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Kiel Working Paper No. 981

How to Finance Economic Development in the New Millennium:

German Capital Exports to Asia and the Debate on the Effectiveness of Official Development Financing

by

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May 2000

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Abstract

Germany's role in financing economic development in Asia on a sustainable basis leaves much to be desired. Direct investors are still underrepresented in the region. Commercial banks have fueled speculative bubbles. Official development financing does not appear to be based on efficiency-related criteria. As concerns development financing in the new millennium, the challenge for relatively advanced emerging market economies is mainly to restructure private capital inflows in order to soften boom and bust cycles. Official development financing needs major reforms in order to promote economic growth, alleviate poverty and support good governance in low-income developing countries.

Keywords: official development assistance, private capital flows
JEL classification: F30, F35

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I. INTRODUCTION

Asian economies, and other developing and newly industrializing countries (DCs), too, are facing a major dilemma when it comes to external financing of economic development in the future. On the one hand, the share of official development finance in total net resource inflows dropped drastically in the 1990s. In all DCs, official development finance accounted for 56 percent of net long-term resource inflows in 1990. This share was down to 17 percent in 1998 (World Bank 1999: 14). On the other hand, the corresponding increase in private external financing is under suspicion to have contributed to recent financial crises and the subsequent economic downturn. This may be why several international organizations, including the United Nations, OECD and the Association of Development Financing Institutions in Asia and the Pacific (ADFIAP) feel compelled to evaluate the prospects of development financing in the 21th century.[1]

By drawing on evidence with regard to Germany's role in financing economic development in Asia, this paper offers both, bad and good news related to future development financing. Major propositions are as follows:

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1 In 2001, the United Nations General Assembly will convene high-level consultations on the issue of development financing. The Development Assistance Committee and the Development Centre of the OECD jointly organized a seminar on "Development Finance – the Way Forward" in March 2000.

- The targeting of German official development assistance leaves much to be desired. The available evidence is in some conflict with the vision that financial cooperation contributes to poverty alleviation, sound macroeconomic policy and good governance in the recipient countries. The German development bank, Kreditanstalt für Wiederaufbau (KfW), is constrained in fostering economic development in DCs. Most importantly, project-related financing is inherently flawed with respect to evaluating the effectiveness of aid.

- While certain items of private capital inflows proved to be volatile in the late 1990s, other items remained fairly stable. This suggests that a differentiated view is required in order to assess the appropriateness of private external financing for sustainable economic development.

- It is unlikely that the balance between official development financing and private capital flows will shift back to the former in the future. Official donors are facing financial constraints. Furthermore, the traditional ways of official development financing are currently under fire from various angles.

- A stronger focus on poor and development-minded DCs figures high on the agenda of reforming official development financing. Consequently, DCs can improve their prospects of receiving official development financing in the new millennium by pursuing sound macroeconomic policies, by designing programs targeted to alleviate poverty, and by establishing good governance.

II. GERMAN CAPITAL TRANSFERS TO ASIA: OFFICIAL VERSUS PRIVATE FINANCE

Aggregated net capital flows from Germany to Asian DCs amounted to about DM 47 billion in 1995–1998. Direct investment by German companies and bank credits accounted for more than 70 percent of total flows (Figure 1).[2] By contrast, official credits and transfers contributed only 8 percent to total flows.

According to Bundesbank statistics, annual flows of official credits and transfers from Germany to Asian DCs remained practically constant since 1994.[3] On the positive side, one may note that official credits and transfers represent the only capital flow item in Figure 2 that did not decline when Asia was hit by financial crisis. However, this stability is of little use for recipient countries considering the low level of official flows.

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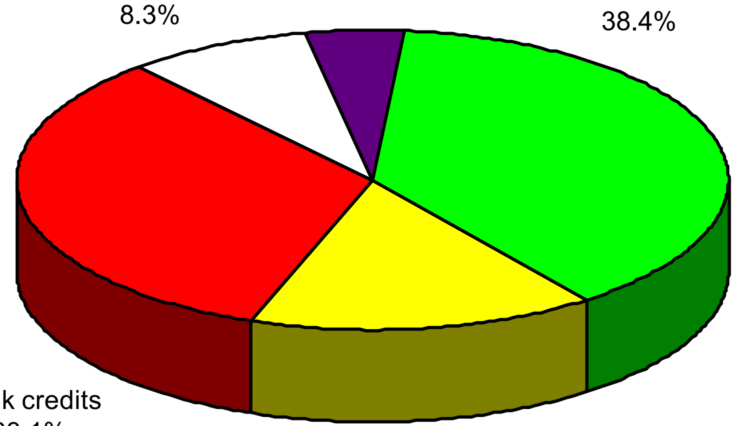
2 This figure includes public (current and capital) transfers, but excludes other transfers (Deutsche Bundesbank: var. iss.).

3 Note that German bilateral ODA (official development assistance) was higher according to statistics provided by the German Ministry for Economic Cooperation and Development (BMZ). German (net) ODA to Asia and Oceania averaged DM 1.6 billion in 1994–1998 (BMZ homepage: www.bmz.de). ODA was higher in 1998 than in 1996/97, but still slightly below the figures reported for 1994/95; see also Section III.

Figure 1 — Structure of German Net Capital Exports[a] to Asian DCs, 1995–1998 (percent; period average)



[a]Including public(current and capital) transfers to developing countries, but excluding other transfers. — [b]Credits by the government plus public (current and capital) transfers.

Source: Deutsche Bundesbank, Zahlungsbilanz nach Regionen, July 1999.

Figure 2 also offers first insights as to the relative importance and volatility of major types of private capital flows from Germany to Asian DCs. Private capital exporters reacted differently to the Asian crisis:[4]

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[4] For the impact of the Asian crisis on foreign direct investment and other capital inflow items, see also UNCTAD (1998).

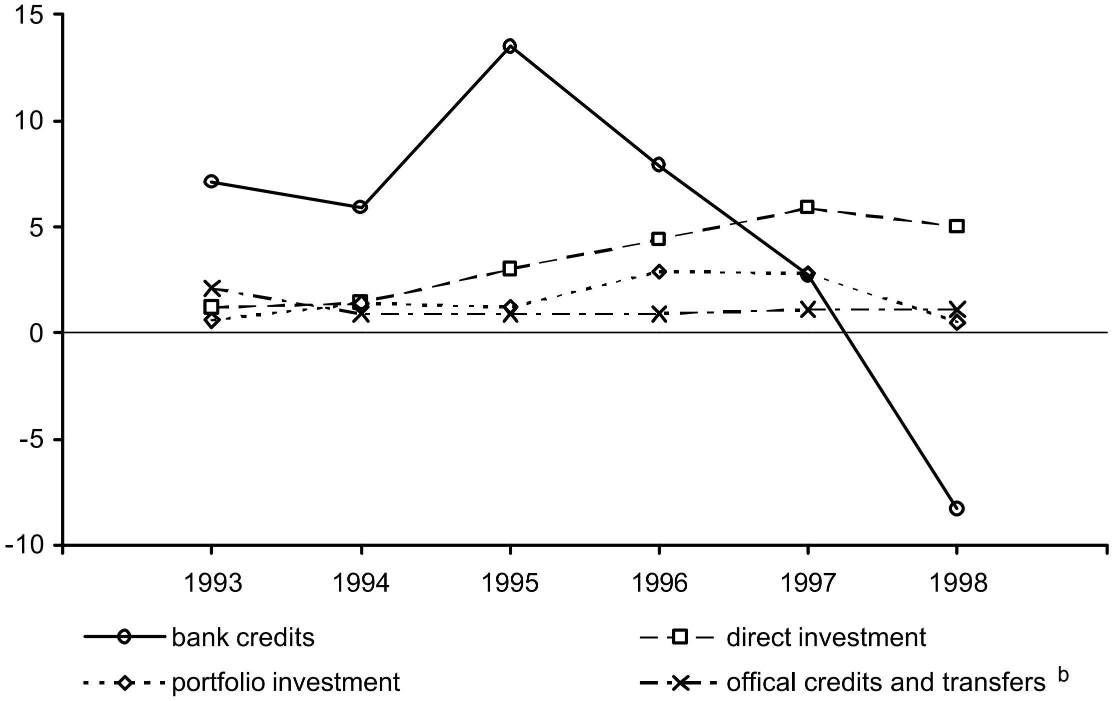
- Bank credits proved most unstable. The generous lending by German banks in the mid-1990s fueled the economic boom in Asia, which turned out to be unsustainable shortly afterwards. Once crisis was looming, banks rushed for the exists. The fact that total net capital flows from Germany to Asian DCs turned negative in 1998 was exclusively due to the withdrawal of bank credits.

