

Overview

The financial crisis that began in Asia almost two years ago has made the environment for developing countries more difficult and uncertain. In recent months, Russia and Brazil have run into severe financial difficulties, and flows to developing countries from international capital markets have been cut in half compared with the precrisis period. At the same time, interest rate cuts in the major industrial countries since last October, adoption of large fiscal stimulus and financial restructuring plans in Japan, and signs that several of the crisis countries in Asia have begun to stabilize have contributed to a climate of improved confidence in international financial markets. This year's *Global Development Finance* report provides an updated assessment of the outlook for developing countries (chapter 1); analyzes the evolution of private capital flows in 1998 (chapters 2 and 3); reviews trends in official finance (chapter 4); and examines experience with debt restructuring and the international rescue packages designed to assist the countries in crisis (chapter 5). The following are the report's main conclusions:

- ◆ Although the risk of a deep global recession has receded in recent months, the crisis in emerging markets is likely to be deeper and more prolonged than earlier assessments had suggested. Compared with forecasts published in early December of last year¹, the growth forecast for developing countries has been revised downward by 1 percentage point in 1999, to 1.5 percent—the lowest rate since 1982. For developing countries as a group, a return to trend rates of growth (4.5–5.0 percent) is unlikely before 2001.

¹ *Global Economic Prospects 1998/99*.

The downward revision of the projections reflects changes in assumptions related to both external and domestic factors. On the external front, prospects for developing countries' export receipts have been downgraded because of cuts in the 1999 forecasts for world trade growth and commodity prices. This implied increase in demand for external finance is unlikely to be met in the current environment, in which the supply of funds to emerging markets is reduced and the cost of such borrowing is higher. Policy measures in a number of countries to restrict economic growth and thus limit financing requirements are an important contributing factor to lower forecasts for developing country gross domestic product (GDP). On the domestic front, the crisis has placed a sharper focus on the difficulties of dealing with chronic fiscal deficits (for example, in Brazil, India, Russia, and Turkey) and corporate and financial restructuring (in the Asian crisis countries). Furthermore, the proliferation or intensification of civil and international conflicts has adversely affected prospects in some regions. The picture is not, however, one of uniform deterioration. World trade should pick up in the second half of 1999 with continued growth in the U.S. and European economies, and stabilization and a recovery of private capital flows in several of the Asian crisis countries.

- ◆ Net long-term financial flows to developing countries, including both private and official finance, fell from \$338 billion in 1997 to \$275 billion in 1998. The large shift into surplus of the current account position of the crisis countries in Asia (equal to almost 13 percent of GDP from 1997 to 1998) was induced primarily by a surge in capital outflows and nonrenewal of short-term credit lines, rather than a decline in long-term financial flows.

- ◆ The decline in long-term financial flows to developing countries was concentrated in flows from international capital markets, which fell from \$136 billion in 1997 to \$72 billion in 1998. Commercial bank loans, bonds, and portfolio equity were all affected. In the first half of 1998 the decline in flows from capital markets was largely limited to East Asia. However, following the eruption of the crisis in Russia, the decline became more generalized, and spread to Latin America. With the situation still fluid in Brazil, the short-term outlook for capital flows remains uncertain. Assuming a favorable resolution of the crisis, flows from international capital markets may recover from their very low end-year levels over the next several months. However, it is likely that flows will register a further decline this year compared to 1998. This reflects, in part, the deterioration in credit ratings of emerging markets, only 15 of which are now above investment grade, versus 21 before the crisis. It is also important to underline that the fundamentals that drove the surge of private capital flows in the early and mid-1990s remain largely in place, including improved policies and differences in factor endowments. Over the medium term, this should get flows moving toward precrisis levels.
- ◆ Foreign direct investment (FDI) flows showed considerable resiliency, falling only modestly—from \$163 billion in 1997 to \$155 billion in 1998. In several crisis countries in Asia, FDI increased as investors took advantage of distressed asset prices, increased international competitiveness, and opportunities for mergers motivated by the need to gain access to finance, as well as to restructure and reduce costs. These motivations appeared to have offset the deterrent effects of recession and the smaller size of markets as expressed in foreign currency. FDI flows to developing countries are likely to slow some over the next year or two, in response to the

slowdown in world trade and output and its effects on corporate earnings in source countries. As corporate restructuring accelerates, FDI flows to some Asian crisis countries should pick up again, however, and FDI is likely to remain the largest source of finance for developing countries in the foreseeable future.

- ◆ Concessional finance continued its decade-long decline, as aid flows fell from \$33.4 billion in 1997 to \$32.7 billion in 1998. Aid flows are now one-third below the 1990 level in real terms, and the prospects are for continued stagnation or decline. The decline ironically coincides with important advances in policy reform in South Asia and Sub-Saharan Africa. Recent studies have found that aid is most effective in reducing poverty in countries with sound economic management. A reallocation of aid to countries with good policies and large numbers of poor people could substantially reduce poverty.
- ◆ Reflecting large rescue packages, net nonconcessional finance rose from \$6 billion in 1997 to \$12 billion in 1998—this figure excludes net IMF lending, which increased from \$15 billion in 1997 to \$21 billion in 1998, up from \$1 billion in 1996. From August 1997 to December 1998 the international community committed almost \$190 billion to Brazil, Indonesia, the Republic of Korea, and Thailand, with \$63 billion disbursed.
- ◆ Official support to countries in crisis has helped alleviate systemic risk and reduce the costs of adjustment in affected countries. The East Asian crisis countries continued to service their sovereign debts, except for Indonesia, where restructuring proceeded smoothly. In recent months exchange rates in the East Asian crisis countries have recovered and interest rates have declined. But the Russian situation remains difficult. Good progress was made in refinancing the external debt of domestic banking

systems in Asia, but the restructuring of corporate debt has been slow. The disbursement of rescue funds has varied with the progress on agreed reforms. But burden sharing by private creditors of the Asian countries' banking systems was limited, raising concerns about whether the right balance was struck between avoiding the spread of crisis and creating moral hazard.

The international community has become deeply engaged in the debate over the causes of the crisis in emerging markets and the steps required to avoid a recurrence. This debate is healthy and has already led to improved understanding of the conditions necessary to sustain flows. Policymakers are beginning to strengthen domestic financial systems, improve transparency in international capital markets, adopt sounder and more consistent macroeconomic policies, and strengthen the social safety net. These reforms will take considerable time to bear fruit. But they are already setting the stage for recovery of capital flows to developing countries in line with that of global economic activity later in the forecast period.