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Financial Flows to Developing Countries: Recent Trends and Near-Term Prospects

THE GLOBAL RECOVERY BROADENED in 2004, boosting world gross domestic product (GDP) by an estimated 3.8 percent—the highest rate in four years and up sharply from 2.5 percent in 2003 and 1.7 percent in 2002.[1] Gradual realignment of stimulative monetary policies in many advanced countries led to modest increases in short-term interest rates during the year (particularly in the United States), but long-term rates remained low in most advanced and developing countries, particularly when adjusted for inflation. Macroeconomic objectives were attained in most developing countries, and progress was made on key structural reform initiatives. These favorable external and domestic factors contributed to strongly improving economic fundamentals, as reflected in a record expansion in developing-world GDP growth (6.6 percent in 2004, much higher than the global average), upgrades in credit ratings, and a reduction in emerging-market bond spreads to near record lows by the end of the year.

Against this favorable backdrop, capital flows to developing countries continued to expand in 2004, following a strong rebound in 2003. This chapter examines key developments and emerging trends in the various components of capital flows and considers the outlook for continued short-term gains. Among our main findings:

- The pickup in capital flows to developing countries over the past two years has coincided with a dramatic improvement in their current account balances. Developing countries continue to export capital to developed countries (mostly the United States) in the form of rapidly growing accumulations of foreign reserves.
- Flows of foreign direct investment (FDI) into developing countries have become increasingly concentrated, while FDI *outflows* from developing countries have increased dramatically.
- Most emerging market economies have taken advantage of favorable financing conditions over the past few years to restructure their debt.
- Strong gains in private capital flows over the past few years have been partly offset by declining official flows arising from large repayments to bilateral and multilateral creditors.
- Within official flows, the shift from loans to grants has accelerated, with the decline in net official lending more than offset by the increase in bilateral aid grants, but not to the extent of official aid commitments. More resources are needed to support efforts to reach the MDGs.

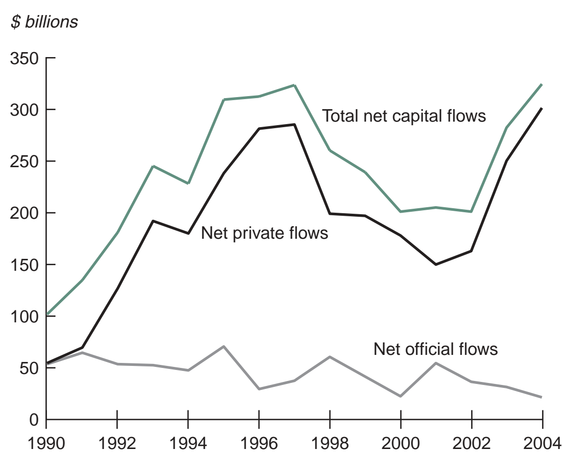
Capital flows to developing countries

Capital flows continue recovery, but pace slows

Net capital flows increased by $42 billion in 2004, continuing the recovery that began in 2003, although at a slower pace than the $81 billion rebound of 2003 (figure 1.1 and table 1.1). Private and official net debt flows reached a record high of $324 billion in 2004, up significantly from $200 billion during 2000–2 and just above the $323 billion level reached in 1997.

The pickup in net capital flows over the past two years appears more modest after taking into account inflation, economic growth, and the sizeable depreciation of the dollar against most major

Figure 1.1 Financial flows to developing countries, 1990–2004



Sources: World Bank Debtor Reporting System and staff estimates.

currencies. The offsetting impact of these factors can be captured by measuring capital flows as a percentage of GDP in the recipient countries (figure 1.2). From this perspective, recent performance has been less robust: net capital flows to developing countries equaled 4.5 percent of their GDP in 2004, up slightly from 4.3 percent in 2003, but significantly below highs of more than 6 percent reached in the mid-1990s.

Developing countries continue to export capital

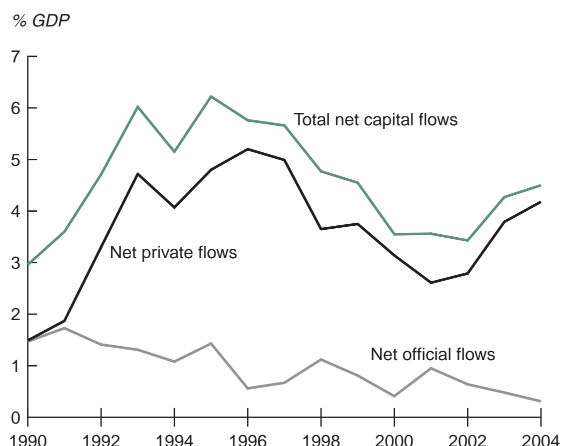
Current account balances in developing countries continue to strengthen, swelling from a slight deficit in 1999 to a surplus of $153 billion in 2004. That surplus was equal to 2.0 percent of their GDP (table 1.1), up from 1.8 percent

Table 1.1 Net capital flows to developing countries, 1996–2004
$ billions

	1996	1997	1998	1999	2000	2001	2002	2003	2004e
Current account balance	−83.6	−87.2	−93.7	−8.0	43.6	16.9	72.0	112.8	152.7
as % of GDP	−1.7	−1.7	−1.6	−0.1	0.8	0.4	1.3	1.8	2.0
Financed by:									
Net equity flows	161.4	190.6	178.1	195.1	178.6	180.9	159.8	176.6	192.3
Net FDI inflows	128.6	168.1	171.5	182.4	166.2	174.8	154.0	151.8	165.5
Net portfolio equity inflows	32.9	22.6	6.6	12.7	12.4	6.0	5.8	24.8	26.8
Net debt flows	123.7	106.9	54.9	15.4	−6.2	−3.5	8.9	62.2	84.1
Official creditors	3.8	12.9	34.4	13.9	−5.8	27.0	5.2	−11.6	−24.9
World Bank	7.3	9.2	8.7	8.8	7.9	7.5	−0.2	−1.2	−1.4
IMF	1.0	3.4	14.1	−2.2	−10.7	19.5	14.0	2.4	−10.9
Others	−4.5	0.4	11.6	7.3	−3.0	0.0	−8.6	−12.8	−12.7
Private creditors	119.9	94.0	20.5	1.5	−0.4	−30.5	3.7	73.8	109.0
Net medium- and long-term debt flows	82.5	84.8	85.0	21.6	7.4	−6.6	0.9	24.9	55.4
Bonds	49.5	38.2	39.7	29.8	17.5	11.0	11.2	28.1	63.0
Banks	30.7	43.8	50.4	−6.8	−5.8	−11.0	−3.8	3.1	−1.8
Others	2.3	2.9	−5.2	−1.5	−4.3	−6.5	−6.5	−6.3	−5.7
Net short-term debt flows	37.4	9.2	−64.5	−20.1	−7.9	−23.9	2.8	48.9	53.6
Balancing item[a]	−111.2	−157.5	−122.9	−169.1	−169.1	−112.5	−69.0	−59.9	−50.9
Change in reserves (− = increase)	−90.4	−52.9	−16.3	−33.4	−46.8	−81.7	−171.7	−291.9	−378.2
Memo items:									
Total foreign aid (grants) (ex technical cooperation grants)	26.7	25.3	26.7	28.5	28.7	27.9	32.2	43.4	47.4
Net private flows (debt + equity)	281.3	284.6	198.6	196.6	178.1	150.3	163.5	250.4	301.3
Net official flows (aid + debt)	30.5	38.2	61.1	42.4	23.0	54.9	37.4	31.7	22.5
Total net capital flows (private and offical)	311.8	322.8	259.6	239.1	201.1	205.2	200.9	282.1	323.8

Note: e = estimate
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.
Sources: World Bank Debtor Reporting System and staff estimates; IMF, *Balance of Payments Yearbook,* various years; and Dealogic Bondware and Loanware.

Figure 1.2 Financial flows to developing countries as a percentage of GDP, 1990–2004



Sources: World Bank Debtor Reporting System and staff estimates.

Figure 1.3 Current account balance of developing countries, 1976–2004

Sources: IMF; World Bank staff estimates.

in 2003. Current account surpluses in the developing world are a dramatic change from previous decades, when the developing countries as a group consistently ran modest current account deficits (figure 1.3) that averaged 1.4 percent of their GDP from 1976 to 1999. The swing in the current account is even more dramatic in low-income countries, where current account deficits averaged 2.3 percent of GDP in 1976–99 (figure 1.3).