- Portfolio investment was seriously curtailed in 1998, but remained positive.

- In sharp contrast to bank lending and portfolio investment, direct investment by German companies in Asian DCs was hardly affected by the financial crisis. The slight setback in 1998 notwithstanding, direct investment was still four times as large as in 1993.

In summary, Figure 2 underscores the need for a differentiated assessment of Germany's role in financing economic development in Asia.

Figure 2 — Development of Major Items of German Net Capital Exports[a] to Asian DCs, 1993–1998 (billion DM)



[a]Including public (current and capital) transfers to developing countries, but excluding other transfers. Due to statistical revisions, data for 1993/94 may not be fully comparable to subsequent years. — [b]Credits by the government plus public (current and capital) transfers.

Source: Deutsche Bundesbank, Zahlungsbilanz nach Regionen, var. iss.

III. OFFICIAL DEVELOPMENT FINANCE

1. German Bilateral Aid: Well Targeted?

In many DCs, official development assistance (ODA) is just a trickle compared to private capital inflows. However, ODA remains an important supplement to domestic savings in DCs lacking access to private foreign capital. The principal aim of foreign aid obviously is to alleviate poverty in the latter countries. However, the recently released report of the International Financial Institution Advisory Commission to the U.S. Congress (Meltzer Commission 2000) has vehemently criticized the distribution of ODA among DCs in the past. The report shows that financial support granted by the World Bank was biased **against** DCs without access to private foreign capital.

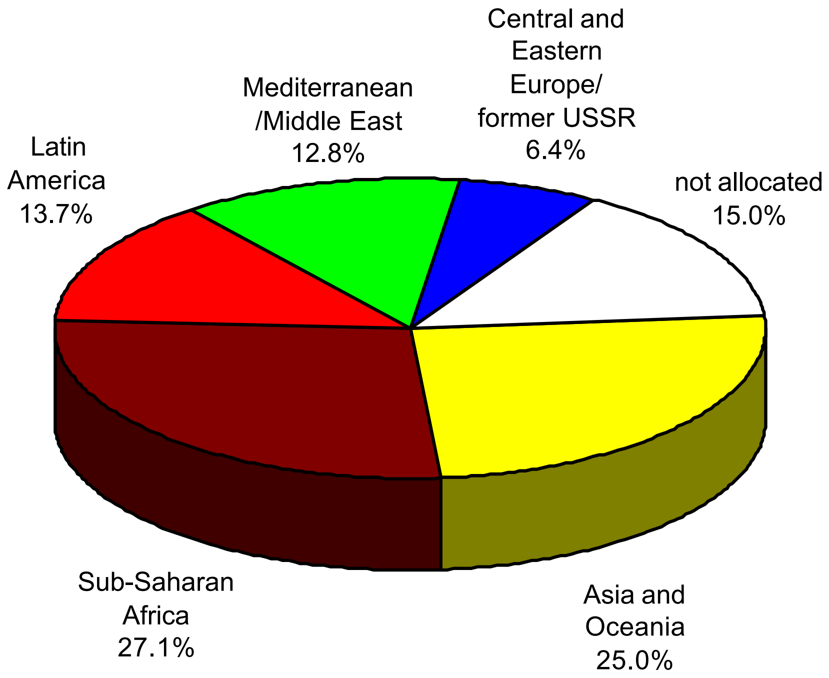
Compared to financial support by the World Bank, German bilateral ODA appears to be less biased towards DCs with fairly high per-capita income. Sub-Saharan Africa, which hosts most of the least developed countries, received priority as a target of German ODA (Figure 3). Measured by the share in total German ODA in 1994-1998, Asia ranked second and far ahead of regions such as Latin America where poverty is not as widespread as in large parts of Asia.

A simple correlation exercise reveals that both, aggregated ODA outflows in 1994-1998 and ODA per head of the recipient countries' population are negatively related to the recipient countries' per-capita income (Table 1).[5] This correlation is significant at the 5 percent level when considering per-capita ODA granted to all DCs. For the subsample of 25 Asian DCs, however, correlations remain insignificant, irrespective of whether ODA is considered in absolute terms or in per-capita terms.

The targeting of German ODA to DCs with low per-capita income is further investigated in Table 2. It turns out that 40 sample countries with a per-capita income of US$ 1500 and more received about 16 percent of total German bilateral ODA in 1994-1998. In per-capita terms, German ODA received by this group was clearly below the average figure of DM 20.7. It is striking, however, that the share of 43 sample countries with low per-capita income (less than US$ 500 in 1996) in German ODA is slightly below the share of 34 middle-income DCs (US$ 500–1499). Another indication of the middle-income bias of German ODA is that middle-income DCs, on average, received as much German ODA in per-capita terms as the group of poorest DCs.

5 As will be shown below, this result does not hold for financial assistance granted by Kreditanstalt für Wiederaufbau.

Figure 3 — Regional Distribution of German Bilateral ODA (net outflows), 1994–1998 (percent)



aggregated net outflows to:

Asia and Oceania:	DM	8.2 billion
Sub-Saharan Africa:	DM	8.9 billion
Latin America:	DM	4.5 billion
Mediterranean/Middle East:	DM	4.2 billion
Central and Eastern Europe / former USSR:	DM	2.1 billion
not allocated:	DM	4.9 billion
total:	DM	32.8 billion

Source: BMZ (internet: www.BMZ.de/epolitik/statistiken/stat-o3c.pdf).

Table 1 — German Bilateral ODA (net outflows), 1994–1998: Correlation with Per-capita Income of Recipient Countries[a]

	Aggregated ODA outflows	ODA per capita[b]
All DCs[c]	–0.17* (117)	–0.19** (117)
Asian DCs[d]	–0.07 (25)	–0.23 (25)

[a] **(*) significant at the 5 (10) percent level (two-tailed test); GNP per capita in 1996 in US$. – [b] Aggregated net outflows in 1994 –1998 divided by population of recipient countries in 1996. – [c] All DCs for which data were complete. – [d] "East Asia" and "South and Central Asia" according to BMZ classification.

Source: Own calculations based on BMZ (internet: www.BMZ.de/epolitik/statistiken/stat-o3c.pdf) and World Bank, World Development Indicators CD-ROM.

