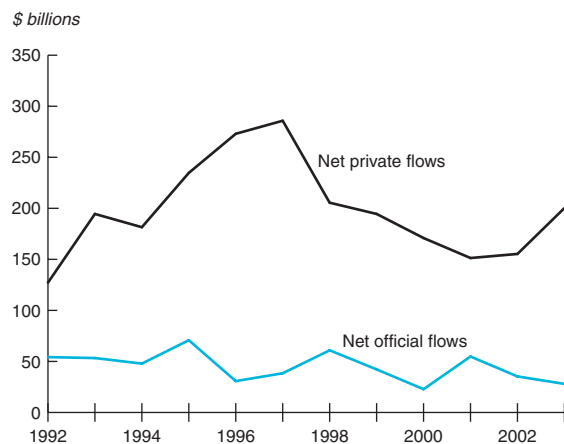


Overview and Policy Messages: Harnessing Cyclical Gains for Development

A STRONG CYCLICAL RECOVERY IN global capital flows to developing countries is underway. Net private flows increased sharply in 2003, reaching \$200 billion—their highest level since 1998. The rapid turnaround in private flows from the subdued levels of the two previous years occurred in all regions, except the Middle East and North Africa. Flows to Europe and Central Asia were particularly strong, as eight transition countries approached accession to the European Union in May 2004. Total net capital inflows, including official flows, reached \$228 billion (3.6 percent of developing-country gross domestic product [GDP]), up from \$191 billion in 2002 (3.2 percent of GDP) (figure 1; table 1). At the same time, the credit quality of developing countries improved markedly, and investor confidence is returning.

Figure 1 Net financial flows to developing countries, 1992–2003



Source: World Bank Debtor Reporting System and staff estimates.

The recovery in capital flows is heavily influenced by cyclical factors—in particular the boost to liquidity arising from stimulative monetary policy in many advanced economies—but it also reflects structural improvements both in developing countries and internationally. The net external liability position of developing countries has strengthened, and the large-scale buildup in developing countries' official reserves—much of which is invested in the financial markets of advanced economies—has introduced a new dimension to the relationship between the developed and developing worlds. More than ever, global capital flows, trade, and exchange-rate policies are intricately linked.

The challenge for international financial policymakers will be to ensure that the cyclical recovery in flows can be sustained over the medium term, and that it can be channeled into areas, such as infrastructure, where it can lay the foundations for sustained growth and poverty reduction, thereby helping to meet the Millennium Development Goals. It will be important to maintain investor confidence, while avoiding the excesses—and increased vulnerability—that have accompanied surges in lending to developing countries in the past. At the same time, aid flows have to increase. These are the central themes of this year's *Global Development Finance*.

The external environment for developing countries has improved—due to the global economic recovery—

The signs of global recovery have become increasingly evident over the past year, improving the external environment for developing countries. World economic growth accelerated

