Foreword

THE GLOBAL ECONOMY IS AT A turning point. Growth has peaked, and pressures to address global imbalances are growing, exposing important risks facing both developed and developing countries as the needed adjustments occur. Whether or not the rebalancing occurs in an orderly fashion will have a crucial impact on whether recent improvements in developing-country performance can be sustained—and whether progress towards the Millennium Development Goals (MDGs) can be accelerated. The stakes are large.

Global economic performance over the last year provides continuing evidence of the growing interdependence of developed and developing countries. Global growth was high, in part from record expansion in developing countries, which have been benefiting from favorable global conditions and from years of domestic policy improvements. Financial flows to developing countries during 2004 reached levels not seen since the onset of the financial crises of the late 1990s. And developing countries' increasing integration with the global financial system continues to raise their stake in the health and resilience of that system.

But the strong recovery has also given rise to sizable global financial imbalances that will have to be addressed. If the global growth cycle has indeed peaked, the likely scenario involves continued (though slower) growth and an orderly reduction in imbalances. But there are also risks—of higher-than-expected interest rates, of abrupt and disorderly exchange-rate movements, and of a pronounced global slowdown that could encourage protectionist sentiments and curtail expansion of trade and investment linkages between developed and developing countries.

The resilience of developing-country financial positions will be tested as global conditions tighten, with special concern for the vulnerability posed by increased debt burdens, which have been at the heart of the financial crises over the last decade. There is some good news here—*aggregate* external debt indicators are down, many developing countries have improved their capacity to manage debt, and many countries have acted aggressively to address the weaknesses that contributed to previous crises. But external debt burdens have risen in more than half of emerging market economies, and, in many, *domestic borrowing* has risen dramatically as well. Although the shift from external to domestic borrowing can reduce vulnerability to external shocks, it also carries risks from possible overborrowing or inadequate supervision. The central policy message is that excessive borrowing is risky, regardless of the source, and that efforts to avoid the discipline required by external borrowing by switching to domestic sources will fail.

Emerging market economies are also vulnerable to the possible impact of larger-than-expected increases in interest rates (which would translate into higher borrowing costs) and possible capital losses on dollar-denominated assets from dollar depreciation. The impact could be particularly acute for economies in which reserve accumulation far exceeds normal prudential levels, which entails fiscal costs as monetary authorities issue low-yield securities to absorb the excess liquidity created by reserve accumulation.

For low-income countries, the major vulnerabilities stemming from the current global environment are linked less to the evolution of interest rates and exchange rates and more to the future of flows of aid from bilateral and multilateral sources. While the challenge of generating sufficient aid to help low-income countries reach the Millennium Development Goals (MDGs) remains large, there are some encouraging signs of progress, as some donors have increased their commitment levels and aid flows have turned upwards. But concerns persist about whether these increases are large enough, and whether adequate flows are reaching areas that need them most, such as Sub-Saharan Africa. As the global community reevaluates progress towards the MDGs in the coming year, donors and recipients alike must remain focused on the imperative of generating resources that can be effectively used in developing countries that have supportive policy and institutional environments.

Equally encouraging is the growing evidence that financial flows other than official aid are growing—from rapid expansion in private investment (including substantial growth in South-South investment flows), to private grants, to other sources of foreign exchange such as workers' remittances. While such flows can not and should not substitute for sustained and targeted official aid, they nonetheless highlight the growing options and opportunities open to low-income countries.

Global Development Finance is the World Bank's annual review of the external financial conditions facing developing countries. The current volume provides analysis and summary tables on selected macroeconomic indicators and financial flows. A separate volume contains detailed, standardized, external-debt statistics for 136 countries. More information on the analysis, including additional material and sources, is available at www.worldbank.org/prospects. A companion online publication, Prospects for the Global Economy, is available in English, French, and Spanish at www.worldbank.org/globaloutlook.

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