Table 2 — German Bilateral ODA (net outflows) to Developing Countries with High, Medium and Low Per-capita Income[a], 1994–1998

	Share in ODA to 117 DCs (percent)	ODA per capita[b] (DM)
40 DCs with per-capita income of US$ 1500 and more	15.9	12.7
34 DCs with per-capita income of US$ 500–1499	43.1	24.9
43 DCs with per-capita income of less than US$ 500	41.1	24.9
All 117 DCs	100.0	20.7

[a] GNP per capita in 1996 in US$. – [b] Aggregated net outflows in 1994–1998 divided by population of recipient countries in 1996; unweighted averages.

Source: BMZ (internet: www.BMZ.de/epolitik/statistiken/stat-o3c.pdf) and World Bank, World Development Indicators CD-ROM.

In Asia, 12 middle-income countries got more than twice as much German ODA as 10 low-income countries (Table 3). This is mainly because (middle-income) China was by far the most important recipient of German ODA in absolute terms. More strikingly, per-capita ODA to China (DM 2.8) was more than three times as large as per-capita ODA to (low-income) India (DM 0.8). Table 3 also shows that per-capita ODA to low-income Asian DCs was significantly below per-capita ODA to low-income DCs in other regions. In only three low-income Asian DCs (Mongolia, Lao PDR and Bhutan), per-capita ODA exceeded the average figure of DM 20.7 reported for all 117 sample countries in Table 2.

The distribution of German ODA among Asian DCs does not seem to be based on efficiency-related criteria:

- Taking the average rate of inflation[6] in 1995–1997 as a proxy of the macroeconomic policy stance of recipient countries, poorly performing Asian DCs actually received considerably more German ODA, in per-capita terms, than Asian DCs pursuing sound macroeconomic policies.[7]

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[6] GDP deflator according to World Bank (2000).

[7] German ODA in 1994–1998, per head of the recipient countries' population, amounted to DM 6, on average, in seven Asian DCs with an inflation rate of less than 7 percent per annum, to DM 9 in eight Asian DCs with an inflation rate of 7–25 percent, and to DM 16 in seven Asian DCs with an inflation rate of more than 25 percent.

Table 3 — German Bilateral ODA (net outflows) to Low-income Asian DCs[a], 1994–1998

	Aggregated ODA outflows (DM million)	ODA per capita[b] (DM)
Mongolia	106.6	42.7
Lao PDR	135.1	28.6
Bhutan	15.5	21.7
Cambodia	130.2	12.7
Nepal	189.0	8.7
Azerbaijan	51.1	6.8
Vietnam	503.5	6.7
Tajikistan	30.3	5.1
Bangladesh	581.2	4.8
India	800.2	0.8
memorandum:		
10 low-income Asian DCs	2542.7[d]	13.9[e]
12 middle-income Asian DCs[c]	5480.5[d]	8.8[e]

[a] "East Asia" and "South and Central Asia" according to BMZ classification. GNP per capita of less than US$ 500 in 1996. Ranked according to ODA per capita. – [b] Aggregated net outflows in 1994 –1998 divided by population of recipient countries in 1996. – [c] GNP per capita of US$ 500–1499 in 1996. – [d] Total for country group. – [e] Unweighted average.

Source: BMZ (internet: www.BMZ.de/epolitik/statistiken/stat-o3c.pdf) and World Bank, World Development Indicators CD-ROM.

- The corruption perceptions index reported by Transparency International[8] is regarded here as an indicator of the quality of governance in Asian DCs. This indicator is available for 16 Asian recipients of German ODA. If Germany had rewarded good governance, Asian DCs in which the degree of corruption is

[8] For details, see the homepage of Transparency International (www.transparency.de/documents/cpi/index.html).

perceived to be relatively low should have been granted more ODA. Actually, however, eight Asian DCs for which the indicator pointed to less corruption received slightly less German ODA (in per-capita terms) in 1994–1998 than eight Asian DCs for which corruption is perceived to be more significant.

All this suggests that the targeting of German bilateral ODA could be improved. The distribution of ODA among DCs reveals a bias towards middle-income DCs. Furthermore, indications are that German ODA is not linked to good governance and sound macroeconomic policies in Asian recipient countries.

2. Kreditanstalt für Wiederaufbau: A Successful Development Bank?

Apart from being the promotional bank for the German economy, Kreditanstalt für Wiederaufbau (KfW) finances investments in DCs on behalf of the federal government of Germany. Since financial cooperation (FC) began in the early 1960s, KfW has committed more than DM 80 billion to project and program assistance.[9] These FC commitments account for about one third of Germany's total development cooperation funds. Financial assistance is provided mainly in the form of low-interest loans, but also as grants. In addition to KfW financing based on budgetary funds of the German Federal Ministry for Economic

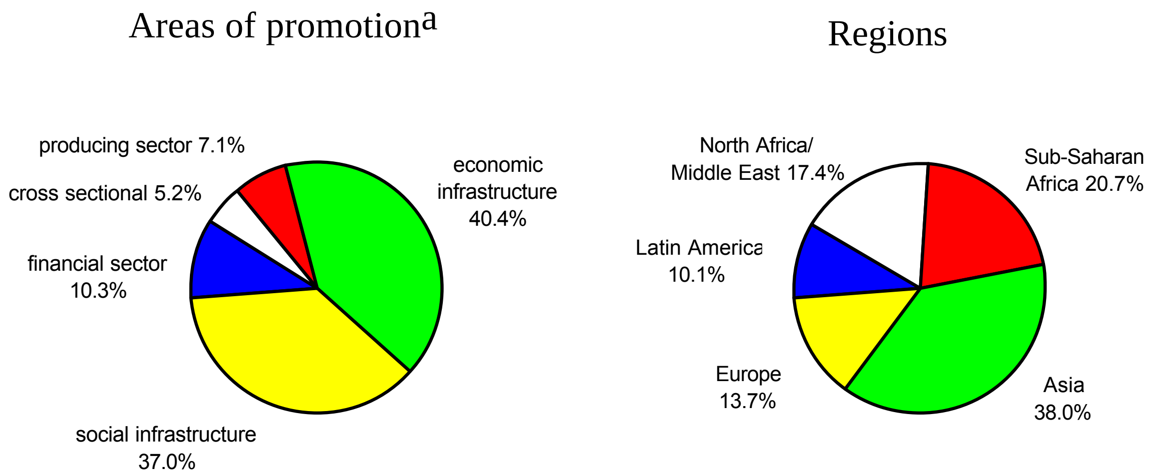
9 Statistical information on KfW activities is drawn from the internet (KfW homepage: www.kfw.de), if not stated otherwise.

Cooperation and Development (BMZ), KfW raises funds for development cooperation in domestic and international capital markets.

KfW's important role in German development cooperation notwithstanding, the promotion of DCs is marginal compared to KfW's role in promoting the German economy (Box 1). As a matter of fact, the relative importance of FC declined drastically since the early 1960s (Glagow et al. 1985: 76 f.). The share of FC in total loans committed by KfW, which exceeded 40 percent, on average, in the 1960s, dropped to about 20 percent in the early 1980s. This decline continued up to the most recent past. In 1997-1999, the promotion of DCs accounted for 5.6 percent, 4.2 percent and 3.7 percent, respectively, of total KfW commitments. Resources devoted to the promotion of DCs stagnated in nominal terms in recent years.

KfW appraises the eligibility of projects for financing according to economic, social and environmental criteria, assists the partner countries in implementing projects, and evaluates their success after project completion. Currently, KfW is engaged in about 1600 development projects in more than 100 countries. The regional distribution of FC commitments shows that Asia was clearly given priority by KfW in 1997-1998 (Figure 4). This is in striking contrast to the distribution of total German bilateral ODA (Figure 3), for which Sub-Saharan Africa turned out to be the most important recipient. The prominence of Asia as a recipient of KfW's FC funds is not restricted to the recent past. The regional distribution of cumulative FC commitments hardly differs from the distribution portrayed in Figure 4.

