

Review session on chapter II of the Monterrey Consensus:

Mobilization of International Resources for Development: Foreign Direct Investment and Other Private Flows

Note by the Division on Globalization and Development Strategies regarding "Other private flows":

The issue of the mobilization of international financial resources for development appears in a different light today than it did in 2002. Since the Monterrey Consensus was formulated, many developing countries, including the poorest, have benefitted from a very favourable global economic environment, enabling them to achieve record levels of exports and relatively high rates of economic growth.

Conventional theory would predict that capital flows from rich to poor countries because of an assumed higher marginal return on investment in the latter. There has indeed been a rapid expansion of gross private capital flows to developing countries in recent years, but total net flows have been in the opposite direction, as many developing countries have recorded large current account surpluses (and some industrial countries accumulating large deficits). Developing countries as a group have thus been able to generate adequate resources for development. However, most of the current-account surpluses and accumulated reserves are concentrated in East Asia and the Middle East and other major oil exporters. Despite favourable commodity prices the situation in most low-income countries and HIPCs has evolved less favourably, and these countries continue to depend on capital inflows.

It is important to repeat that capital flows do not only have a financial aspect, but also a macroeconomic aspect, which is at least as important for their impact on growth and development. It is well known by now that growth in developing countries is not a direct function of capital inflows, and that, private flows are not a reliable source of financing for development, because private flows other than FDI are highly volatile. Developing countries that temporarily received more capital inflows than others often grew more slowly and faced higher volatility than countries that received less capital inflows.

Therefore, not all private capital flows to developing countries are desirable. This is particularly the case for flows that are unrelated to the financing of trade and real investment. They raise the degree of instability in the financial sector of the countries that receive these inflows, since they are mostly motivated by short-term arbitrage profits, making their size and direction dependent on market sentiment in international financial markets and decisions on monetary policy in other countries. Even more

important, such flows tend to lead to an overvaluation of the exchange rate with negative implications for the competitiveness of domestic producers, which has the double effect of reducing net exports and thereby making the debt repayment more difficult even if the amount of foreign debt expressed in domestic currency shrinks.