DEVELOPMENT COMMITTEE
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On the
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RECENT TRENDS IN FINANCIAL FLOWS TO DEVELOPING COUNTRIES

Attached for the September 22, 2003 Development Committee meeting is a background note entitled "Recent Trends in Financial Flows to Developing Countries". This note was prepared by the members of the International Finance Team of the Development Prospects Group of the World Bank. It focuses on developments in 2003 to date – developments that have occurred after the publication of the 2003 issue of Global Development Finance.

Recent Trends in Financial Flows to Developing Countries
A Background Note for the Development Committee Meeting of September 2003
Prepared by Staff of the World Bank[1]

The slow growth that has characterized the recovery from the global recession continued early in the year, although recent data indicate some pick up in economic activity and a firming of confidence among households and businesses. In the first quarter, the war in Iraq, transatlantic tensions, persistent concerns about terrorism, and the outbreak of severe acute respiratory syndrome undermined confidence and limited spending by consumers and businesses. GDP growth in industrial countries slowed markedly in the first quarter, to 1.4 percent in the United States, 0.6 percent in Japan, and to close to zero in the Euro Area. However, sentiment has improved more recently across the industrial countries, first in the United States with the end of the Iraq war and signs of a recovery in manufacturing. Equity prices have rallied as investors became more upbeat on earnings prospects and interest rates declined (prior to the U.S. bond sell-off in June). Equities also have rebounded strongly in Japan, coupled with a rise in industrial production and better-than-expected export performance. European economies remain sluggish, however, with declines in production indices for both manufacturing and services. Despite improved global prospects, global growth is forecast at only 2 percent for 2003, the third year in a row where growth would be well below potential.

Capital market flows

Despite the uneven recovery and political uncertainties, lower interest rates spurred investors' demand for high-yield debt.[2] Spreads on global high-yield bonds have fallen by almost half compared with the Fall of 2002. Spreads on emerging market benchmark bonds declined to just above 550 basis points by end-July, down from almost 1000 basis points in October 2002 (figure). However, the recent spike in bond yields has created significant uncertainty in the market, and secondary market spreads on developing countries' bonds rose somewhat in late July/early August.

The recovery in the secondary market through most of the first half of this year was accompanied by increased bond issuance by developing countries, to $44 billion in the first half of 2003, up from only $19 billion in the second half of 2002 (although only slightly higher than the $36 billion of bond issues in the first half of 2002) (see table). Non-investment grade bonds dominated the issuance calendar from May through August. Access for Latin American issuers eased significantly compared with the previous year. For example, Brazil was able to come to

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[1] This report was prepared by the members of the International Finance Team of the Development Prospects Group. The note focuses on developments in 2003 to date – developments that have occurred after the publication of the 2003 issue of Global Development Finance. In order to provide a broader perspective to these recent developments, a detailed table of longer-term trends in financial flows to developing countries is provided at the end of this note.

[2] Lower interest rates also encouraged borrowers to lock in rates, as the share of fixed-interest rate bonds rose to 98 percent of developing country issues, compared with just over 90 percent through 2002.

the market with a $1 billion issue, after being absent for a year. Bond issues by European developing countries also rose significantly over the first half of 2002. Access by lower-rated borrowers improved, and a few of the larger borrowers appear to have moved forward funding requirements in light of improved market conditions. The decline in interest rates could have been associated with an even sharper recovery in capital market flows, but demand for funds from the more creditworthy countries in Asia remained limited. Bond issues by Asian developing countries fell to just $4 billion, less than half the figure for the first half of 2002.