Figure 4 — Distribution of KfW Financial Cooperation Commitments by Region and Area of Promotion, 1997–1998 (percent)



[a]Economic infrastructure consists of power industry, transport and storage, and communications; social infrastructure consists of water supplies and sewage elimination/waste disposal, education, health care/population policy, and other social services.

Source: KfW (internet: www.kfw.de/e_kfw/fz/content/c_fz3.htm).

Figure 4 also reveals major promotional tasks pursued through FC by KfW.[10] The bulk of FC is devoted to improving the economic and social infrastructure in the recipient countries. Projects related to the economic infrastructure mainly comprise commitments to the power industry (25 percent of total FC commitments) and to transport and storage (15 percent). As concerns social infrastructure, projects related to water supplies and sewage elimination/waste disposal figure most prominently (23 percent of total FC commitments). While KfW rightly stresses education and health-care facilities as crucially important to alleviate poverty, these two items together accounted for only 12 percent of total FC commitments in 1997-1998. Finally, nearly one third of FC commitments are reported to help protect the environment and natural resources in the recipient countries. The classification of projects under this heading may be subject to considerable discretion, however.

10 For differences and similarities between KfW operations and operations of DEG – German Investment and Development Company, see Box 2.

Box 1: Kreditanstalt für Wiederaufbau (KfW)

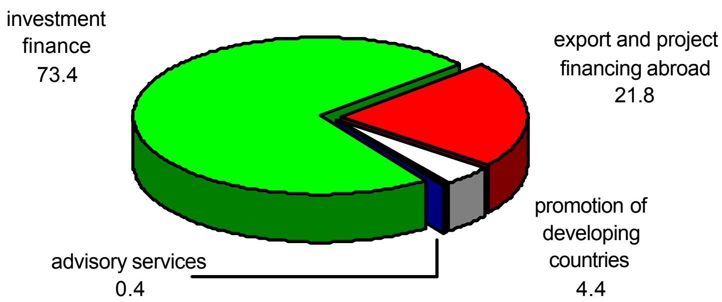
KfW was established as a public corporation in 1948. Its original purpose was to finance reconstruction projects in post-war Germany. While KfW disposed of several sources of financing, reconstruction relied heavily on Marshall Plan funds. Today KfW is the promotional bank for the German economy and a development bank for developing countries. With a balance sheet total of almost € 200 billion, it ranks among the largest banks in Germany.

The KfW's fields of operation are:

- providing the German economy with a broad range of loan programs to promote investment, innovation and equity participation;
- extending long-term loans for exports of German capital goods and for projects in Germany and abroad;
- financing investments in developing countries on behalf of the federal government of Germany;
- advising countries, municipalities and enterprises on how to finance and operate projects;
- raising funds in domestic and international capital markets to refinance its lending business.

In 1997–1999, KfW committed loans, grants and guarantees totaling € 107 billion. The distribution of these commitments between major fields of operation is portrayed in the figure below.

Distribution of Loans, Grants and Guarantees, 1997–1999 (percent)



The figure clearly reveals that promoting the German economy, mainly by extending long-term loans at favorable interest rates, is KfW's principal concern. According to press reports, KfW claims to have created or secured 2 million jobs in Germany in 1999 by extending loans (Die Welt, March 3, 2000). The assumptions underlying this estimate are open to question. The figure may provide a grossly overstated impression on KfW's labor market impact, if it is not taken into account that KfW borrowers might have referred to alternative sources of finance (even though interest rates would have been higher for credits from private sources).

Promotional **investment financing** comprises the following elements (percentage of total committed amounts of investment finance in 1997–1998 in brackets):

- business investment and investment in environmental protection in Germany (42.9%);
- business investment outside Germany (1.5%);
- technology, innovation and equity participation (5.6%);
- housing investment (33.4%);
- communal infrastructure investment (16.6%).

KfW claims that promotional investment financing is targeted particularly to small and medium-sized enterprises (SMEs). However, the relative importance of SME-financing cannot be assessed on the basis of available statistics. Another area deemed important concerns the promotion of technological innovations and the provision of venture capital. Especially small innovative enterprises are often said to be constrained in accessing private capital markets in Germany.

A recent evaluation of KfW programs to promote R&D and innovations by SMEs underscores such concerns (Kulicke et al. 1997). Official lending to innovative SMEs is considered an appropriate means to help overcome financial constraints. The positive assessment of KfW lending programs in this study is mainly based on a survey that covered almost 3000 SMEs, of which about 1200 firms participated in KfW lending programs. Participating SMEs applauded KfW loans for several reasons. Small firms, in particular, reported that they could not have realized innovative projects if KfW loans had not been available. Positive effects of KfW loans were noted with respect to the firm's liquidity, further R&D activity, employment, and qualification of the work- force. Yet the study finds few significant differences with respect to various aspects of innovative activity between SMEs that received KfW loans and SMEs that did not (ibid.: 107). As it seems, KfW loans were instrumental to the realization of specific innovative projects, while their impact on overall innovative activity of loan recipients, compared to SMEs not participating in the lending programs, remained weak at best.

The composition of investment financing also suggests that KfW played a modest role in overcoming financial constraints faced by SMEs; "technology, innovation and equity participation" accounted for less than 6 percent of total committed funds of investment finance. In any case, it is questionable whether innovators should be granted **subsidized** loans. Instead, the relatively high risk typically involved in financing innovative projects should be reflected in the interest rate charged. Market-based interest rates would not discourage economically viable projects, if the problem small innovators are facing in private capital markets is related to the availability of financing, rather than the cost of financing.

Loans for housing investments, too, are offered by KfW at subsidized interest rates. In Eastern Germany, KfW runs a program for renovating and modernizing housing. In Western Germany, KfW provides incentives for energy saving investments in residential buildings. KfW also supports young families in buying or building their own homes. Economically speaking, it is not obvious why housing investments should be subsidized. Subsidies would only be justified for housing investments involving positive external effects that are ignored by private capital markets.

Export and project financing represents the second major field of KfW operations (see figure above). KfW is mandated by the legislator to promote German exports and administers different official support schemes for export financing. In addition to the so-called KfW/ERP Export Fund, special programs exist for financing ship and aircraft exports. Even though officially supported export loans are governed by consensus rules agreed upon by OECD countries, the economic rationale for subsidizing exports is debatable on several grounds. The existence of export subsidies indicates that mercantilistic attitudes prevail even in major exporting countries such as Germany. Underlying is the widespread misconception that economies should strive primarily for exports, rather than for imports. From a consumer's welfare point of view, the opposite is true. Moreover, export subsidies of advanced countries such as Germany may hinder the economic development of lower-income importing countries, by putting import-competing local producers at a competitive disadvantage.

Project financing loans are considered to be particularly suited for large-scale investment projects. For example, KfW supported the construction of shopping centers in Poland by Metro AG, i.e., one of the leading retailers in Germany. KfW notes that Germany has "considerable interest" in such projects. From a macroeconomic point of view, however, the rationale for subsidies is as dubious as in the cases mentioned before.

As concerns **advisory services**, KfW draws on its own experience in assisting DCs, notably in Central and Eastern Europe and in the former USSR, to set up promotional banks and to develop official support programs for local enterprises. However, KfW devotes a marginal share of its overall resources to activities other than investment financing and export as well as project financing (see figure above).

Source: KfW (homepage: www.kfw.de).