Table 1 Net capital flows to developing countries, 1997–2003

\$ billions

	1997	1998	1999	2000	2001	2002	2003e	For more detail
Current account balance	-83.7	-102.4	-6.9	56.2	21.0	78.5	75.8 →	Chapter 1
as % of GDP	-1.4	-1.8	-0.1	1.0	0.4	1.3	1.1	
<i>Financed by:</i>								
Net equity flows	193.7	182.1	194.4	174.8	179.4	152.0	149.5 →	Chapter 3
Net FDI inflows	171.1	175.6	181.7	162.2	175.0	147.1	135.2	
Net portfolio equity inflows	22.6	6.6	12.6	12.6	4.4	4.9	14.3	
Net debt flows	105.3	57.6	13.8	-9.8	-1.2	7.3	44.3	
Official creditors	13.2	34.2	13.7	-5.9	26.9	4.1	-6.3 →	Chapter 4
World Bank	9.2	8.7	8.8	7.9	7.5	-0.2	-1.9	
IMF	3.4	14.1	-2.2	-10.6	19.5	14.0	8.0	
Others	0.6	11.4	7.1	-3.1	-0.1	-9.7	-12.4	
Private creditors	92.2	23.4	0.1	-3.9	-28.1	3.2	50.6 →	Chapter 2
Net medium- and long-term debt flows	84.2	87.0	22.4	5.2	-5.3	1.8	18.6	
Bonds	38.2	39.7	29.8	16.5	12.2	12.7	33.1	
Banks	43.9	52.4	-5.1	-5.8	-10.2	-3.9	-6.6	
Others	2.0	-5.1	-2.3	-5.5	-7.3	-7.0	-7.9	
Net short-term debt flows	8.0	-63.6	-22.3	-9.1	-22.9	1.4	32.0	
Balancing item ^a	-162.5	-120.7	-163.1	-168.6	-119.0	-65.0	6.3	
Change in reserves (- = increase)	-52.8	-16.6	-38.1	-52.6	-80.2	-172.9	-276.0 →	Chapter 1
<i>Memo items:</i>								
Total foreign aid (grants) (excluding technical cooperation grants)	25.3	26.7	28.5	28.7	27.9	31.2	34.3 →	Chapter 4
Net private flows (debt+equity)	285.8	205.5	194.5	170.9	151.3	155.3	200.2	
Net official flows (aid+debt)	38.4	60.9	42.2	22.8	54.8	35.3	28.0	
Total net capital flows (private+official)	324.3	266.5	236.7	193.7	206.1	190.6	228.2	
Infrastructure finance ^b	89.7	70.3	72.1	77.0	53.8	44.7	50.5 →	Chapter 6
Trade finance ^c	24.2	16.1	17.0	21.4	19.3	21.1	23.7 →	Chapter 5
Workers' remittances	66.1	62.9	67.6	68.4	77.0	88.1	93.0 →	Appendix A

Note: e = estimate.

a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries. Over the past two years, there has been a marked reduction in the net accumulation of international assets, other than official reserves, by developing-country residents. These flows are captured in the "balancing item." One explanation for the reduction may lie in a—possibly temporary—reversal of such outflows from China amid speculation about an adjustment in exchange-rate policy.

b. The total volume of capital raised internationally through bank loans, bonds, and equity offering for developing countries' infrastructure.

c. The trade finance figures refer to gross publicly announced commitments from international banks for trade-related purposes. Thus, only the commercial bank lending component of trade finance is included.

Sources: World Bank Debtor Reporting System and staff estimates; IMF, *Balance of Payments Yearbook*; and Dealogic Bondware and Loanware.

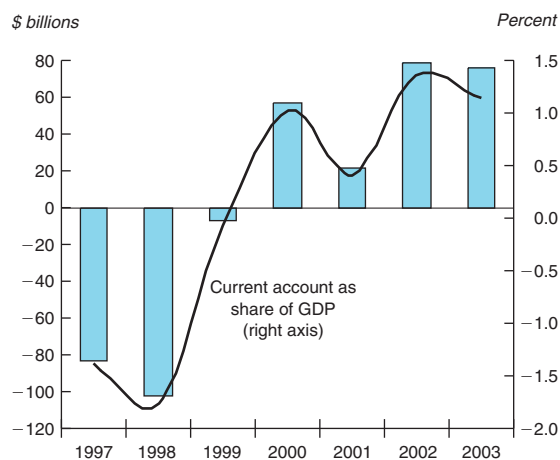
from an annual rate of 1.8 percent in 2002 to 2.6 percent in 2003. It is forecast to jump to 3.7 percent in 2004. With profit margins rising—and interest rates low—global investment is recovering strongly, laying the foundation for continued growth. The recovery also reflects the strong stimulus created by the easing of fiscal and monetary policies in the advanced economies, notably in the United States, where the budget moved from a surplus equivalent to 1.6 percent of GDP in 2000 to a deficit of 4.6 percent of GDP in 2003. Low interest rates in many of the advanced economies helped propel the growth in capital flows to developing countries; modest recent increases in long-term interest rates so far have not sapped that growth.