The pace of reserve accumulation accelerates

The dramatic current account surpluses chalked up in the past few years have been used primarily to accumulate foreign exchange reserves, rather than to finance productive domestic investments. That trend accelerated last year, as foreign reserve accumulation in developing countries continued to finance a large share of the U.S. current account deficit in 2004. Foreign reserves held by developing countries grew by $378 billion in 2004 (4.9 percent of GDP), following a $291 billion (4.1 percent of GDP) increase in 2003. Meanwhile, the U.S. current account deficit ballooned from $531 billion in 2003 (4.8 percent of GDP) to $666 billion in 2004 (5.6 percent of GDP).

The acceleration in reserve accumulation was highly concentrated in just a few countries.[2] China accounted for more than half of the increase in 2004, with foreign reserves increasing by $207 billion. China's share of developing-country reserve holdings rose from 33 percent in 2003 to 38 percent in 2004.

Strong gains in private flows were partly offset by declining official flows

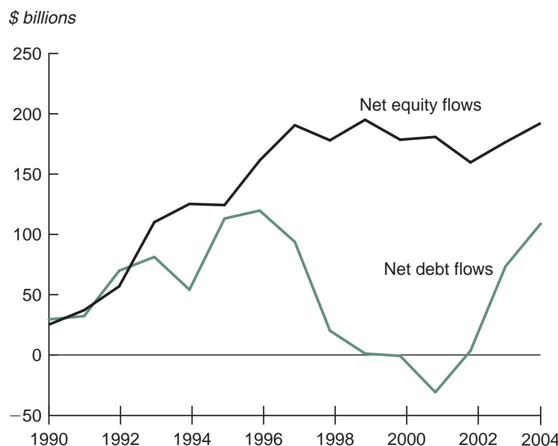
The pickup in net capital flows over the past few years (measured in dollars) reflects strong gains in net private flows as well as declines in net official flows (figure 1.1). Net private flows (debt and equity) have grown by a cumulative total of $140 billion since 2001, rising from 3.8 to 4.2 percent of GDP—still below the high of 5.2 percent reached in 1996 (figure 1.2). In contrast, net official flows (concessional aid and long-term debt) have declined by a cumulative total of $32 billion since 2001 (from 1.0 to 0.3 percent of GDP). The $20 billion increase in bilateral aid that has occurred has been eclipsed by a $52 billion decline in net official lending, which reflects large repayments made to multilateral and bilateral creditors. From a historical perspective, the recent decline in net official flows continues a downward trend that began in the early 1990s (figures 1.1 and 1.2).

Capital flows from the private sector

Debt and equity flows showed modest gains

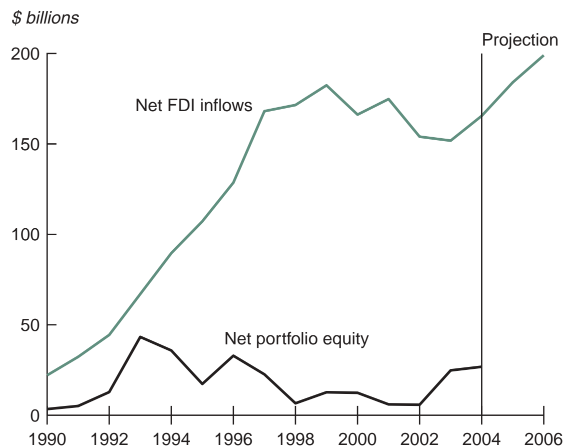
Net private flows (debt and equity) increased by $51 billion in 2004, following a $87 billion surge in 2003. The modest gains in 2004 were split between net debt and equity flows (figure 1.4).

Figure 1.4 Financial flows to developing countries from the private sector, 1990–2004



Sources: World Bank Debtor Reporting System and staff estimates.

Figure 1.5 Net equity flows to developing countries, 1990–2006



Sources: World Bank Debtor Reporting System and staff estimates.

Net equity flows increased by $16 billion in 2004, reaching $192 billion in 2004, marginally below the $195 billion peak attained in 1999. Net equity flows have been stable at 2.7 percent of GDP since 2002, below the high of 3.7 percent attained in 1999.

Net private debt flows increased by $35 billion in 2004, reaching $109 billion, up significantly from a low of –$30 billion recorded in 2001, but still below the high of $120 billion recorded in 1995. As a percentage of GDP, net debt flows increased from –0.5 percent in 2001 to 1.4 percent in 2004 (compared to the high of 2.3 percent reached in 1995).

Equity flows have been much more stable than debt flows since the late 1990s (figure 1.4). Why? First, FDI inflows—the largest component of equity flows—have been much more stable than flows of debt and portfolio equity (figures 1.4 and 1.5).[3] Second, net FDI and portfolio equity flows have been negatively correlated over the past few years,[4] so that the sum (net equity flows) becomes even more stable. This negative correlation reflects the substitutability of the two categories of equity. For example, mergers and acquisitions often involve reclassifying portfolio equity claims as FDI claims, which entails offsetting changes in net FDI and portfolio equity flows.[5]

FDI is increasingly concentrated

Economic conditions over the past few years have favored FDI inflows to developing countries. The investment climate in many developing countries has improved markedly, with higher corporate earnings, liberalization of foreign ownership rules, and a stronger global recovery. In response to these improvements, net FDI inflows to developing countries increased by $14 billion (9 percent) in 2004, partly reversing a $23 billion cumulative decline in the previous two years (figure 1.5).

The increase was spread across most regions, with the exception of the Middle East and North Africa (table 1.2). In Latin America, a $6 billion rebound reversed substantial declines in the previous four years and raised Latin America's share of net FDI inflows to developing countries slightly from 25 percent in 2003 to 26 percent in 2004, still well below the share of 48 percent the region reached in 1999–2000. The East Asia and Pacific region

Table 1.2 Regional composition of net FDI inflows to developing countries, 2002–4
$ billions

	2002	2003	2004e
All developing countries	154.0	151.8	165.5
Regional composition			
East Asia and Pacific	55.6	59.6	63.6
of which China	49.3	53.5	56.0
Latin America and Caribbean	45.7	36.5	42.4
East Europe and Central Asia	35.0	35.6	37.6
Sub-Saharan Africa	9.0	10.1	11.3
South Asia	4.8	5.2	6.5
Middle East and North Africa	3.8	4.8	4.1

Note: e = estimate
Sources: World Bank Debtor Reporting System and staff estimates.

received a $4 billion increase in FDI inflows in 2004, bringing its share of FDI flows to the developing world to 38 percent, down slightly from 2003 but still substantially above the 27 percent average share for the period 1999–2001. FDI to Europe and Central Asia has stabilized over the past three years at 23 percent of the developing-world total, significantly above its 9 percent share in 1994.

The widely distributed regional gains in FDI inflows mask concentration at the country level. Fully 88 percent of the estimated *increase* in net FDI flows to developing countries in 2004 went to five countries—Brazil, China, India, Mexico, and the Russian Federation. To understand this pattern, remember that several of these countries—China, India, and the Russian Federation—grew significantly faster than other developing countries. The same five account for just over 60 percent of net FDI inflows in 2004, up from 57 percent during the previous three years. China accounted for one-third of net FDI inflows to all developing countries[6] (down from 35 percent in 2003) and for almost 90 percent of net FDI inflows to the East Asia and Pacific region, a share unchanged from its average of the previous three years.