KfW involves international and local non-governmental organizations in its project work, and considers the participation of the beneficiaries to be an important prerequisite for the successful completion of projects. Yet, state institutions in the recipient countries are the principal partners of KfW. Hence, it is regarded as crucial that these partner institutions are "development-minded". In other words, FC should be subjected to the same test as ODA in general, namely whether it is directed primarily towards poor countries which are governed relatively well and which pursue sound macroeconomic policies.

Some simple correlations suggest that the distribution of FC across recipient countries leaves much to be desired (Table 4):

- First of all, DCs with lower per-capita incomes did not receive significantly more FC funds from KfW than DCs with higher per-capita incomes. It does not make any difference whether FC funds are considered in absolute terms or in per-capita terms. The correlation between FC and the per-capita income of recipient countries is considerably weaker than the correlation reported above for total bilateral ODA.

- Second, KfW did not discriminate between recipient countries with sound macroeconomic policies and DCs in which relatively high inflation pointed to macroeconomic policy failures.

- Third, KfW funds received by DCs for which the corruption perceptions index pointed to better governance did not exceed funds received by DCs in which corruption was considered a more serious problem. Correlation coefficients remain insignificant when calculations are based on a subsample of DCs with relatively low per-capita income.[11]

Nevertheless, KfW considers FC projects to have been "largely successful".[12] According to a recent evaluation report, two thirds out of 177 projects finally evaluated in 1994–1995 were classified successful in terms of developmental impacts. For less than 10 percent of all evaluated projects, the effects were "clearly unsatisfactory"; only two projects were rated complete failures. Relatively poor results were reported for projects in manufacturing. Differentiated by region, projects in Asia tended to be more successful, particularly when compared to projects in Africa.

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[11] In this way, one may control for a possible bias arising from high-income DCs which did not benefit from KfW funds, while they ranked relatively favorable in terms of perceived corruption.

[12] The correlation results of Table 4 were discussed in personal communication with KfW staff. KfW questioned the relevance of the results for the following reason: Instead of focusing FC on DCs already characterized by good governance and sound macroeconomic policies, KfW considers the dialogue with recipients of FC to be instrumental to better governance and macroeconomic management in DCs which have not performed well in these respects so far. The issue of whether external aid "buys reform" is taken up in Section V.

Table 4 — Cross-Country Distribution of FC by KfW, 1997–1998: Correlation Coefficients[a]

	FC in absolute amounts	FC in per-capita terms[b]
per-capita income of recipient countries, 1996	–0.16 (–0.07)	–0.13 (–0.11)
average rate of inflation in recipient countries[c], 1995–1997	–0.06 (–0.18)	–0.03 (–0.05)
corruption perceptions index[d], 1999	–0.06 (0.12)	0.12 (0.15)

[a] None of the correlation coefficients is statistically significant at the 10 percent level. Number of observations: 59; correlation coefficients in brackets are based on a subsample of 35 DCs with per-capita incomes of less than US$ 1500 in 1996. – [b] FC inflows in 1997–1998 per head of the recipient countries' population in 1996. – [c] GDP deflator. – [d] High (low) index values indicate highly clean (highly corrupt) countries.

Source: Own calculations based on KfW (homepage: www.kfw.de), Transparency International (homepage: www.transparency.de), and World Bank (World Development Indicators, CD-ROM).

Success or failure of FC projects is largely attributed to governments and project-executing agencies in the recipient countries. In almost all projects rated unsuccessful, local partners were criticized for insufficient commitment and competence. To quote KfW: "What we misjudged most often was the prospects of the executing agency's performance and of the demand for the services provided".

Box 2: DEG – German Investment and Development Company[a]

In the context of German development policy, DEG is a government corporation whose aim is to promote economic growth and alleviate poverty in developing and transition countries through private sector development. DEG focuses on establishing and developing efficient private enterprises in partner countries by offering finance and consultancy services. Apart from directly supporting private investments, DEG aims at improving the efficiency of financial institutions in partner countries. The four key areas of private-sector oriented development policy are defined as follows:

- promotion of direct investment, including the provision of venture capital by DEG;
- extension of long-term loans (including subordinated loans) for investment projects;
- support granted to pioneer investors in DCs;
- development of the local financial sector and financial institutions.

At the end of 1998, DEG's portfolio contained financial commitments of DM 3.4 billion. Overall commitments were spread over 434 companies in 86 countries. It should be noted that the selection of partner countries is not only motivated by development policy opportunities. Another major criterion concerns "the contribution to the globalization activities of German enterprises".

Equity holdings by DEG accounted for 21 percent of overall commitments, and long-term loans for 79 percent. Total investment of enterprises to which DEG had contributed equity or loan finance amounted to DM 32.7 billion. By relating DEG commitments to this figure, DEG claims that investments of about DM 8 were mobilized by DEG per DM of its own commitments. This calculation is based on the – dubious – assumption that none of these investments would exist in the absence of DEG commitments.

The composition of DEG's commitment portfolio at the end of 1998, according to sectors and regions, is portrayed in the table below. Similar to financial cooperation funds granted by KfW, Asia figures most prominently as a partner region of DEG (see Section III.2 in the text). Unlike KfW, however, the producing sector (manufacturing plus agriculture and mining) accounted for almost half of DEG commitments. Infrastructure, the major concern of KfW, is of minor relevance in DEG operations.

The Commitment Portfolio of DEG by Sector and Region, End of 1998 (percent)

by sector		by region	
manufacturing	41	Asia/Oceania	40
financial institutions	36	Latin America/Caribbean	26
infrastructure	9	Africa	21
tourism/hotels	6	Europe	13
other	8		

DEG operates on the basis of equity capital provided by the federal government of Germany. Profits earned from lending and equity participations are retained by DEG and combined with funds raised in capital markets, in order to finance new engagements on a revolving basis. In contrast to KfW, DEG does not provide subsidized finance to DCs. Commercial terms attached to finance and consultancy services are considered appropriate "because only profitable, viable enterprises can contribute to sustainable growth and raising living standards in developing and transition countries".

In this context, it may be noted that DEG claims that it can "take market risks that others rate as too high". This invites two questions: Does DEG really command over superior knowledge of markets? Are relatively high market risks taken into account when specifying the terms of financial commitments?

[a] The author appreciates comments and suggestions made by Hans-Gert Braun, director of DEG.

Source: DEG homepage (www.deginvest.de).

Ex-post evaluation of FC projects by KfW usually takes place five years after projects have been completed. Hence, experience gathered during the operating phase of projects is part of the evaluation process. In this respect, the evaluation of KfW projects is superior to World Bank practice. The latter has been criticized by the Meltzer Commission (2000) for paying insufficient attention to the sustainability of projects, as most World Bank audits occur between six months and three years after final disbursements. All the more surprisingly, the World Bank reportedly has a considerably higher failure rate than KfW.[13]

Yet, a fundamental problem remains even if final project evaluation is done well after the disbursement of funds, i.e., when an operational history is available. Project evaluation is systematically flawed as money is fungible. This means that the marginal project that a KfW (or World Bank) loan makes possible is generally not the project that is evaluated (Meltzer Commission 2000). As a consequence, even the high success rate reported for KfW loans cannot refute critics claiming that official development financing has had little effect on economic development in the recipient countries. In the end, the effectiveness of official development financing can only be assessed at the macroeconomic level (see also Section V below).

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13 According to the Meltzer Commission (2000), World Bank loans have a failure rate of 40 percent in East Asia, and 60–75 percent in South Asia and Africa.