World commodity markets have moved in tandem with recovery in global economic activity. Non-energy U.S. dollar commodity prices in 2003 averaged 10 percent above their 2002 levels, while metal prices—traditionally a reliable leading indicator—surged toward the end of 2003, driven partly by the interest of fund investors.

—and an improvement in their net liability positions—

Seeking to avoid excessive reliance on external financing, developing countries, as a group, have run large current account surpluses in recent years. In 2003, the surplus in the developing world amounted to \$76 billion—about 1.1 percent of GDP (figure 2). The pickup in growth during the

Figure 2 Developing countries' current account balance, 1997–2003



Sources: IMF, *International Financial Statistics*, 2004, and World Bank staff estimates.

year resulted in smaller current account surpluses in several countries, although these were largely offset by Brazil's move into surplus.

Increased reliance on equity finance—together with current account surpluses—has improved the external liability positions of developing countries. By 2003, the total external debt of developing countries had declined to about 37 percent of their GDP, compared with 44 percent in 1999. Despite the recent increase in short-term lending, short-term external debt was about 15 percent of the total debt stock in 2003, down from 19 percent in 1997. Meanwhile, the costs of external debt service have fallen with lower global interest rates—the ratio of debt service to exports for developing countries fell to 15 percent in 2003 from 19 percent in 1997—and many developing-country borrowers have taken the opportunity to restructure their debt to take advantage of the low rates.

—with structural measures to enhance stability—

Structural influences behind the recovery in flows include the increasing maturity and depth of markets for emerging-market bonds and important progress in improving transparency and adherence to standards and codes. The presence of collective action clauses (CACs) in international bond issues—including those of several Latin American issuers—is a welcome further step, and it is encouraging that such clauses have achieved

such rapid and widespread acceptance in international capital markets. By making future bond restructurings—should they be necessary—more manageable and predictable, CACs should encourage capital flows in the near term. But they are not a panacea. A large outstanding stock of bonds does not include such clauses. And the handling of the Argentine debt restructuring will have an important influence on investor attitudes—and hence potentially on capital flows. The upswing in bank lending is predominantly short term—net medium-term flows remain negative. Nevertheless structural changes—including strengthened risk management—likely mean that it is more soundly based than in previous upswings.

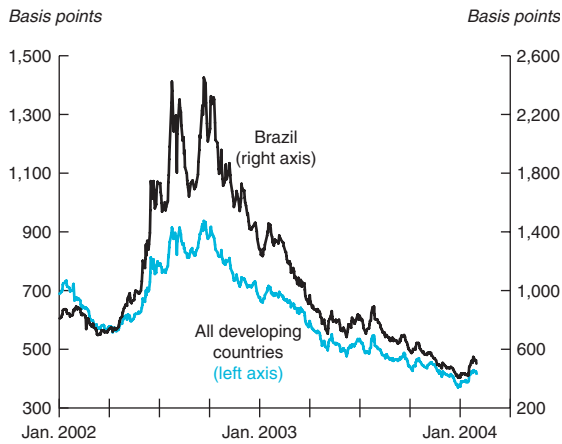
—furthermore, the credit quality of developing countries has improved, reducing the cost of capital—

One of the most important factors behind the recovery in private flows has been an improvement in the credit quality of developing countries. To some extent, the improvement reflects the favorable external environment, with many developing countries benefiting from strong commodity prices and brisk growth in world trade, much of it between developing countries. But many countries also have undergone significant adjustments in recent years, including a move toward market mechanisms and increased openness to international trade and investment. Fiscal policies have generally been more prudent, although concern persists about the sustainability of public debt in several countries. Flexible exchange-rate systems have become much more prevalent, reducing the possibility that an exchange-rate crisis will turn into a debt crisis—and forcing increased awareness of the risks inherent in currency mismatches. Relatively low inflation rates have become established, and many developing countries are showing strong growth in productivity.