The share of net FDI inflows going to low-income countries increased substantially over the past four years, rising from a low of less than 7 percent in 2000 to almost 11 percent in 2003/04, the highest level in the past 15 years (figure 1.6). The increase reflects strong gains in FDI in India's service sector and in the oil and gas sectors of a few African countries (Angola, Chad, Equatorial Guinea, and Sudan). The share of FDI going to the least developed countries has shown steady gains over the past 10 years, rising from a low of 1 percent in 1994 to just under 5 percent in 2003/04.[7]

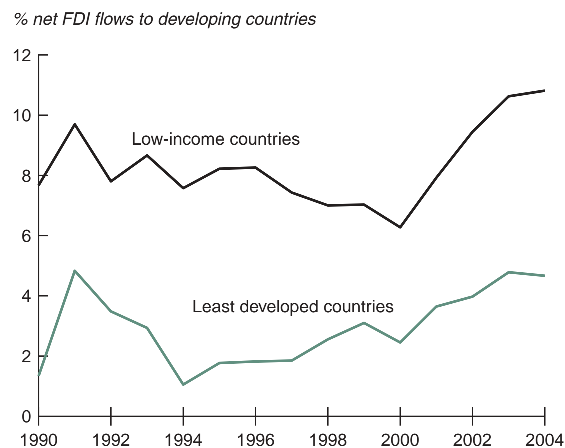
FDI outflows from developing countries increased dramatically

Faced with growing competition and limited markets at home, many companies in developing countries have sought to expand their operations abroad. Relaxed controls on capital outflows have allowed them to pursue global investment opportunities more aggressively in recent years. As a consequence, FDI outflows from developing countries have swelled over the past few years, rising from $3 billion (0.1 percent of GNI) in 1991 to $16 billion (0.3 percent of GNI) in 2002, and then surging to an estimated $40 billion (almost 0.6 percent of GNI) in 2004 (figure 1.7).

The increase in FDI outflows is concentrated in many of the same countries that receive the bulk of FDI *inflows* to developing countries—Brazil, China, India, Mexico, and the Russian Federation).[8] However, the correspondence between developing-country shares of FDI inflows and outflows is not very tight. For example, China accounted for one-third of FDI inflows to developing countries in 2004, but less than 10 percent of the estimated outflows.

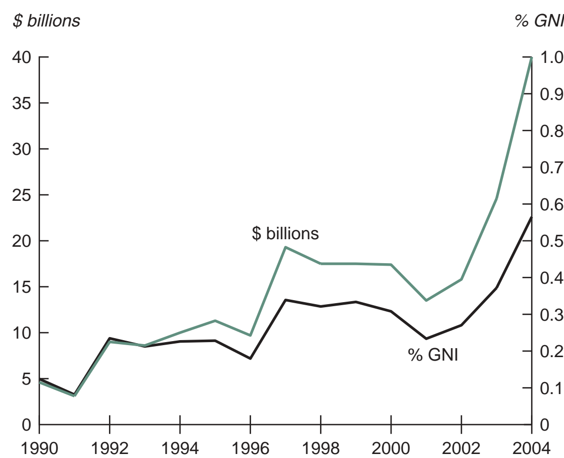
Much of the surge in FDI outflows in recent years can be traced to developing countries

Figure 1.6 Share of net FDI inflows to low-income and least developed countries, 1990–2004



Sources: World Bank Debtor Reporting System and staff estimates.

Figure 1.7 FDI outflows from developing countries, 1990–2004



Sources: World Bank Debtor Reporting System and staff estimates.

investing abroad in developed countries, as well as other developing countries.[9] This has enabled companies to expand and diversify their operations across a wider spectrum of countries and provide greater scope for diffusion of technical innovation and managerial expertise.

Because of the poor quality and coverage of data on FDI outflows from developing countries (many developing countries do not even record statistics on FDI outflows), the reported figures are substantial underestimates.[10] The quality and country coverage of the data are improving, however, and measurement improvements almost certainly account for some of the increase in reported FDI outflows over the past few years, as shown in figure 1.7.

Prospects for net FDI flows

The short-term prospects are good for further modest gains in FDI inflows to developing countries. As

Box 1.1 Measuring capital flows in dollars versus as a percentage of GDP

Capital flows to developing countries are in one of three major currencies—the dollar (the most common), the euro, or the Japanese yen. Transactions in currencies other than the dollar are typically converted into dollars to facilitate comparison. The exchange rate used in the conversion can have a major influence on comparisons across countries and over time.

To illustrate, consider a case in which transactions are made in euros. A €1 billion transaction would have been valued at $0.88 billion in February 2002, but $1.34 billion in December 2004—a 52 percent increase caused by the depreciation of the dollar against the euro.

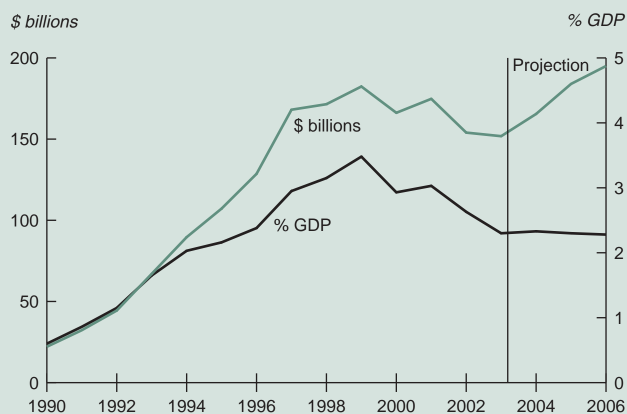
In the simple case where the recipient country's exchange rate is fixed to the euro and it trades exclusively with euro zone countries, the purchasing power of capital flows is best measured in euros. Converting the euro value to dollars in such cases greatly overstates the purchasing power of capital flows.

In general, the purchasing power of capital flows will depend on the recipient country's exchange-rate regime, as well as the response of domestic prices to changes in the exchange rate. This can be captured by comparing the value of capital flows received with the value of goods and services that the recipient country produces, as measured by its GDP. Returning to the simple example outlined above, the 52 percent appreciation of the euro against the dollar would have no effect on capital flows measured as a percentage of GDP.

Measuring capital flows as a percentage of GDP also takes into account inflation and economic growth. The value of GDP in developing countries, measured in dollars, has grown at an average annual rate of 7.6 percent over the past 40 years, which reflects an average real growth rate of 4.2 percent and an implicit average inflation rate of 3.4 percent (measured in dollars). Meanwhile, the value of capital flows to developing countries (again measured in dollars) has increased at an average annual rate of 9 percent, thereby exceeding the rate of real economic growth and inflation by 1.4 percentage points on average. This indicates that the value of capital flows has not only maintained its purchasing power relative to the general price level (inflation), but also has increased faster than the expansion in real economic activity.

The distinction between measuring capital flows in dollars and as a percent of GDP is well illustrated with reference to net FDI flows to developing countries, as shown in the figure. Net FDI inflows are projected to increase from $152 billion in 2003 to a record high of $195 billion in 2006. The projected average growth rate of 9 percent is similar to that projected for GDP; hence, net FDI inflows are projected to be constant as a share of GDP. They are not expected to meet or exceed the level of 3 percent of GDP observed in the late 1990s.

Net FDI flows to developing countries, 1990–2006



Sources: World Bank Debtor Reporting System and staff estimates.

economic fundamentals strengthen further and countries continue to implement policies designed to attract investment, the climate should continue to improve, especially with regard to liberalization of restrictions on foreign ownership (notably in India).

Econometric projections based on economic fundamentals indicate that over the next two years, FDI inflows will grow at the 9 percent rate recorded in 2004, keeping net FDI inflows at about 2.3 percent of developing-country GDP (see box 1.1).[11]

Small gains in portfolio equity flows in the face of volatile equity prices

Net portfolio equity flows registered a small increase of $2 billion in 2004, following a surge of $19 billion in 2003. The $21 billion increase over the past two years was spread across most regions, with the exception of Latin America and the Caribbean, where flows dropped by $5 billion in 2004, after increasing by $2 billion in 2003 (table 1.3). Almost half of the global gains of the past two years came in the East Asia and Pacific region ($9.5 billion). China dominated, with a $8.3 billion increase, accounting for almost 40 percent of net portfolio equity flows to all developing countries in 2004. There were also strong gains in South Asia, where India recorded a $6.4 billion increase over the past two years, bringing its share to one-third of the total for the developing world.

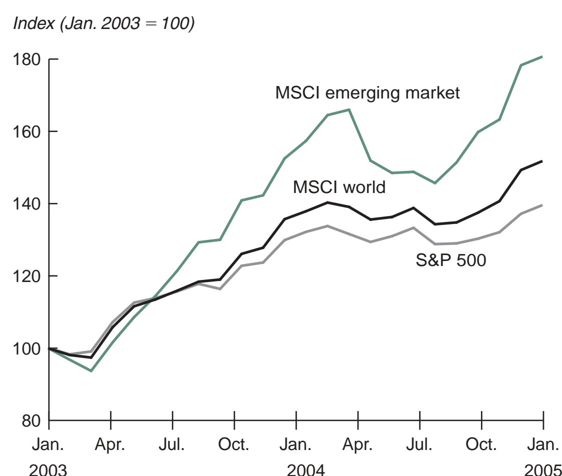
Portfolio equity flows continue to be highly concentrated in just a few countries—China, India, and South Africa together accounted for 82 percent of all portfolio equity flows to developing countries in 2004, close to their average share for the past five years (85 percent). Eleven percent of portfolio equity flows to developing countries went to low-income countries, up from 7 percent five years ago, while 5 percent went to the least-developed countries, up from 3 percent five years ago.