To conclude, it is almost impossible to decide whether KfW is a successful development bank. KfW is financially constrained as it largely depends on the provision of budgetary funds by the federal government. If ODA in general is stagnant, KfW can hardly escape from being affected. The focus on project-related FC implies that the much debated question of the overall effectiveness of official development financing is beyond KfW's reach. The evidence presented above suggests that KfW should improve the allocation of FC funds among recipient countries, in order to primarily support poor countries characterized by good governance and development-oriented economic policies. KfW is constrained even in this respect, however. According to KfW staff, decisions on annual FC funds directed to individual DCs (i.e., country quotas) are taken by superior authorities of BMZ.

IV. PRIVATE CREDITORS AND INVESTORS

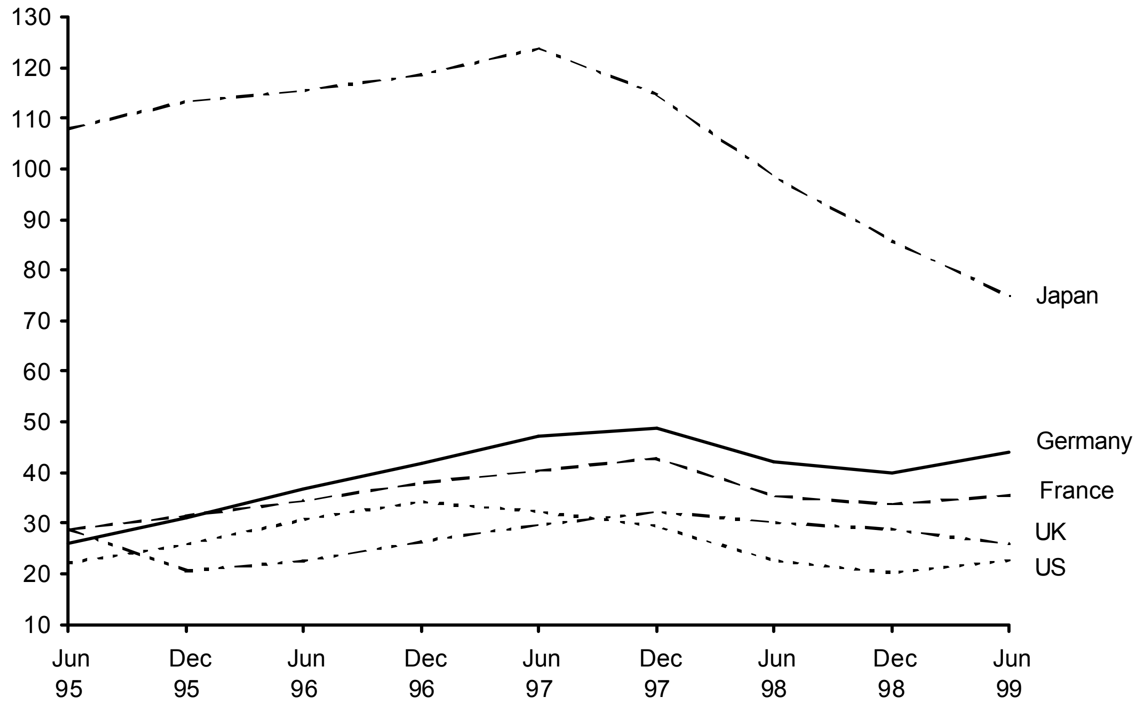
Questions related to the volume and effectiveness of official development financing would likely be of minor relevance to policymakers and economists, if the recent financial crisis in Asia had not highlighted concerns about the role of private capital inflows in financing economic development of recipient countries. Skepticism relates to the instability of some private capital inflow items in the first place. Another concern is of a more structural nature, namely that German companies traditionally tended to prefer investment locations other than Asian DCs.

1. German Banks: A Reliable Partner for Asia?

German banks rank second only to Japanese banks with respect to their current engagement in Asian DCs, measured by outstanding bank claims in mid-1999 (Figure 5). German bank lending turned out to be less volatile after Asia had been hit by financial crisis than bank lending by other major industrialized countries. Outstanding claims of German banks fell by 18 percent within twelve months subsequent to the peak of outstanding claims at end–1997. The decline in outstanding claims was more pronounced for all other creditor countries considered in Figure 5. When comparing the respective peaks and lows in outstanding claims, the decline was most dramatic in the case of Japanese banks (–40 percent) and US banks (–34 percent).

Yet it would be a fallacy to conclude that lending by German banks served Asian DCs relatively well in financing economic development on a sustainable basis. German banks are to be blamed for having fueled speculative bubbles in Asia before the crisis hit. Outstanding claims of German banks almost doubled from mid–1995 to end–1997. Comparing mid–1995 and the respective peaks in outstanding claims of banks from other industrialized countries, the increase in bank claims was significantly lower in the cases of France and the United States (about 50 percent), and especially in the cases of Japan and the United Kingdom (10–15 percent).

Figure 5 — Bank Claims on Asian DCs by Major Creditor Countries, 1995–1999 (US$ billion)



Source: BIS, Consolidated International Banking Statistics (formerly: The Maturity, Sectoral and Nationality Distribution of International Bank Lending), var.iss.

Moreover, German banks (and other European banks, too) were late to realize that the lending boom was unsustainable. While outstanding claims of German banks continued to increase until end–1997, outstanding claims peaked earlier in the case of Japanese banks (mid–1997) and, in particular, in the case of US banks (end–1996).

All in all, German banks contributed significantly to excessive lending to Asian DCs. Compared to banks from other industrialized countries, German banks may have caused less trouble to Asian borrowers by rushing for the exits when crisis was looming. However, the previous lending spring was not less damaging for sound economic development in Asian DCs, as it gave rise to speculative investments. Too little lending after the crisis was just the flip side of too much lending before the crisis, in which German banks played a prominent role.

2. German Direct Investors: Still Underrepresented in Asia?

While recent financial crises added to concerns about the sustainability of external loan financing, there is widespread consensus among economists and policymakers that foreign direct investment (FDI) provides a solid basis on which DCs should rely when seeking external funds to supplement national savings, and thereby foster economic development. FDI is considered superior to other types of private capital inflows for several reasons:

- In contrast to the short-term orientation of foreign banks and investment funds, the engagement of foreign direct investors in host countries is perceived to be longer term in nature. As a matter of fact, FDI proved to be rather stable when DCs experienced financial crises (see, e.g., UNCTAD var. iss., 1999: 56; UNCTAD 1998; see also Figure 2 above).

- Unlike other types of capital inflows, FDI does not only allow DCs to tap foreign savings. In addition to capital, the FDI package offers access to internationally available technologies and managerial know-how. Furthermore, the presence of foreign direct investors may render it easier for host countries to penetrate world markets for goods and services.

- FDI explicitly provides for risk sharing between host countries and foreign companies, whereas debt-related capital inflows constitute repayment obligations that are fixed ex ante.

Hence, FDI is regarded to be the most reasonable means to secure external financing on a sustainable basis and to overcome local impediments to economic development.[14]

Until recently, many Asian DCs made use of FDI to a limited extent. FDI inflows were subject to considerable restrictions during the 1970s and 1980s. In a survey by the European Round Table of Industrialists (1996: 304) only three Asian DCs

[14] Positive economic growth effects of FDI inflows cannot be taken for granted, however. Growth effects tend to vary over time and across countries (Nunnenkamp 2000a).

(Malaysia, Sri Lanka and Taiwan) were classified as "moderately open to private investment" in 1992; a "relatively high scope of remaining impediments to private investment" was found in countries such as China, India, Indonesia, Pakistan and Vietnam.

