creating inflows can also provide a temporary solution, but the associated increase in the cost of servicing liabilities will off-set this in the longer term.

Debt cancellation under the Heavily Indebted Poor Countries (HIPC) Initiative and increases in aid budgets (although in 2005 it remained less than half the target of 0.7% of donors’ gross national income set in 1970) have helped to keep net financial flows positive for some low-income countries, including the countries eligible for the HIPC Initiative (taken as a whole), although many still have a burden of liabilities (primarily debt) above the sustainable level. Among other low-income countries, the net flow has become progressively smaller since the late 1990s, and is estimated to have turned negative in 2006 both for Sub-Saharan Africa (even excluding South Africa and Nigeria) and for least developed countries. For Latin America, the net flow turned negative in 2002, and the net outflow has increased continuously since, to an estimated \$123m in 2006.

The accumulation of reserves by some “emerging market” economies is, in some senses, particularly perverse, in that they entail the purchase by developing countries’ central banks of debts issued by developed country governments (eg US Treasury Bills). That is, they mean poorer countries lending to richer countries, although the former are, in principle, more capital scarce than the latter. Since the accumulation of such reserves is financed by domestic borrowing, typically at higher interest rates, this also gives rise to a substantial net cost to the public finances in these countries.

The accumulation of reserves by emerging markets is partly a reflection of the problems in the response to the financial crises in East Asia and other developing regions in the late 1990s, which has led those “emerging market” governments able to do so seeking to avoid the need to rely on official “rescue” packages in the future. Another important factor is the large balance of payments and fiscal deficits of the US. The rate of accumulation of official reserves by developing countries as a whole has increased from \$92bn pa on average in 1995-7 to \$487.5bn in 2005, and is projected to rise further to \$593bn in 2007 (UN DESA, 2007).

The counterpart of the accumulation of official reserves (and other foreign assets) by emerging market economies is a rapid increase in liabilities in the US, which has become increasingly dependent on continued financing from this source. The potential for these liabilities to become unsustainable, or for a loss of market confidence in US assets, necessitating a rapid adjustment of US macroeconomic imbalances and a major devaluation of the dollar, represents a potentially serious risk to the stability of the global economy.