Performance of benchmark spreads
Basis points

Capital market flows to developing countries
(US$ billions)

	H1 2002	H2 2002	H1 2003	Q1 2003	Q2 2003
Total	77	72	85	36	49
Bond issues	36	19	44	20	24
Bank loans	36	47	38	14	24
Equity placements	5	6	3	2	1
Latin America	26	19	32	13	19
Europe	16	19	27	12	15
Asia	21	23	15	8	7
Others	14	10	11	3	8

In contrast to the bond market, gross commercial bank lending to developing countries fell in the first half of 2003 to $38 billion, from $47 billion in the second half of 2002 (although roughly the same level as in the first half of 2002). Data available on bank claims from the Bank for International Settlements (BIS) confirm that lending to developing countries remained weak in the first quarter. The international claims of BIS-reporting banks on developing countries did increase slightly, from $730 billion in December 2002 to $747 billion in March 2003. However, this shift reflected a moderate recovery in emerging Asia after a contraction in the previous quarter, coupled with the appreciation of the euro (which raised the dollar value of euro claims). The share of developing countries in BIS-reporting banks' international claims fell below 9 percent, compared with 11 percent in 2001. It appears that banks' appetite for risk remains limited, as their exposure to the corporate sector declined while their claims on lower-risk industrial country government securities rose.

International equity placements by developing country issuers totaled only $3 billion in the first half of 2003, down from $5 billion in the same period of 2002. Equity placements from Latin America have totaled only $136 million from July 2002 to June 2003, compared with $1.1 billion in the first half of 2002. Equity placements from East Asia, which had boomed to $5 billion in the second half of 2002, fell to only $1.3 billion, or about 60 percent of the level for the first half of 2002.

Foreign direct investment

Net foreign direct investment (inward flows less profit repatriation) to developing countries fell sharply in 2002, to an estimated $143 billion, compared to $172 billion in the previous year. The decline was centered in Latin America, due to the crisis in Argentina, slow growth or recession elsewhere, the winding down of the privatization wave, and the absence of the large mergers and acquisitions transactions that boosted flows in 2001. The availability of data on FDI flows in 2003 is limited. However, available information, gleaned from a sample of monthly and quarterly balance of payments reports from 20 countries that have typically been major recipients of FDI (and account for about 85 percent of developing countries' FDI), suggests that the downward trend is continuing (see table). Net FDI flows to this sample of countries for the first half of 2003 show a further decline, compared with the first half of 2002.

FDI flows to selected developing countries a/
(US$ billions)

	H1 2002	H2 2002	H1 2003 b/
Total	61.4	61.8	53.6
Latin America	20.3	17.3	12.6
East and South Asia	29.9	31.7	32.6
Europe and Central Asia	11.2	12.8	8.4

a/ For 20 countries (Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Venezuela, China, India, Kazakhstan, Malaysia, Philippines, Thailand, Bulgaria, Czech Republic, Hungary, Poland, Russia, Slovakia, and Turkey).
b/ Estimate.

The overall decline in FDI flows so far this year masks differences in trends across the major FDI-receiving regions:

(i) Once again, Latin America accounted for a large share of the fall in FDI. Flows increased to Chile and Ecuador, but declined to Argentina, Brazil, Colombia, Mexico and Venezuela.

(ii) Net FDI flows to East and South Asia rose slightly in the first half of 2003. But this masks the growing dominance of China in FDI, coupled with declines in other major countries. FDI to China reached $30 billion in the first half of this year, up almost $6 billion from the first half of 2002. FDI to China accelerated into the second quarter, despite the wide media attention accorded the SARS epidemic beginning in late March. By contrast, FDI declined to some of the other Asian countries for which data are available.

(iii) FDI flows to Europe and Central Asia fell by 25 percent compared with the first half of 2002. While FDI to Russia recovered from the very low level of the previous year, FDI to the Czech Republic and Hungary dropped owing to the economic slowdown in Europe.

Prospects for FDI for the remainder of 2003 are cloudy. Absent a faster-than-expected pick up in industrial economies, multinationals are likely to be constrained by balance sheet considerations. And privatization-related inflows are likely to remain weak, given the advanced stage of programs in some of the major FDI recipients (except China, where a new round of privatizations is scheduled). Still, it is notable that the disruptions from the Iraq conflict and SARS have had very limited impact on FDI flows for the last few months, indicating a continued resilience of FDI flows in the face of shocks.