The improved credit quality has translated into improved credit ratings, with the average sovereign credit rating of developing countries reaching its highest level since the beginning of 1998. Several developing countries, including India, the Russian Federation, and Turkey, all received upgrades from the major credit rating agencies in 2003.

Investor perceptions that credit risk has fallen have contributed to a major decline in bond spreads. The average spread on emerging-market bonds (EMBIG) fell from more than 725 basis

Figure 3 Spreads on emerging-market bonds, January 2002–February 2004



Source: J.P. Morgan Chase.

points at the end of 2002 to just 390 basis points in early January 2004, before rebounding to 420 basis points by mid-February 2004 (figure 3). Average emerging-market bond spreads for Latin America were halved from more than 1,000 basis points at the end of 2002 to just 535 basis points over the same period, reflecting a more favorable assessment of prospects for Brazil. Although credit quality has clearly improved, the compression in emerging-market spreads may have outstripped improvements in fundamental credit quality, leaving some scope for a future correction. The spread compression has boosted the returns investors have received on emerging-market debt over the past year—and investors will not be able to match these gains in the future.

—but there is no room for complacency

Further increases in interest rates in some advanced economies could dampen flows, and some correction in spreads is possible. Renewed volatility in the financial markets—likely stemming from imbalances in advanced economies—might also have an adverse impact on flows. The string of crises since the mid-1990s exposed vulnerable spots in developing-country debt markets. Together, the countries that experienced those crises account for almost 60 percent of the outstanding debt stock of developing countries. Borrowers in developing countries should bear in mind the lessons of recent years and remain prudent about incurring additional external liabilities.

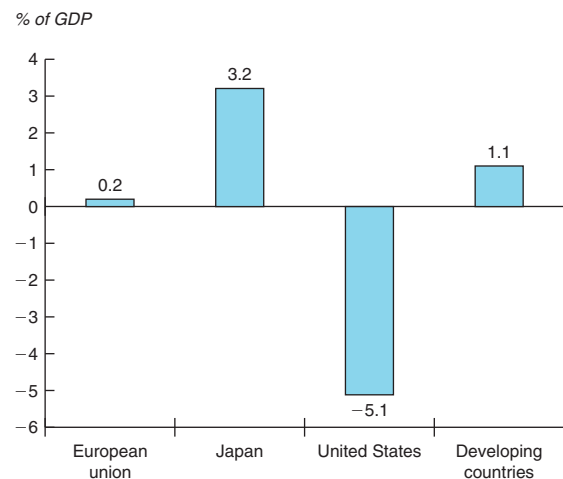
Particular care should be taken to ensure that foreign-currency liabilities are appropriately hedged. Moreover, borrowers should remain wary of possible fluctuations in the availability of finance, particularly in light of the renewed pickup in short-term financing.

Developing countries should also maintain prudent macroeconomic policies and persevere with needed reforms to foster sustainable growth, consolidate the improvement in credit quality, and maintain the confidence of investors and creditors, particularly in the face of political pressures from forthcoming elections in several countries.

To keep the recovery on track, imbalances in advanced economies need to be addressed

The macroeconomic policies of high-income countries must be adjusted toward more balanced global economic growth and more sustainable financing of existing current account imbalances (figure 4). The same developed-country policies that helped prevent the 2001 downturn from deepening pose substantial medium-term challenges. The U.S. current account deficit, to take the most prominent example, is now more than 5 percent of GDP, and the reluctance of private investors to finance that deficit at the prevailing exchange rate has already led to a sharp fall in the value of the dollar against most major currencies. The nature and timing of the necessary adjustments

Figure 4 Global current account balances, 2003



Source: World Bank staff estimates.

will depend on several factors, including how fast economic activity picks up in the rest of the world—particularly in the euro area—and on the success of policymakers in facilitating orderly adjustments in exchange rates. Also important is the willingness of foreign central banks to continue to finance the U.S. current account through the use of accumulated reserves. This policy can continue as long as the surplus countries see higher benefits from trade expansion than costs from reserve accumulation, among them risks of monetary expansion.