Table 1.3 Regional composition of net portfolio flows to developing countries, 2002–4
$ billions

	2002	2003	2004e
All developing countries	5.8	24.8	26.8
Regional composition			
East Asia and Pacific	4.0	11.8	13.6
of which China	2.2	7.7	10.5
Latin America and Caribbean	1.4	3.4	−1.5
East Europe and Central Asia	−0.1	0.6	3.6
Sub-Saharan Africa	−0.4	0.7	3.5
South Asia	1.1	8.2	7.5
Middle East and North Africa	−0.2	0.1	0.2

Note: e = estimate
Sources: World Bank Debtor Reporting System and staff estimates.

Figure 1.8 Equity price indexes, 2003–4



Sources: J.P. Morgan Chase and Standard and Poor's.

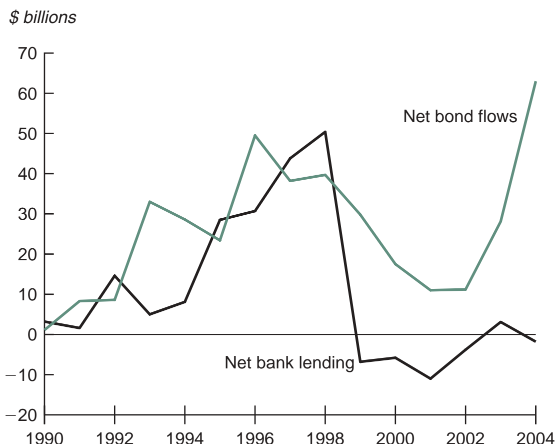
The strong rebound in portfolio equity flows in 2003, followed by small gains in 2004, rode the back of large swings in emerging-market equity prices. Equity prices rallied strongly throughout much of 2003, followed by a sizeable correction in the first half of 2004 and then a rebound in the second half of the year (figure 1.8).

The large swings in equity prices over the year were mirrored in investments in emerging-market equity funds. Inflows reached $3.1 billion in the first quarter, reversed quickly to net outflows of $1.4 billion between May and August, and then recovered partially to finish the year with net inflows of $0.4 billion. Average returns on equity in emerging markets have been higher than in mature markets over the past two years (figure 1.8), but prices have been much more volatile. Major divergences in equity prices have occurred across regions, with emerging Europe and Latin America outperforming emerging Asia by a wide margin.

The ongoing shift from bank to bond finance

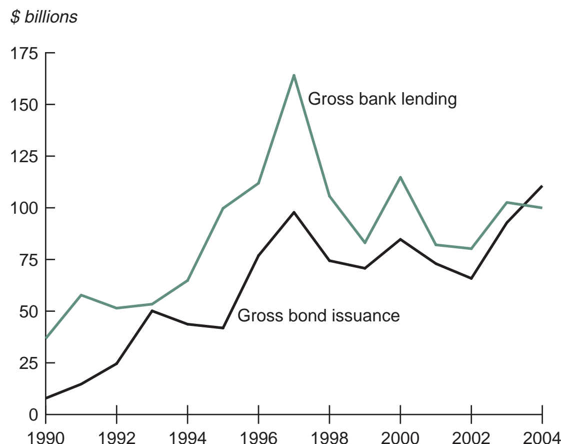
Net medium- and long-term lending by banks to developing countries has been on the decline since the late 1990s, as bond issuance has risen. Net medium- and long-term bank lending declined by $2 billion in 2004, following a $3 billion increase in 2003 and declines averaging $7 billion during the previous four years (figure 1.9). In contrast, medium- and

Figure 1.9 Net private debt flows to developing countries, 1990–2004



Sources: World Bank Debtor Reporting System and staff estimates.

Figure 1.10 Gross private flows to developing countries, 1990–2004



Sources: Dealogic Bondware and Loanware.

long-term net bond flows rebounded sharply over the past two years, increasing by a total of $52 billion, reaching a record high of $63 billion in 2004. *Gross* bond financing also increased dramatically over the past two years, exceeding *gross* bank lending for the first time (figure 1.10).

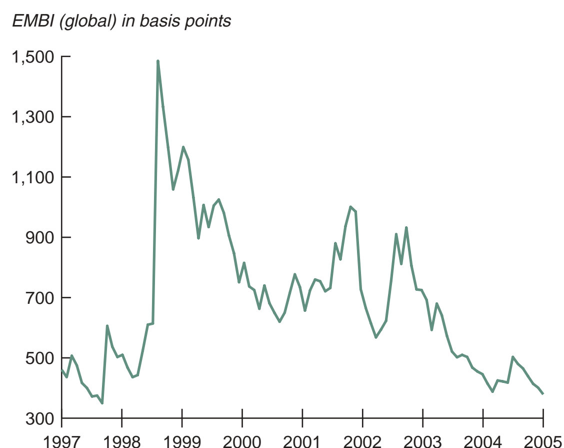
Bank lending continues to cater to a wide array of developing countries' financing needs, despite the declines in net lending over the past six years. Twice as many countries tapped this segment of the debt markets in 2004 than the bond financing segment. The private corporate sector accounts for a growing share of bank credit to developing countries. That share increased to 67 percent in 2004, compared with 57 percent in 2003. In comparison, the private sector accounted for only a third of total developing-country bond financing.

The strong gains in bond issuance over the past two years reflect both "push" and "pull" factors that sparked investors' interest in the emerging-market asset class. Low interest rates in advanced countries propelled a search for yield in higher-risk assets, while improved fundamentals in most emerging-market economies lowered investors' assessment of default risk significantly.

Emerging market bond markets exhibited volatility in the first half of 2004, matching that in portfolio equity. In April/May, bond spreads widened by about 125 basis points as various indicators suggested that the global recovery was stronger than anticipated (particularly in the United States and Japan), which raised concerns that central banks would be forced to raise interest rates abruptly. These concerns dissipated over the course of the year, however, as it became evident that the global recovery was decelerating and interest rate increases would be implemented gradually. Emerging-market bond spreads narrowed over the second half of 2004—despite increases in short-term interest rates in many advanced countries (the United States in particular). The Emerging Markets Bond Index (EMBI) spread narrowed from a peak of 550 basis points in May to below 350 basis points in December, the lowest level since 1997 (figure 1.11). The last time that the EMBI spread was below 500 basis points was in April 1998, just before the sharp increase to almost 1,500 basis points in August 1998, in the wake of the financial crisis in the Russian Federation.

Some emerging market economies, particularly in Latin America, had difficulties accessing external capital markets when bond spreads widened suddenly in the spring. Since then, bond issuance by developing countries has been resilient, even in the face of heightened economic and geopolitical uncertainty. The narrowing of bond spreads to near record lows indicates that the transition to higher interest rates in most advanced countries over the course of the year and the significant increase in world oil prices have had little impact to date on investors' assessment of risk in the emerging-market asset class. Investors' sanguine assessment is also reflected in improved credit ratings for many emerging market economies.

Figure 1.11 Emerging-market bond spreads, 1997–2004



Source: J.P. Morgan Chase.

Prospects for private debt flows

The outlook for private debt financing is expected to remain quite positive in the short run, but could become less benign over the medium term. However, the probability of a generalized credit compression or major retrenchment remains low.

The dynamics of both the supply of capital by investors and the demand for funds by developing countries are likely to dampen flows in 2005. Creeping tensions in pricing may put pressure on benchmark spreads to widen, while rising benchmark rates used in pricing bank loans (the Libor, in particular) may also curtail loan financing. In addition, uncertainty surrounding the future path of interest rates may raise market volatility and further discourage bond issuance. Given the competitive pricing of developing-country risk, opportunistic profit-taking by investors may also exert occasional pressures on spreads to widen.