Official flows

According to data released earlier this year by the OECD Development Assistance Committee, official development assistance (ODA) to developing countries from members of the DAC increased by 4.9 percent in real terms in 2002. Total ODA amounted to $57 billion, equivalent to 0.23 percent of gross national income, up from 0.22 percent in each of the last three years. Twelve of the 22 DAC countries achieved increases in ODA in 2002, with the largest gains coming from: (i) the United States ($1.5 billion), mainly in response to the terrorist attacks of September 11, 2001, as well as new aid initiatives, especially in relation to health and humanitarian aid; (ii) France ($1 billion), in line with that country's commitment to raise ODA levels to 0.5 percent of GNI by 2007 and 0.7 percent of GNI by 2012; and (iii) Italy ($0.7 billion), or 31.5 percent in real terms, reflecting contributions towards the Heavily Indebted Poor Countries Initiative, as well as contributions to the European Commission and Global Funds.

Net official development assistance, 2001-02
(US$ billions)

	2001	2002	ODA/GNI in 2002 (%)	Percent change in real terms in 2002 a/
Total ODA	52.3	57.0	0.23	4.9
G-7 countries	38.2	41.7	0.19	6.9
o/w: United States	11.4	12.9	0.12	11.6
Japan	9.8	9.2	0.23	-1.8
Germany	5.0	5.4	0.27	0.4
France	4.2	5.2	0.36	15.3
Non-G7 countries	14.1	15.3	0.46	-0.7
Memo item:				
EU countries	26.3	29.1	0.34	2.8

a/ Takes into account inflation and exchange rate movements.
Source: OECD Development Assistance Committee

Some of the smaller countries are the largest contributors to ODA, in comparison with their gross national income. The non-G7 countries had average ODA levels equal to 0.46 percent of GNI, while G7 countries' ODA levels averaged only 0.19 percent of GNI. Denmark, Norway, the Netherlands, Luxembourg, and Sweden remained the only DAC countries to achieve ODA levels above the United Nations target of 0.7 percent of GNI. In addition, three other countries (Belgium, Ireland, and France) have given a firm date to reach the 0.7 percent target.

Further increases in aid are likely to be driven by the war on terrorism and assistance to reconstruction efforts in Iraq and Afghanistan and the commitments to increase aid made leading up to or in the aftermath of the 2002 Conference on Financing for International Development in Monterrey, Mexico. The OECD estimates that if all DAC countries were to meet their targets for increases in aid, then ODA levels would rise by 31 percent, and the ODA/GNI ratio would increase to 0.26 percent, by 2006. This level would remain well below the UN target, as well as below the ratio of 0.33 percent consistently achieved until 1992. However, this target would represent a substantial rise in ODA from current levels, and some countries have made commitments for future increases in ODA beyond 2006.

Long-Term Capital Flows to Developing Countries

$ billions	Average 1985-89	1990-94	1995	1996	1997	1998	1999	2000	2001	2002
Official Development Finance	40.7	54.4	54.7	30.6	36.3	48.2	45.0	34.0	38.1	34.5
Concessional Flows	31.4	45.3	45.5	38.7	34.1	37.7	41.2	36.5	37.8	43.0
Official Grants [1]	16.7	31.0	32.8	27.8	26.7	28.2	29.4	29.6	29.5	32.9
Official Concessional Loans	14.6	14.3	12.7	10.9	7.4	9.5	11.8	6.9	8.3	10.2
Official Non-concessional Loans	9.4	9.1	9.2	-8.1	2.2	10.5	3.8	-2.5	0.3	-8.5
Private Flows	31.8	106.6	180.0	243.4	280.0	269.4	216.2	201.1	169.1	149.5
Private Loans	16.7	30.7	54.2	81.9	84.0	87.5	21.9	14.5	-8.6	-2.9
Foreign Direct Investment [2]	14.3	52.3	105.6	127.9	169.3	174.5	179.3	160.6	171.7	143.0
Portfolio Equity Investment	0.9	23.6	20.2	33.6	26.7	7.4	15.0	26.0	6.0	9.4
AGGREGATE NET FLOWS	72.6	161.0	234.7	274.0	316.3	317.6	261.2	235.1	207.2	184.0
Memorandum Items:										
Interest payments	53.2	53.0	73.9	77.7	83.1	92.4	97.1	101.9	102.5	87.1
Profits on Foreign Direct Investment	13.3	22.8	42.3	47.1	55.4	57.4	59.8	74.7	76.8	66.0
Private Grants	3.7	5.8	6.4	5.9	6.4	7.2	8.9	9.5	10.4	..
Related Data:										
Net Use of IMF Credit [3]	-3.2	1.5	16.8	1.0	14.7	19.2	-12.6	-10.8	13.4	14.5
Technical Coop. Grants	10.3	16.4	20.0	18.5	15.6	16.1	16.5	15.6	16.6	17.4
World Bank Net Flows	4.6	2.3	1.4	1.5	3.9	3.9	4.2	3.6	2.5	-4.1
IDA-Net Flows	3.3	4.7	4.9	5.7	5.3	4.8	4.5	4.3	5.0	5.6