At the same time, direct investors based in major industrialized countries grasped existing opportunities of investing in Asian DCs to varying degree. European companies, including German companies, were underrepresented as direct investors in Asia according to recent studies. The European Commission and UNCTAD (1996) found, for example, that Germany's FDI stock in Asian DCs was only about half of its FDI stock in Spain. The limited attention paid to Asia during the 1980s and early 1990s could be attributed to two factors:

- First, direct investors based in Germany and other European countries focused on investment opportunities offered by the process of European integration.

- Second, among emerging market economies, German companies traditionally preferred Latin America over Asia[15], mainly because some host countries in the former region offered large and protected markets which German investors were eager to penetrate (Nunnenkamp 1997).

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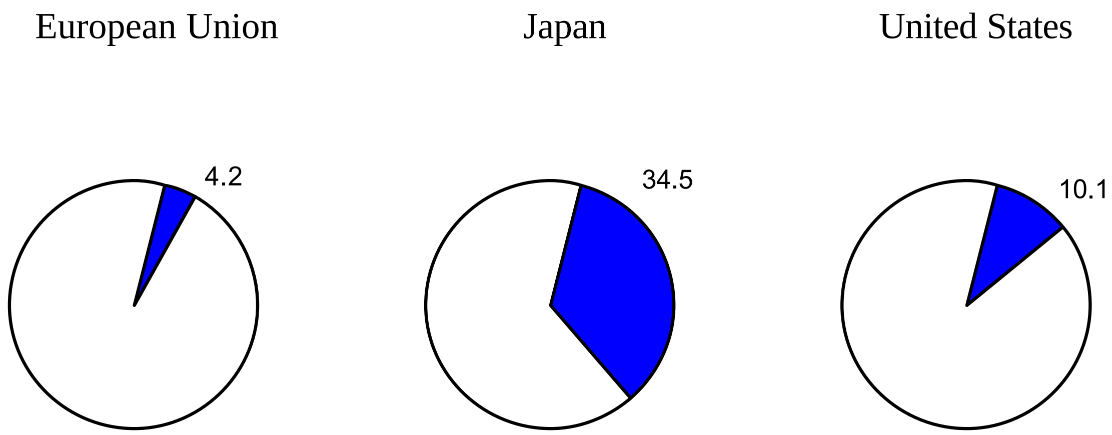
[15] Latin America accounted for 7 percent of Germany's outward FDI stock in 1993, whereas the corresponding share of Asian DCs was 3 percent (European Commission and UNCTAD 1996: 31).

As a result, direct investors based in Germany and other European countries lagged behind Japanese and US investors in exploiting the regional market potential of Asian DCs, and in integrating these countries into global production and marketing networks.

The underrepresentation of European direct investors in Asia persists, even though Asian DCs attracted a somewhat higher share of total European FDI outflows in 1992-1997 than before. For example, the share of Asian DCs in US FDI outflows during this period was still twice as large as their share in German FDI outflows (Figure 6).

Figure 6 — Share of Asian DCs[a] in Total FDI Outflows of Major Foreign Investors[b], 1992–1997 (percent; period average)



major EU investors:	
Germany:	**5.3**
France:	3.5
Netherlands:	7.5
United Kingdom:	8.4

[a]Near and Middle East not included. — [b]1992–1996 for the EU and the United Kingdom. Reinvested earnings included when available.

Source: EUROSTAT, European Union Direct Investment Data, 1998 Edition, Luxembourg 1999

From the perspective of Asian host countries, Germany contributed just 2 percent to total FDI inflows into Asian DCs in 1992-1997 (EUROSTAT 1999; UNCTAD var. iss., 1999). This compares with about 13 and 11 percent coming from the United States and Japan, respectively. The Triad (European Union, Japan and the

United States) as a whole accounted approximately for one third of total FDI inflows into Asian DCs in 1992-1997.

In summary, "FDI has become the single most important source of private development financing for the region [i.e., East and South-East Asia], and it is likely to be particularly important for the economies most affected by the crisis" (UNCTAD var. iss., 1998: 198). FDI relations among Asian DCs played an increasingly important role in this development (European Commission and UNCTAD 1996: 27). Various Asian host countries received the bulk of FDI from neighboring DCs (UNCTAD var. iss., 1999: 59). Nonetheless, FDI from the Triad remains important, especially as a source of technology transfers. But German companies contributed only marginally so far to sustainable development financing by investing in Asian DCs.

V. CHALLENGES AHEAD

Various DCs in Asia and elsewhere have witnessed the vagaries of private international capital markets during recent financial crises. This experience has highlighted the need for putting the external financing on a less crisis-prone basis, in order to promote sustainable economic development at home.

Particularly for relatively advanced DCs, this task is primarily related to the structure of **private** capital inflows. Official development financing will play a marginal role in these DCs when it comes to supplementing national savings by drawing on foreign capital. DCs with relatively high per-capita income will have to rely still more on private capital inflows, if official development financing will be directed more strongly towards low-income DCs in the future. Such a redirection of official development financing has been recommended, for example, by the Meltzer Commission (2000), in order to strengthen the orientation of multilateral lending towards poverty alleviation. The evaluation of German bilateral ODA, and FC in particular, in previous sections lends support to this suggestion.

Hence, economically advanced DCs should not pin their hopes on official development financing. With rising per-capita income, it becomes less likely that official capital inflows can compensate a sudden shortfall of private capital inflows. However, private international capital markets offer some good news for relatively advanced DCs: Volatility is largely confined to particular items of private capital flows, notably short-term bank loans and portfolio investments. By contrast, FDI inflows proved to be fairly stable even at times of crisis. This suggests that advanced DCs should welcome foreign direct investors, in order to reduce the risk of a sudden reversal in capital flows.

This is not to say that FDI provides a panacea. The growth-enhancing effects of FDI are determined by a host of factors that vary over time and across countries

(Nunnenkamp 2000a). Inter alia, the future prospects of Asian DCs to attract FDI depend on:

– whether multinational corporations will increasingly pursue global production and marketing strategies, and whether a larger number of DCs will be integrated into such strategies;

– whether European direct investors in general, and German companies in particular, will no longer prefer locations other than in Asia;

– whether still existing restrictions governing the inflow of FDI into Asian DCs will be removed;

– and whether the foreign trade regime of Asian DCs will encourage FDI inflows of "higher quality", namely world-market oriented FDI (which requires openness of recipient countries with regard to international goods markets) instead of purely local-market oriented FDI.

Recent studies offer still more good news: They reject the widespread view that FDI has persistently been concentrated on an exclusive group of some large and fairly advanced DCs (Nunnenkamp 2000a). It rather turned out that small and less advanced DCs, too, have favorable chances to attract FDI.

Yet, it is beyond serious doubt that many low-income DCs stand on the sidelines when multinational corporations take locational choices. The future of official development financing matters primarily for these DCs. This future will be shaped by two major factors: (i) the shortage of funds in major donor countries, and (ii) the critique currently raised against the traditional way of official development financing.

The financial constraints of donor countries are obvious when looking at the development of net ODA granted by all DAC-members[16] in the 1990s. While net ODA doubled in current US$ terms from 1980 to 1990, we witnessed a stagnation of net ODA in the 1990s (OECD: www.oecd.org/dac/htm/dacstats.htm). In real terms, net ODA in 1998 was by 10 percent lower than in 1990. Net ODA granted by Germany declined by 12 percent in current US$ terms, and by 22 percent in real terms, when comparing 1998 and 1990.[17] Even if the recent trend of declining ODA were stopped at the beginning of the new millennium, it is unlikely that ODA will expand considerably in real terms in the foreseeable future.