Since 2000, the developing world has been a net exporter of capital to the advanced economies. For developing countries as a whole, foreign-exchange reserves rose about \$276 billion in 2003, bringing total reserves to \$1,227 billion—equivalent to nearly four times their short-term external debt. This buildup reflects a precautionary reaction to the costly crises of the 1990s, as well as broader factors related to trade and exchange rates. It underlines the strong financial interdependence between developed and developing countries. That interdependence, intensified in recent years, gives the developed and developing economies a common interest in addressing the macroeconomic imbalances and long-term risks discussed here.

As the global economic recovery gathers momentum, the phase of generalized easing of monetary policy appears to be coming to an end. The Bank of England and Reserve Bank of Australia recently increased interest rates, and the U.S. Federal Reserve has suggested that it is likely, in time, to return to a more neutral monetary stance, though concerns persist about job creation. Fiscal deficits in high-income countries have widened every year since 2000—from 0.1 percent of GDP to 3.7 of GDP in 2003. If uncorrected, fiscal imbalances could push real interest rates higher globally, potentially dampening capital flows to developing countries as the public sector in advanced economies competes with developing countries for global savings.

As foreign direct investment moves into the service sector, the local investment climate becomes more important

Flows of foreign direct investment (FDI) to developing countries declined in 2003 for the second consecutive year. At \$135 billion, they were 23 percent below the level reached in 2001. The equity

component of FDI was somewhat more resilient than intercompany debt and reinvested earnings. Much of the decline is attributable to weaker service-sector FDI, which, being largely location bound and generating local-currency earnings that are vulnerable to devaluation risk, is particularly sensitive to the local investment climate and vulnerable to financial crisis. FDI inflows in services rose during the second half of the 1990s to overtake FDI in manufacturing, but in the past two years, in particular, there was a significant drop in Brazil—where investment in telecommunications and energy has fallen steeply, and where the privatization cycle has wound down.

FDI flows are expected to recover in 2004, in line with the global economic recovery. The pace of recovery will depend on the liberalization of service sectors in the developing world, on the restoration of investors' confidence after recent crises, and on the availability of political risk insurance, for which demand remains high. Concern over regulatory risks may have a particular impact on FDI in the banking and utilities industries.

Flows of portfolio equity capital to developing countries topped \$14 billion in 2003, up from \$5 billion in 2002, as growth strengthened and equity markets rebounded globally. Nevertheless, these flows remain small relative to other sources of capital, reflecting the volatility of emerging-market economies, concerns over corporate governance, limited diversification benefits because of strong correlations with advanced-country equity markets, and a continuing "home bias" on the part of investors. Additional constraints on growth include the technological underdevelopment of stock markets in developing countries and the uncertain quality of their supervisory institutions. Stock exchanges in Latin America and the Caribbean, and in Europe and Central Asia, continue to experience stock delisting, as companies migrate to major global stock exchanges in industrial countries.

The improvement in private capital flows has benefited most regions

—but broader access would be desirable—

The increase in private capital flows has affected all regions, with the exception of the Middle East and North Africa (table 2).

- Net private flows to Sub-Saharan Africa strengthened slightly in 2003, due mainly to

Table 2 Net private capital flows to developing countries, 1997–2003

\$ billions

	1997	1998	1999	2000	2001	2002	2003e
East Asia and Pacific	85.8	7.1	27.5	24.3	38.0	55.2	71.0
Europe and Central Asia	52.9	64.2	47.2	51.5	32.2	55.2	62.9
Latin America and the Caribbean	114.1	98.8	95.0	78.0	58.1	25.6	47.3
Middle East and North Africa	7.8	16.3	4.2	-0.7	7.7	6.1	-3.8
South Asia	8.2	5.3	3.5	9.2	4.0	8.0	10.4
Sub-Saharan Africa	17.0	13.8	17.0	8.6	11.3	5.2	12.4

Note: e = estimate.