The supply of capital for developing countries may be affected by new, high-yield investment opportunities in the developed world. Improved corporate profitability in industrial countries, particularly for firms in high-yield sectors, would sharpen competition for investment funds. At the same time, the lingering weakness in global equity markets, especially in the technology sector, could erode investor sentiment, reducing appetite for risk.

The prospect of higher interest rates in advanced countries continues to pose a major downside risk. Although short- and long-term interest rates in the United States and the euro zone remain relatively low, particularly when adjusted for inflation, the monetary tightening that began in the United States in June 2004 has brought higher short-term rates. To date, long-term rates have shown little movement. In fact, the yield on the benchmark 10-year U.S. Treasury note decreased by 50 basis points between June and December, while the yield on one-month U.S. Treasury bills increased by 100 basis points. Monetary conditions in the United States are expected to continue to tighten gradually over the balance of the year as the slack in the U.S. economy is reduced. The risk of an abrupt increase in U.S. interest rates remains a serious concern. Large, sudden movements in long-term rates, in particular, could provoke a sharp widening of emerging-market bond spreads.

The potential impact of global imbalances on exchange rates also clouds the prospects for private capital flows to developing countries. Abrupt movements in exchange rates—as in interest rates—could cause emerging-market bond spreads to widen dramatically, which could have significant implications for those emerging market economies that have high debt burdens and heavy financing needs (see chapter 3).

On the upside, most developing countries are now less vulnerable to a sudden shift in investor sentiment than they were a few years ago. The external and domestic credit quality of many countries has improved significantly over the past few years. Moreover, there has been a marked decline in speculative positions in emerging-market assets over the past 10 years.

Favorable financial conditions have enabled many emerging market economies to prefinance a significant portion of their external funding requirements for 2005. Some countries have also taken the opportunity to strengthen their debt management by issuing a higher proportion of bonds that have longer maturities, are denominated in domestic currency, or are not indexed to the exchange rate, inflation, or short-term interest rates. In addition, many emerging market economies have accumulated additional foreign reserves over the past year (see chapter 3). Taken together, these initiatives should make many emerging market economies less vulnerable to the risk of a sharp deterioration in financing conditions.

Contagion is always a possibility, but it is less likely than in earlier periods, as investors appear to

be more discerning in assessing risks across countries. Thus, while pressures on pricing remain, the probability of a sharp sell-off of emerging-market debt remains limited.

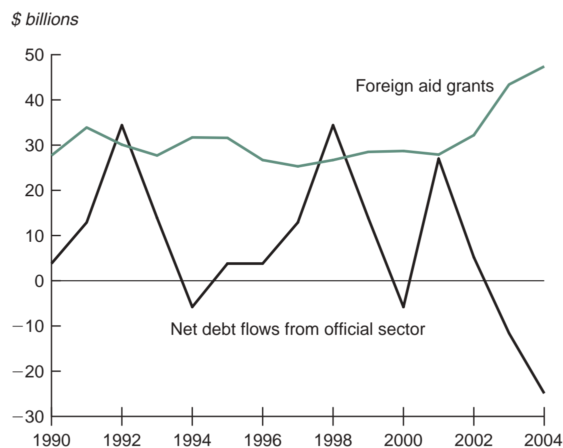
Capital flows from the official sector

Shift from loans to grants accelerates

Official flows of development finance have shown a dramatic shift from loans to grants over the past three years (figure 1.12). Foreign aid grants have increased by a cumulative total of $20 billion during the period, while net official lending has declined by $52 billion—implying a $32 billion decline in net official flows (aid and lending combined).

Most of the decline in net official lending over the past three years can be attributed to a cumulative $30 billion decline in net lending by the IMF, which reflects net repayments to the IMF of large disbursements of emergency assistance in 2001—mainly to Argentina, Brazil, and Turkey. Net lending by bilateral donors declined by a cumulative total of $14 billion over the past three years, largely from the shift in funding from loans to grants and because of prepayments by some developing countries of earlier debt obligations to the Paris Club. In addition, net lending by the World Bank fell by a cumulative total of $9 billion over the three years as some developing countries (notably China, India, and Thailand) repaid a portion on their loans ahead of schedule, while other developing countries (notably Argentina, Indonesia, and the Russian Federation) repaid structural adjustment loans made in the midst of financial crises in the late 1990s.

Figure 1.12 Official debt flows and foreign aid grants, 1990–2004



Source: World Bank Debtor Reporting System.

Net official debt flows, then, have been dominated by cycles in medium-term (three- to five-year) financing to developing countries in crisis and by unscheduled repayments (prepayments) on bilateral and multilateral loans. A better measure of the resources available to finance countries' long-term development needs is provided by official development assistance (ODA), because ODA is defined by the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD) as aid grants and concessional loans made by donor governments and multilateral agencies *for the purpose of promoting economic development and welfare.*

Progress on official aid commitments

ODA data for 2004 will not be available until April 2005. In 2003, ODA increased by $10 billion to reach $69 billion, following a $6 billion increase in 2002 (table 1.4). This represents a nominal increase of 18 percent in 2003, following a 2002 increase of 11 percent. But in real terms (adjusting for inflation and exchange-rate changes), ODA increased by just 5 percent in 2003 and 7 percent in 2002.

Strategic factors continue to play a major role in the allocation of ODA across recipient countries. In particular, the share of bilateral ODA disbursements to five countries—Afghanistan, Colombia, Iraq, Jordan, and Pakistan—has increased from 3 percent on average during 1980–2000 to more than 6 percent in 2001–2, and more than 11 percent in 2003. Reconstruction aid to Iraq alone totaled $2.2 billion in 2004. Although the scope for improved aid effectiveness has improved in some of those countries, such changes alone cannot account for the size of the increase in their shares of ODA.

From the perspective of the recipient countries, net ODA flows have grown gradually over the past few years. ODA has been quite stable as a share of GDP in recipient countries, averaging just over 1 percent since 1996, below the high of 2 percent reached in 1991 (figure 1.13). For the poorest recipient countries (excluding those in conflict or postconflict), ODA has averaged just over 2 percent since 1996, well below the high of 3.7 percent in 1992.

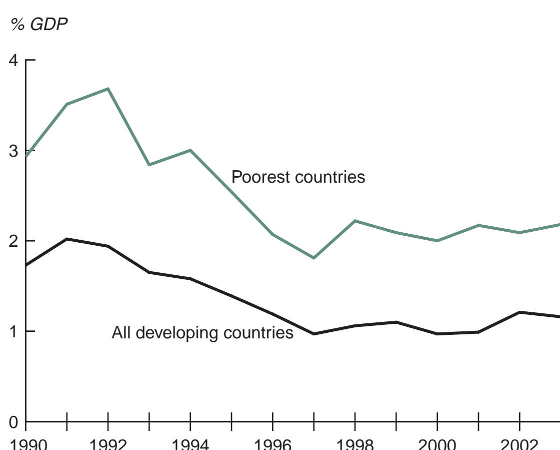
Half of net ODA flows in 2003 were comprised of special-purpose grants, which include

Table 1.4 Net official development assistance (ODA) from principal donor countries, 1990–2003
$ billions

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	Percent change in real terms in 2003[a]
Total ODA	54.3	58.3	62.4	56.1	58.8	58.8	55.6	48.5	52.1	53.2	53.7	52.4	58.3	69.0	4.8
G-7 countries	42.4	45.6	48.6	44.6	46.6	44.7	41.3	35.1	38.6	39.4	40.2	38.2	42.6	49.9	6.3
United States	11.4	11.3	11.7	10.1	9.9	7.4	9.4	6.9	8.8	9.1	10.0	11.4	13.3	16.3	20.4
Japan	9.1	11.0	11.2	11.3	13.2	14.5	9.4	9.4	10.6	12.2	13.5	9.8	9.3	8.9	−9.2
France	7.2	7.4	8.3	7.9	8.5	8.4	7.5	6.3	5.7	5.6	4.1	4.2	5.5	7.3	8.7
Germany	6.3	6.9	7.6	7.0	6.8	7.5	7.6	5.9	5.6	5.5	5.0	5.0	5.3	6.8	5.3
Non-G-7 countries	11.8	12.7	13.8	11.5	12.2	14.1	14.3	13.3	13.5	13.8	13.5	14.2	15.6	19.1	0.5
memo item:															
EU countries	28.3	30.3	33.5	29.5	30.1	31.2	31.4	26.8	27.6	26.7	25.3	26.4	30.0	37.1	3.0

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

Figure 1.13 ODA as a percentage of GDP in recipient countries, 1990–2003



Source: OECD Development Assistance Committee.

technical cooperation, debt forgiveness, emergency and disaster relief, and administrative costs. Although special-purpose grants are an essential element of the development process and have budgetary consequences for donor countries, they do not provide additional financial resources to recipient countries to support programs that are needed to achieve the Millennium Development Goals (MDGs).[12]

Once special-purpose grants are subtracted from the bilateral portion of ODA, development aid declined slightly in 2003 (in nominal terms), after increasing by about $1 billion in 2002 (table 1.5).