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[16] DAC stands for the Development Assistance Committee of the OECD.

[17] In contrast to Section III.1, this calculation is based on total ODA of Germany, rather than bilateral ODA.

This bleak outlook is also because official development financing is currently under fire from different angles:

- In its study "Assessing Aid", the World Bank found that traditional aid methods failed to stimulate economic growth and alleviate poverty in DCs whose economies were highly distorted due to poor economic management (World Bank 1998).

- The Meltzer Commission (2000) noted that, at the entrance to the World Bank's headquarters, a large sign reads: "Our dream is a world without poverty". The Commission continues: "Unfortunately neither the World Bank nor the regional development banks are pursuing the set of activities that could best help the world move rapidly toward that objective or even the lesser, but more fully achievable, goal of raising the living standards and the quality of life, particularly for people in the poorest nations of the world". The gap between the multilateral development banks' rhetoric and promises and their performance is attributed to the misallocation of financial resources by these banks; for instance, 70 percent of the World Bank's non-concessional resources flowed to 11 DCs that enjoyed substantial access to private international capital markets.

- Furthermore, the Meltzer Commission argues that the effectiveness of official development financing suffers from overlapping activities of international financial institutions. Regional development banks and the World Bank compete for donor funds, clients and projects. The division of labor between international financial institutions has become increasingly blurred since the IMF started lending to DCs for long-term development assistance (based on the Enhanced Structural Adjustment Facility and its successor, the Poverty Reduction and Growth Facility). The IMF is also blamed for having been excessively generous in financing large rescue packages for countries in financial distress.

- The lack of coordination among donors is not confined to multilateral institutions. In addition, the presence of various bilateral donors results in "a plethora of highly disparate aid delivery systems within each country" (Kanbur et al. 1999). Donors competing for promising projects tend to ignore that aid is largely fungible. Project-related aid releases domestic resources that may – or may not – be used productively by the recipient country (Gwin 1999). Eventually, it is not the project for which the donor provides aid, but rather the marginal project financed by released domestic resources which determines the effectiveness of aid.

- A related critique is directed towards "conditionality". Kanbur et al. (1999) argue that policymakers in recipient countries spend more time fulfilling donor requirements than discussing their own development strategies. Conditionality is typically supposed by donors "to buy economic reforms" in the recipient country: "Unfortunately, it does no such thing" (Collier 1997: 56). Conditionality may even undermine the local policymakers' incentives to take real charge of their economic reforms.[18] In other words, conditionality cannot substitute for "ownership" of development projects and programs by countries receiving assistance.

- Foreign aid tended to be almost exclusively country-based in the past. Various economists have spotted a "dearth of instruments and processes for responding to the transnational development challenges of the global era" (Ferroni 1999: 2). Accordingly, the donor community has to deal with a new challenge, namely the provision of international public goods (Kanbur et al. 1999; Kaul 1999). Frequently mentioned examples of global public "bads" that aid may help overcome include: the spread of infectious diseases, global financial instability and the degradation of the global environment.

[18] Collier (1997: 60) offers an example: "During a 15-year period, the Government of Kenya sold the same agricultural reform to the World Bank *four times*, each time reversing it after receipt of the aid".

Official development financing thus faces two major tasks in the new millennium: The effectiveness of country-focused assistance must be improved, and transnational problems must be taken into account. The latter task will require "to assist poorer countries in making their national contribution to agreed-upon global priorities" (Kaul 1999: 10). It is an open question, whether this new type of aid will be "additional". In the light of the above mentioned financial constraints of donor countries, it is not far-fetched to anticipate that the fulfillment of new tasks will at least partly come at the expense of traditional tasks.

This dilemma will be easier to resolve if recent proposals to make traditional aid more effective are taken up by the international donor community. Some of these proposals have quite dramatic consequences for the management of official development finance. First, the World Bank (1998) and the Meltzer Commission (2000) suggest that financial assistance should be targeted to low-income countries with sound economic management. This may be achieved by phasing out aid to fairly advanced DCs, and by being more selective in allocating aid among poor recipient countries (see also Gwin 1999; Hiemenz 1989).

Second, donors are required to accept that there are diminishing returns to aid, i.e., for a given policy environment, the marginal impact of aid declines as more aid is given (Gwin 1999; Berg 1997). Donors should thus prevent recipient countries from permanently becoming dependent on aid.

Third, scarce aid resources might be saved without any damage done to recipient countries, if donors avoided the duplication of activities by a better division of labor among them. In this context, the Meltzer Commission (2000) suggests that the IMF should focus on fighting financial panics by providing liquidity at times when solvent economies cannot borrow; the IMF should cease lending to countries for long-term development assistance and leave this task to the development banks. As concerns the latter, the Meltzer Commission recommends that the **regional** development banks should be given primary responsibility for country and regional programs, whereas the World Bank should concentrate on the production of global public goods and serve as a center for technical assistance.

Such a division of labor is appealing. However, it is not translated easily into practice (The Economist 2000):

- The lender-of-last-resort function of the IMF involves a fundamental conflict between fighting financial crises effectively and limiting moral hazard that tends to go along with generous IMF lending. It has been argued elsewhere (Nunnenkamp 2000b) that private creditors and investors would have to share the financial burden of the international crisis management, in order to resolve this conflict.

- The Meltzer Commission's request to scale down World Bank lending will not necessarily result in reduced overall aid flows to DCs. It is rather meant to strengthen the incentives of bilateral donors to significantly increase their support of effective programs to reduce poverty. It is highly dubious, however, whether donor countries would use released World Bank capital for expanding bilateral aid. Particularly in the United States, legislators "have masked their parochialism with rhetoric about international bureaucracies" (The Economist 2000: 86).

Fourth, the recognition that aid is largely fungible provides an important argument to move from project-related financial assistance to economy-wide approaches (Gwin 1999). Moreover, the latter should be based on development strategies designed by the recipient countries, rather than relying on externally imposed conditionality. In order to strengthen local commitment to and ownership of externally supported programs and policy reforms, a so-called common pool approach to development assistance has been suggested (Kanbur et al. 1999). The recipient country would develop its own strategy, programs and projects. It would present its plans to the donors. Each donor could then assess these plans and decide on the amount of financial assistance to the recipient country. All contributions by donors would be collected in a common pool. Earmarking of the contributions of donors and project-related monitoring by them would not be permitted.

Advocates of this new approach acknowledge that it may lead to less aid in the short run, but they expect a more positive effect of aid in the longer run. Donors may support greater effectiveness if they redirected resources absorbed traditionally by staff engaged in monitoring adherence of recipient countries to the donors' conditions, towards technical assistance for enhancing the recipient countries' capabilities to design and implement their own development strategies (Berg 1997).

If the traditional aid system will be reformed along these lines, future access to official development financing depends in large part on DC governments. Governments of DCs with low per-capita income could improve their chances to receive official development financing by designing economic reform agendas, by presenting programs targeted to poverty alleviation, by offering productive investment projects, by establishing good governance, and by contributing to the supply of international public goods. Advanced DCs, which would no longer be eligible to country-based aid, could still benefit from official development assistance by taking part in the definition and implementation of global priorities.

With donors being prepared to honor such efforts, the nexus between official development financing on the one hand and economic growth, poverty alleviation and good governance on the other hand could be strengthened. This may result in a virtuous circle: If official development financing produces more success stories in the new millennium, this may help stop the current trend of stagnating, or even declining aid. In turn, further success stories would be possible if financial constraints were eased in this way.

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