Sources: World Bank Debtor Reporting System and staff estimates.

- stronger debt flows to South Africa. FDI to the region remained steady—and concentrated in countries rich in petroleum and minerals.
- Flows to many countries in Europe and Central Asia were particularly strong in 2003, as eight transition countries approached accession to the European Union. Effective implementation of EU-related structural reforms and past FDI should contribute to a step-up in productivity growth, although mounting fiscal deficits are likely to pose an increasing challenge.
 - South Asia saw a marked strengthening in portfolio equity investment, bank lending, and FDI in 2003, although this was offset in part by a substantial bond repayment by India.

However, private capital flows (except for trade finance) are heavily concentrated on specific countries and regions. For example, East Asia and Latin America accounted for two-thirds of international investment in developing-country infrastructure between 1992 and 2003, while Latin America and Eastern and Central Europe continue to dominate international bond issuance. Ten countries accounted for 68 percent of FDI in 2003, down from a peak concentration of 78 percent in 2000, but still significant. There is an important role for multilateral agencies in promoting broader, sustained access to capital and in facilitating higher levels of official aid for countries that do not have access to international capital flows.

—and efforts should be taken to reduce the transaction costs of workers' remittances

Workers' remittances have become a major source of external development finance for many developing countries. Remittances to developing countries increased by more than 20 percent during 2001–03, reaching an estimated \$93 billion in

2003. More remittances were diverted to formal channels from alternatives—a result of efforts to curb money laundering. Also, the increased focus on remittances resulted in better reporting of data in many developing countries.

The development community should view remittances as a welcome source of external finance and strive to improve the financial infrastructure supporting them. Steps should be taken to reduce remittance costs, which remain high. Appropriate policies include improving competition among money transfer agents, increasing access to banking services for migrant workers in source countries and households in recipient countries, and improving the investment climate (by liberalizing exchange restrictions, for example) in the receiving countries.

The landscape for official flows is improving, but increases are not enough to reach the MDGs

Political developments and changes in attitudes are dramatically altering the landscape for official flows. Net official development assistance (ODA) did increase to \$58 billion in 2002 but remains well below historical levels and what is required to meet the Millennium Development Goals. Moreover, half the \$6 billion increase in nominal ODA reflects debt relief and a further \$1 billion higher aid to Afghanistan and Pakistan.

In light of discussions surrounding the 2002 Monterrey Conference, donors have made pledges to increase aid, although actual disbursements will be subject to future decisions and the normal legislative process of each donor country. The international community should do its utmost to ensure that the existing commitments are met

and new ones made. The failure to reach agreement at the Cancún talks on reducing agricultural subsidies and trade barriers makes finding additional sources of finance for the world's poorest countries especially urgent.

Aid donors and recipients are taking steps to change the means of allocating and using aid. Major donors are providing more funds for global public goods and paying more attention to the policy framework in recipient countries when making aid-allocation decisions. The Poverty Reduction Strategy Papers and the New Partnership for Africa's Development are aimed at strengthening policies in recipient countries and ensuring greater ownership of development programs, thereby increasing aid effectiveness. Those steps should be encouraged. In the light of recent international conflicts, which have increased the role of strategic factors in allocating aid, the message of aid effectiveness must not be lost.