Sources : *Global Development Finance Country Tables* and sources cited therein, World Bank Global Economic Model, OECD Development Assistance Committee's *Geographic Distribution of Flows* .

Note: 2002 numbers are estimates.

1/ Excludes Technical Cooperation.

2/ Source: IMF data complemented by country cources.

3/ Includes IMF Trust Fund and PRGF.

Long-Term Capital Flows to Developing Countries

(US$ billions, at constant 2002 prices)	Average 1985-89	1990-94	1995	1996	1997	1998	1999	2000	2001	2002
Official Development Finance	48.9	58.3	53.9	29.2	35.0	48.3	45.3	33.6	38.4	34.5
Concessional Flows	37.6	48.5	44.9	37.0	32.9	37.8	41.5	36.1	38.1	43.0
Official Grants [1]	20.0	33.1	32.3	26.6	25.7	28.3	29.6	29.3	29.7	32.9
Official Concessional Loans	17.5	15.3	12.5	10.4	7.1	9.5	11.9	6.8	8.4	10.2
Official Non-concessional Loans	11.4	9.8	9.1	-7.7	2.1	10.5	3.8	-2.5	0.3	-8.5
Private Flows	38.1	112.7	177.5	232.6	269.9	270.2	217.7	198.9	170.3	149.5
Private Loans	20.1	32.5	53.4	78.2	81.0	87.8	22.1	14.3	-8.7	-2.9
Foreign Direct Investment [2]	17.0	55.3	104.1	122.2	163.2	175.0	180.6	158.8	172.9	143.0
Portfolio Equity Investment	1.0	24.9	19.9	32.1	25.7	7.4	15.1	25.7	6.0	9.4
AGGREGATE NET FLOWS	87.0	171.0	231.4	261.8	304.9	318.6	263.1	232.5	208.7	184.0
Memorandum Items:										
Interest payments	63.9	56.6	72.9	74.2	80.1	92.7	97.8	100.8	103.2	87.1
Profits on Foreign Direct Investment	15.9	24.2	41.7	45.0	53.4	57.6	60.2	73.9	77.3	66.0
Private Grants	4.4	6.2	6.3	5.6	6.2	7.2	9.0	9.4	10.5	..
Related Data:										
Net Use of IMF Credit [3]	-3.7	1.6	16.6	1.0	14.2	19.3	-12.7	-10.7	13.5	14.5
Technical Coop. Grants	12.3	17.5	19.7	17.7	15.0	16.1	16.6	15.4	16.7	17.4
World Bank Net Flows	5.5	2.5	1.4	1.4	3.8	3.9	4.2	3.6	2.5	-4.1
IDA-Net Flows	4.0	5.0	4.8	5.4	5.1	4.8	4.5	4.3	5.0	5.6

Sources : *Global Development Finance Country Tables* and sources cited therein, World Bank Global Economic Model, OECD Development Assistance Committee's *Geographic Distribution of Flows* .

Note: 2002 numbers are estimates.

1/ Excludes Technical Cooperation.

2/ Source: IMF data complimented by country cources.

3/ Includes IMF Trust Fund and PRGF.