Total ODA increased from 0.22 percent of GNI in the DAC donor countries in 2001 to 0.25 percent in 2003, but it remains significantly below the 0.34 percent level reached in the early 1990s (table 1.5) and well below the UN target level of 0.7 percent of GNI. The bilateral portion of ODA (less special-purpose grants) declined from 0.06 percent of GNI in 2000 to just under 0.05 percent in 2003, well below the 0.12 percent level reached in 1990.[13]

Prospects for development aid

The World Bank's International Development Association (IDA) helps the poorest countries alleviate poverty by providing interest-free loans and some grants for programs aimed at boosting economic growth and improving living conditions. The fourteenth replenishment of IDA (IDA14), finalized in late February 2005, set a positive tone for future development financing.

During the replenishment negotiations, donor countries stressed the importance of several key initiatives:

- A new system for allocating IDA grants based on countries' risk of debt distress
- A strong focus on growth, private sector development, and infrastructure
- A results-measurement system for IDA14
- Increased transparency and accountability, including the disclosure of IDA's country performance assessments
- Measures to strengthen coordination and harmonization among development partners.

Financial resources provided by IDA over the coming three years are set to increase by 25 percent at a minimum—the largest expansion in IDA resources in more than two decades. The proportion of IDA resources provided through grants is set to increase from about 19 percent over the thirteenth

Table 1.5 Net bilateral ODA and special purpose grants, 1990–2003
$ billions

	1990	1995	2000	2001	2002	2003
Total ODA	54.3	58.8	53.7	52.4	58.3	69.0
Bilateral ODA	38.5	40.5	36.1	35.1	40.8	49.8
Special purpose grants:	18.7	24.0	21.5	22.4	26.9	36.1
Technical cooperation	11.4	14.3	12.8	13.6	15.5	18.4
Debt forgiveness	4.3	3.7	2.0	2.5	4.5	8.3
Emergency and diaster relief	1.1	3.1	3.6	3.3	3.9	5.9
Administrative costs	2.0	2.9	3.1	3.0	3.0	3.5
Bilateral ODA less special-purpose grants	*19.8*	*16.5*	*14.6*	*12.8*	*13.9*	*13.7*
As percentage of GNI in DAC donor countries						
Total ODA	0.34	0.26	0.22	0.22	0.23	0.25
Bilateral ODA	0.24	0.18	0.15	0.15	0.16	0.18
Bilateral ODA less special-purpose grants	*0.12*	*0.07*	*0.06*	*0.05*	*0.06*	*0.05*

Source: OECD Development Assistance Committee.

replenishment to an estimated 30 percent over the IDA14 period. The allocation of grants in IDA14 will be determined primarily through assessments of debt sustainability. Half of IDA14 resources will be directed to those African countries that can meet performance standards required to make aid effective.

This will be supplemented by an agreement on the tenth replenishment of the African Development Fund (ADF-X) that was reached in late December 2005. The African Development Fund was established in 1972 to provide concessional development finance to the poorest member countries. The new agreement will provide $5.4 billion in funding, a 43 percent increase over the ninth replenishment (ADF-IX). The grant component of funding will rise as well, from 21 percent under ADF-IX to about 44 percent. ADF assistance to two-thirds of the eligible countries (26 countries) will be in the form of grants only.

The Commission for Africa issued a report in March 2005 that urges a doubling of aid to Africa, including an investment of $150 billion in infrastructure over the next decade. The report calls for an additional $25 billion per year in aid, to be achieved by 2010. Subject to a review of progress, a further $25 billion per year is to be provided by 2015.

Participants at the United Nations Conference on Financing for Development in Monterrey in March 2002 recognized that a substantial increase in ODA and other resources would be required if developing countries were to achieve internationally agreed development goals and objectives. Developed countries were urged to "make concrete efforts" to increase ODA to the UN target of 0.7 percent of GNI.[14] New development assistance commitments announced at Monterrey implied that by 2006, ODA would increase by a total of $12 billion per year. Moreover, there was agreement at Monterrey that although additional debt relief was an essential element of the development agenda (box 1.2), it should not detract from augmenting the other financial resources required to enable developing countries to attain the MDGs.

In 2003, ODA in 5 of the 21 DAC donor countries exceeded the United Nations target of 0.7 percent of their GNI: Denmark, Luxembourg, the Netherlands, Norway, and Sweden (table 1.6). Three of these countries (Luxembourg, Norway, and Sweden) have agreed to increase ODA further to 1 percent of GNI. Four additional donor countries (Belgium, Finland, France, and Ireland) have specified a firm date for raising ODA to 0.7 percent of GNI. Spain and the United Kingdom have projected dates. Other donor countries have specified interim targets for raising ODA as a percent of GNI over time. As a group, the members of the European Union aim to increase ODA from 0.35 percent of GNI in 2003 to 0.39 percent by 2006.

Reflecting those commitments, ODA is projected to increase from 0.25 percent of GNI in donor countries in 2003 to 0.30 percent by 2006,

Box 1.2 Implementation of the Heavily Indebted Poor Countries (HIPC) Initiative

In 1996, concerned that excessive debt was stifling economic growth and crippling efforts to reduce poverty in some of the world's poorest countries, the World Bank and International Monetary Fund (IMF) launched the Heavily Indebted Poor Countries (HIPC) Initiative. The Initiative was based on an agreement by all major international lenders to offer a fresh start to countries that were making efforts to reduce poverty. The Initiative was enhanced in 1999 to provide deeper and faster debt relief to a larger group of eligible countries and to increase the program's links with ongoing poverty reduction efforts in those countries.

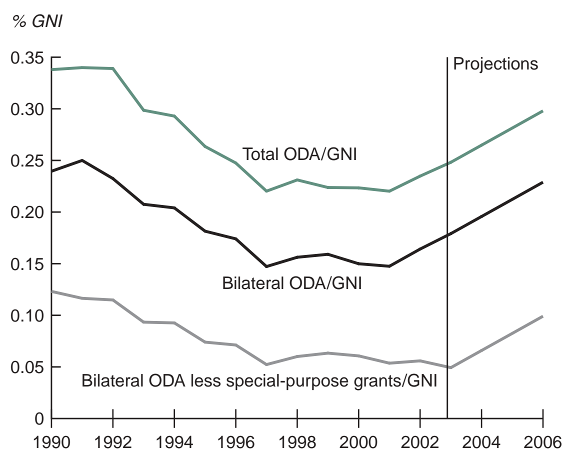
Currently eligible for debt relief under the HIPC Initiative are 38 countries, 32 of them in Sub-Saharan Africa. Twenty-seven have reached the HIPC "decision point" at which donors make a commitment to provide the debt relief necessary to meet a specified debt ratio. (Most of the 11 countries that have not reached the decision point have been beset by internal strife, cross-border conflict, governance challenges, or substantial arrears.) Fifteen countries have reached their "completion points," seven since September 2003—Ethiopia, Ghana, Guyana, Madagascar, Nicaragua, Niger, and Senegal. All 15 have received irrevocable debt relief. The debt relief accorded the other 12 "decision point" countries will not become irrevocable until they pass the completion point.

The debt stock of the 27 countries that have reached the decision point under the HIPC Initiative has been reduced by two-thirds. The World Bank alone has committed about $13 billion in nominal debt-service relief to this group of countries over the next two decades. As a result of the relief, ratios of debt service to exports have been substantially reduced. Funds freed up by debt relief are directed, under the terms of the HIPC Initiative, to programs designed to improve the lives of the poor. Poverty-reducing expenditures, on average, have risen from 6.4 percent of GDP in 1999 to 7.9 percent of GDP in 2003, nearly three times higher than debt service expenditures.

