KFW-DEVELOPMENT RESEARCH

Development in Brief

One Pager

No. 28, 06 August 2015

Net capital flows from developing to industrialised countries: is the world upside down?

Author: Simone Sieler
Editor: Clara-Luisa Weichelt

Discussions in the course of the UN's Third International Conference on Financing for Development in Addis Ababa (July 2015) focused again on the fact that ultimately, looking at all public and private international cash flows, more money probably flows from emerging and developing countries to industrialised countries than vice versa. Even if the statistical basis of such statements is often weak due to rough estimates of illicit financial flows and the risk of double counting, the findings of experts are hardly ever disputed.

Overall picture distorted by emerging countries: poor countries are net beneficiaries!

Upon close analysis, however, it is clear that this result is heavily influenced by high net cash outflows from emerging countries (upper middle-income countries). Poorer countries (lower middle-income countries and low-income countries) display a de facto net cash inflow balance, but this is covered by the high negative balance of the emerging countries in the overall analysis.

The high negative balance of emerging countries is primarily derived from commercial capital flows (including illegal financial transfers) and can partly be explained by a simple balance of payments mechanism: the high current account surpluses (high exports from China, oil exporters) are offset by correspondingly high debts to foreign countries, which are reflected in the balance of payments as growth in foreign exchange reserves or capital exports.

Capital inflows: mainly private and commercial

Capital inflows are often at the heart of discussions regarding development policy. These primarily consist of foreign direct and portfolio investment, net borrowing abroad, remittances as well public and private development aid. Commercial inflows are focused strongly on the group of emerging countries, whilst development aid primarily goes to low-income and lower middle-income countries.

Capital outflows: high losses due to illicit outflows and income from development investments

Cash outflows consist of direct and portfolio investments in net donor countries, profit transfers of foreign investors, the build-up of foreign exchange reserves and interest payments on received loans. In addition, there are illegal financial transfers estimated by experts (e.g. the Global Financial Integrity Institute in Washington) to be roughly 4% of the gross domestic product of developing countries, and could therefore represent the biggest outflow items.

Illicit financial transfers are outflows of capital not recorded in statistics that are illegally earned, transferred or used (often from drugs and weapons trafficking, tax evasion and avoidance, corruption and fraud). These activities are harmful in terms of development and should be pursued and prevented emphatically with close international cooperation. However, the extent to which successfully combating the issue would increase local availability of resources remains an open question (various contrary effects).

The profit transfers of foreign investors must be differentiated in terms of their developmental effect: the amount of profit transfers of foreign investors alone provides no information on use of the underlying investment in terms of development policy. Provided that fundamental environmental, labour and social standards are respected, foreign investments are usually very pro-development because they create local employment and income, promote the transfer of technology and expertise and increase local tax revenue. Although the effect in terms of development policy could still be increased if the profits were also invested in the developing country, investors expect a transferable profit in the long term, otherwise they would not invest (and the aforementioned developmental effects would thus not be reaped). The same is true for the outflow items "interest payments on loans", provided that the loans were used for productive purposes.

Another important outflow item is the build up of foreign exchange reserves. A reasonable amount of foreign exchange reserves indicates creditworthiness and economic stability to foreign investors, and therefore promotes economic growth. However, foreign exchange reserves that are too high can distort the market and therefore inhibit development (e.g. if they lead to an extremely artificial undervaluation of the local currency, which actually promotes uncompetitive export industries at the expense of increased prices for importers).

Conclusion: capital outflows are not a developmental problem per se

A sweeping interpretation of cash inflows in developing countries as "gain", and cash outflows as "losses", is misleading. It always depends on what is behind the flows: illicit financial transfers are a serious crime and must be tackled consistently, whilst profit transfers of foreign investors and interest on received loans can be positive indications of successful domestic economic growth.

To mobilise as much capital as possible for development financing, reliable and attractive framework conditions (including decent environmental, labour and social standards) are the method of choice for national and international investors, rather than controls on capital movements. ■