In recent years, there has been a sharp decline in nonconcessional net lending. Bilateral nonconcessional lending declined from $-\$8.8$ billion in 2002 to $-\$11.8$ billion in 2003 as donors continued to reduce their lending in favor of grants—and as some developing countries continued to make repayments to the Paris Club under past rescheduling agreements. The sharp decline in nonconcessional lending from multilateral sources partly reflects the decline in emergency financing packages from the International Monetary Fund, particularly in comparison with the large net disbursement in 2001. But lower multilateral lending also reflects the prepayment of loans to the World Bank, particularly by China, India, and Thailand.

Trade finance facilitates international trade and provides access to foreign capital for less creditworthy countries

Developing countries' international trade is equivalent to about one-half of their gross national income. Trade finance supplies the liquidity needed to conduct trade, and governments can support it by ensuring a sound and efficient financial system.

Trade finance to developing countries increased strongly before the East Asian crisis, in response to the growth of developing countries' international trade and in conjunction with their growing participation in the international financial system. Trade

finance fell sharply with the crisis but resumed its upward trend thereafter.

Trade finance is particularly important in facilitating finance for firms in less creditworthy countries, in part because traded goods are available as security for lenders. In addition, relationships built with foreign trading partners often ease access to credit, for example, in the form of extended payment terms offered by suppliers. Moreover, developing-country firms involved in international trade, and foreign-owned firms, can serve as intermediaries that pass on credit to firms (particularly in poor countries) that lack direct access to international finance.

Trade finance remains vulnerable to episodes of financial crisis, when commercial banks may reduce their exposure by failing to renew short-term facilities. Nonetheless, finance linked to trade transactions may hold up better than other forms of foreign borrowing—for several reasons. Lenders can rely on security arrangements linked to traded goods. Suppliers' information on their borrowers may limit contagion. Suppliers have an incentive to support their customers during cyclical downturns. And in some cases governments have provided preferential treatment to trade finance in the context of rescheduling agreements. Trade credit from suppliers and customers, in particular, appears to have held up better during crises than bank lending.

Steps governments can take to strengthen trade finance include providing legal standing for electronic documents (to facilitate more efficient letters of credit) and for the assignment of receivables (to encourage factoring).

Channeling capital to long-term infrastructure requires a balanced public-private approach

Infrastructure needs in developing countries remain largely unmet—1.1 billion people lack access to safe drinking water, 2.4 billion are affected by inadequate sanitation, 1.4 billion have no power, and telecommunication links are five times less dense than in the developed world. Worldwide, future demand for infrastructure is likely to come mainly from the developing world. The challenge is to translate this demand into viable investment opportunities that are accessible to private investors and creditors, and to unlock the potential

of the global capital markets to finance them. From 1992 to 2003, total international investment in developing countries' infrastructure is estimated to have been \$622 billion—an average of \$52 billion a year and 3.8 percent of total gross domestic investment in the developing world.

Since the 1980s, the global infrastructure industry has undergone unprecedented changes, including a technological revolution in the telecommunications industry, deregulation and competition in mature markets, and liberalization in the developing world. The importance of private ownership and finance in electrical power, transport, water, and telecommunications is now well recognized. It is also well recognized that public providers of infrastructure services will continue to play a significant role in infrastructure development, ownership, and operation—at least for the next few years. The challenge, therefore, is to achieve stable investment environments and creditworthy public and private infrastructure enterprises that can access these global capital markets.

The issues to be addressed in tapping global and domestic capital markets to meet the infrastructure financing needs of developing countries are three. First, a strong institutional framework for the protection of creditors' rights, effective covenants, and reliable avenues of legal enforcement and remedy. Second, growth, maturation, and stability in local capital markets—these markets provide both long-term local-currency financing and hedging against exchange-rate risk. Third, a renewed effort to improve the creditworthiness of public infrastructure providers—both to facilitate their access to capital markets and to make private equity investment in public-private ventures less risky.

As multilateral institutions incorporate the Millennium Development Goals into their targets and strategic vision, they have come increasingly to view infrastructure financing within the broader context of financing for development. They can help meet infrastructure needs in developing countries through their own lending and by leveraging private capital.