Eligibility for the Initiative is based on several criteria related to income and indebtedness. In September 2004, the IMF and Bank extended the enhanced HIPC Initiative by two years to end-2006. The extended timeframe may allow other countries to enter the program. They will have to establish a track record of macroeconomic performance in order to reach their decision point and qualify for debt relief. In addition, several proposals are currently being considered to provide additional debt relief to make debt more sustainable in low-income countries.

Sources: IMF/World Bank (2004) and World Bank staff.

Figure 1.14 ODA as a percentage of GNI in DAC donor countries, 1990–2006



Source: OECD Development Assistance Committee.

still significantly less than the 0.34 percent level reached in the early 1990s (table 1.4 and figure 1.14).[15] The near-term increases imply an average 9 percent annual increase in ODA in real terms over the period 2004–6, well above the average rate of real increases for the past two years (6 percent).[16] The EU members as a group are projected to raise their net ODA contributions to 0.44 percent of their GNI, exceeding their stated goal of 0.39 percent by a significant margin. The projected increase in EU contributions (equal to $11.7 billion) accounts for 60 percent of the total projected increase in ODA ($19.4 billion). If donor countries are to raise the amount of aid that can be used for development purposes by the same proportion, bilateral ODA, less special-purpose grants, would have to increase from 0.05 percent

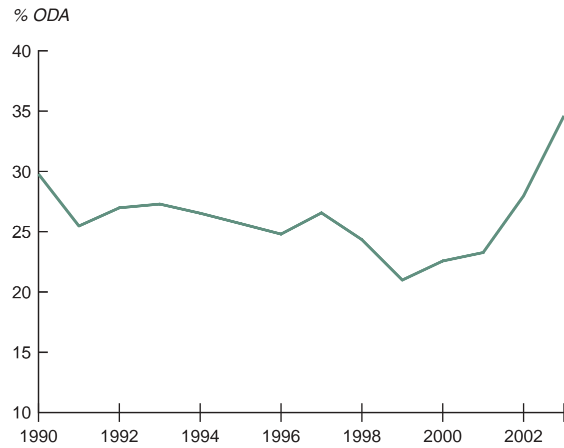
Table 1.6 Projected increases in ODA from DAC donors, 2003–6

ODA as a percentage of GNI

	2003	2006	Change
Norway	0.92	1.00	0.08
Denmark	0.84	0.83	−0.01
Luxembourg	0.81	0.87	0.06
Netherlands	0.80	0.80	0.00
Sweden	0.79	1.00	0.21
Belguim	0.60	0.64	0.04
France	0.41	0.47	0.06
Ireland	0.39	0.61	0.22
Switzerland	0.39	0.38	−0.01
Finland	0.35	0.41	0.06
EU members	0.35	0.44	0.09
UK	0.34	0.35	0.01
Germany	0.28	0.33	0.05
Australia	0.25	0.26	0.01
Canada	0.24	0.27	0.03
Spain	0.23	0.33	0.10
New Zealand	0.23	0.26	0.03
Greece	0.21	0.33	0.12
Austria	0.20	0.33	0.13
Japan	0.20	0.22	0.02
Italy	0.17	0.33	0.16
United States	0.15	0.19	0.04
Total	**0.25**	**0.30**	**0.05**

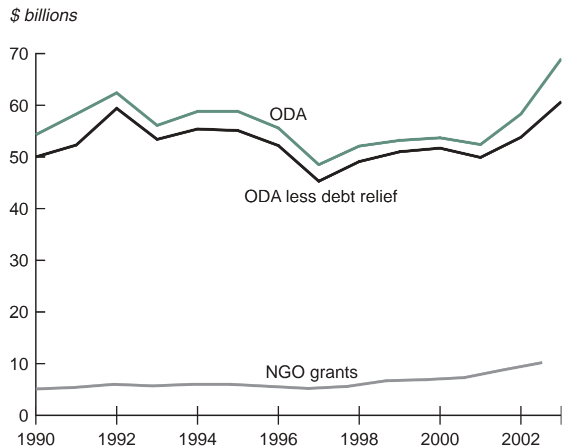
Source: OECD Development Assistance Committee.

Figure 1.15 Percentage of ODA disbursed to Sub-Saharan Africa, 1990–2003



Source: OECD Development Assistance Committee.

Figure 1.16 ODA and grants from nongovernmental organizations, 1990–2003



Source: OECD Development Assistance Committee.

of GNI in donor countries in 2003 to 0.10 percent by 2006.

African countries deemed to be strategically important are likely to be the largest recipients of increases in ODA. The Africa Action Plan announced at the G-8 Leaders Summit in Kananaskis (Canada) in June 2002 suggested that "in aggregate half or more of our new development assistance could be directed to African nations that govern justly, invest in their own people, and promote economic freedom." Sub-Saharan Africa received 60 percent of increases in ODA disbursements over the five years from 1998 to 2003, raising its share of total ODA disbursements by DAC donors from 24 percent to 34 percent (figure 1.15). However, most of these funds were allocated to postconflict situations, limiting the amount provided for development aid.

The major challenge facing most donor countries will be to augment aid to levels required to support the MDGs and the Monterrey consensus in the face of growing fiscal pressures. Vigilance is needed to ensure that unanticipated events (such as the devastation caused by the tsunami in late December 2004), as well as funding for crisis response and postconflict recovery,[17] do not divert resources from efforts to attain the MDGs. In addition to providing emergency relief to the countries affected by the tsunami, substantial aid will be needed to provide medical care and rebuild infrastructure over the medium term (box 1.3).

Growing fiscal imbalances in many key donor countries, along with the prospect of further financing gaps as populations age, are exerting intense pressures on donor countries to pursue fiscal consolidation. Financing for development will need to be a top priority on the political agenda of

Box 1.3 Aid in the wake of the Asian tsunami

The tsunami that hit the Indian Ocean basin on December 26, 2004, is one of the worst human disasters of modern times. Triggered by an earthquake measuring 9.0 on the Richter scale, the tsunami affected eight countries in East Asia, South Asia, and Africa. Fatalities are expected to exceed 200,000, and some 1.5 million people lost their homes and livelihoods. The world's response has been generous: some $7.8 billion in official emergency and reconstruction aid has been pledged, supplemented by private donations of between $1 billion and $2 billion.

This global response continues an upward trend in emergency relief. Since 1970, the proportion of ODA accounted for by emergency relief has increased from 0.1 percent to 7.8 percent—a rise from $6.9 million to $5.4 billion. The trend is believed to reflect two factors:

- ***Heightened awareness and concern about events in the developing world among people everywhere.*** Emergency aid can be seen as an altruistic response to more thorough and timely news from abroad, as well as a reflection of the growing importance of developing countries in the global economy.
- ***An increase in the number of people living in vulnerable areas.*** As the global population has grown from 3.7 billion in 1970 to 6.2 billion in 2003, more people now live in areas vulnerable to natural disasters—on fault lines, in floodplains and regions susceptible to hurricanes, and in areas affected by environmental degradation or climate change. Population growth has been concentrated in developing countries, where fewer public and private resources are devoted to prevention and early warning, building codes are inadequate, and infrastructure is old. Between 1985 and 1999, 96 percent of recorded disaster fatalities were in developing countries (Center for Research on the Epidemiology of Disasters 2005).

Ensuring that disbursements follow the substantial resources pledged will require careful monitoring. According to the United Nations, resources actually delivered have fallen far short of pledges in recent natural disasters. Just half of the $400 million pledged after the 2000 floods in Mozambique was received. And only one-third of the $8.7 billion promised to Honduras and Nicaragua after Hurricane Mitch in 1998 was sent. Obstacles—damaged or destroyed transport and logistical infrastructure, a multiplicity of donor organizations, and shortages of local staff and officials to coordinate aid distribution—need to be overcome before pledged aid can reach the affected areas.

In addition to the emergency and reconstruction aid outlined above, Paris Club creditors announced a debt moratorium for countries affected by the disaster. The countries have the option to request a deferral of principal and interest payments due to Paris Club creditors so that more resources can be allocated to the reconstruction effort.

Tsunami aid should come on top of, rather than in lieu of, other programmed development assistance. With many of the bilateral donors making tsunami pledges approaching or exceeding their 2005 annual disaster relief budgets, there is reason to be concerned that the assistance may be reallocated from existing commitments or diverted from other recipient countries' aid budgets. Emergency aid clearly plays a vital role in the broader development agenda, but it cannot displace other financial resources that are required to support the MDGs.

these countries if ODA is to increase as a percentage of GNI—as foreseen in Monterrey.

Grants from nongovernmental organizations (NGOs) play a more prominent role

NGOs are providing a growing source of financial resources for developing countries.[18] Grants by private voluntary agencies (the private-sector component of NGO grants) have increased by $5 billion (in nominal terms) between 1990 and 2003. ODA has increased by $15 billion over this period, while ODA less debt relief has increased by $10 billion (figure 1.16). Between 1990 and 2003, NGO grants increased from a value equal to 10 percent of ODA less debt relief to 17 percent.

Annex: Recent trends in workers' remittances to developing countries

Strong gains in workers' remittances to developing countries

Workers' remittances provide valuable financial resources to developing countries, particularly the poorest.[19] Remittances to developing countries from overseas resident and nonresident workers are estimated to have increased by $10 billion (8 percent) in 2004, reaching $126 billion. That increase followed a $17 billion (17 percent) increase in 2003 (table 1A.1). Much of the $10 billion increase in 2004 occurred in low-income countries, where remittances rose by $6.7 billion (18 percent).[20] Since 2001, remittances to developing countries have increased by $41 billion (almost 50 percent). Low-income countries account for almost half of the increase: the share of remittances going to low-income countries rose from 28 percent in 2001 to 35 percent in 2004.

Most of the $41 billion increase in remittances to developing countries from 2001 to 2004 was concentrated in South Asia ($17 billion), Latin America and the Caribbean ($13 billion), and, to a lesser extent, East Asia and the Pacific ($7 billion). Remittances are more evenly distributed than capital flows to developing countries.

Increases in remittance flows have been particularly strong in China, India, Mexico, Pakistan, and the Philippines (table 1A.2). Those five countries together account for $31 billion of the $41 billion increase in remittances to all developing countries between 2001 and 2003. The data available for 2004 suggest that remittance flows will continue to show strong gains in India, Mexico, and the Philippines.

Even though most top recipient countries are large, remittances to many small developing countries are significant as a share of GDP or in per capita terms. Examples include Lesotho, Tajikistan, and Tonga. Lebanon also is among the top recipients of remittances, when measured on a per capita basis.

The surge in remittance flows over the past few years reflects several factors. There have been significant reductions in remittance sending costs in some countries—for example, 60 percent in the U.S.-Mexico corridor since 1999. Growing migration and measurement issues also play prominent roles. The sizeable depreciation of the dollar against most other major currencies (the euro in particular) over the past three years has increased the dollar value of nondollar remittances over time. Some of the increase in remittance flows can

Table 1A.1 Workers' remittances to developing countries, 1990–2004

$ billions

	1990	1995	2000	2001	2002	2003	2004e	Change 2001–4
Developing countries	31.3	56.7	76.8	84.6	99.0	116.0	125.8	41.2
Lower middle-income	17.5	34.8	41.9	44.1	49.1	54.8	55.6	11.5
Upper middle-income	5.7	8.6	13.1	16.8	18.7	24.4	26.8	10.0
Low income	8.1	13.3	21.7	23.8	31.2	36.7	43.4	19.6
Latin America and the Caribbean	5.8	13.4	20.2	24.2	28.1	34.1	36.9	12.7
South Asia	5.6	10.0	16.0	16.0	22.3	26.7	32.7	16.7
East Asia and the Pacific	3.2	9.0	11.2	12.9	16.6	19.5	20.3	7.4
Middle-East and North Africa	11.7	13.0	13.5	15.2	15.5	16.8	17.0	1.8
Europe and Central Asia	3.2	8.1	11.0	11.4	11.5	12.8	12.9	1.5
Sub-Saharan Africa	1.9	3.2	4.9	4.9	5.1	6.0	6.1	1.2

Note: e = estimate

Remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers.

Sources: IMF *Balance of Payments Statistics Yearbook 2004* and World Bank estimates.

Table 1A.2 Developing countries with highest remittance flows, 2001 and 2003
$ billions

	2001	2003	Change
India	11.1	17.4	6.3
Mexico	9.9	14.6	4.7
China	1.2	4.6	3.4
Pakistan	1.5	4.0	2.5
Philippines	6.2	7.9	1.7
Poland	1.1	2.3	1.2
Bangladesh	2.1	3.2	1.1
Brazil	1.8	2.8	1.0
Colombia	2.1	3.1	1.0
Vietnam	2.0	2.7	0.7
All developing countries	84.6	116.0	31.4

Sources: IMF *Balance of Payments Statistics Yearbook 2004* and World Bank estimates.

be attributed to improvements in data recording by central banks. In addition, security concerns and heightened scrutiny by immigration authorities in many rich countries are believed to have encouraged outward remittance of savings by undocumented migrants. This is reportedly the case in Pakistan, which recorded a tripling of remittance receipts between 2001 and 2003.

As a final point, it should be recognized that the above data represent *officially recorded* remittances, which are sometimes estimated. Flows through informal channels, such as *hawala,* are not captured in the official statistics but are believed to be quite large. Also, a significant portion of remittances flows through formal channels that are not included in the official statistics, because most countries do not insist on regular reporting of flows below certain predefined thresholds.[21]

Notes

1. Projections of world GDP growth are measured using market exchange rates; projections measured using purchasing power parity (PPP) weights are reported in table 2.1.

2. For a more detailed discussion of foreign reserve accumulation in developing countries and global imbalances, see chapter 3.

3. More specifically, the equity capital component of FDI tends to be stable; the other two components—intercompany loans and reinvested earnings—tend to be as volatile as portfolio equity and debt flows. This is discussed in greater detail in World Bank (2004: 86–90) and in box 4.2 in World Bank (2003: 89).

4. Net FDI and portfolio equity flows have a correlation coefficient of –0.6 over the period 1996–2004.

5. For a more complete discussion of the main factors explaining substitution between FDI and portfolio equity flows, see box 4.8 in World Bank (2004: 101).

6. A recent study by Xiao (2004) estimates that FDI inflows to China are overstated by between 26 and 54 percent, implying that China's share of FDI inflows to all developing countries is in the 15–25 percent range.

7. See chapter 5 for a more detailed discussion of FDI flows to low-income developing countries.

8. FDI outflows from Brazil totaled $9.5 billion in 2004. This includes a $5 billion merger between *Ambev* (a Brazilian beverage group) and *Interbrew* (a Belgium-based brewer), which was financed by an equity swap (*Ambev* shareholders received shares of *Interbrew* and vice versa). This $5 billion transaction was reported in the inward and outward FDI flows in Brazil's balance of payments.

9. Developing countries are estimated to have accounted for about one-third of FDI inflows to other developing countries ("South-South flows") over the period 1997–2001 (World Bank 2004: 81).

10. For a more complete discussion of the extent to which FDI outflows from developing countries are underestimated see box 4.3 in World Bank (2004: 90).

11. Econometric projections for net FDI inflows to developing countries over the period 2005–6 are generated using the model discussed in World Bank (2004: 100).

12. For one set of estimates of the financial resources required to meet the MDGs, see chapter 4 of the Overview Report in United Nations (2005).

13. See chapter 5 for a more complete discussion of the evolution of aid flows since the early 1990s.

14. The 0.7 percent target was originally specified in a 1970 resolution of the UN General Assembly.

15. Reported in OECD (2005: 12).

16. This calculation is based on a projected growth rate for GNI in donor countries of 2.5 percent in 2004 and 2.7 percent in 2005–6 and abstracts from exchange-rate changes over the projection period.

17. Donor conferences have already committed substantial funding to postconflict countries, notably Iraq ($32 to $36 billion over the period 2004–7), Afghanistan ($8 billion over the period 2004–6), and Haiti ($1 billion over the period 2004–6).

18. See box 5.2 in chapter 5 for a discussion of the growing importance of NGOs in financing poor countries.

19. For more detailed analysis of workers' remittances see chapter 7 in World Bank (2003), and "Monetary Lifeline" in *The Economist*, July 31, 2004, 66.

20. See chapter 5 for a discussion of the growing importance of remittances sent to the poorest countries.

21. For example, remittances under $10,000 are not required to be reported in the United States; nor are remittances under €12,500 in the European Union.

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