Overview and Policy Messages: Mobilizing Finance and Managing Vulnerability

2004 WAS A ROBUST YEAR FOR THE global economy, especially for developing countries, which recorded their fastest growth in more than three decades. The global recovery strengthened, with much of the momentum coming from the United States and Asia (notably China), and broadened, with a pickup in Latin America, acceleration in Japan, and modest recovery in the European Union (EU). Driven by favorable global conditions and strong domestic performance at home, developing countries continued to attract capital in 2004, although more slowly than in 2003.

Favorable global economic and financial conditions over the past few years, along with domestic policy initiatives, have improved economic fundamentals in most developing countries, strengthening their external positions and making them less susceptible to external pressures. But significant global financial imbalances suggest the need for adjustment. History has shown time and again that financial crises often take markets and policymakers by surprise. The Asian crisis that erupted in mid-1997 offers a striking example—large exchange-rate exposures on balance sheets in the corporate, financial, and public sectors were not widely recognized until after the fact.

Valuable lessons can be learned from these past episodes. One is that there is a tendency for financial markets and policymakers to miss the warning signs and overshoot, making the necessary adjustment larger when it does occur. Overshooting has contributed to "boom-bust" cycles in global financial markets, which have impeded economic development in many regions. In the current context, the memory of past mistakes raises the question of whether the strong pickup in capital flows to developing countries over the last two years can be sustained over the medium term.

Emerging market economies with access to global finance are particularly vulnerable to changes in interest and exchange rates that may occur as markets anticipate and adjust to policy measures intended to relieve the yawning imbalances. Countries that have accumulated large dollar-denominated reserve holdings face acute pressures and large potential investment losses from the weakening dollar, though their dollar-denominated debt burdens may ease. Those that have failed to take advantage of recent favorable conditions to lighten their debt burden may face debt-servicing difficulties as conditions worsen. All countries, whatever their circumstances, stand to benefit from a better understanding of the complex challenges that are changing the borrowing environment (both external and domestic) and the options open to policymakers.

The risks are somewhat different for low-income countries that are more reliant on official and concessional sources of external finance. Official aid flows are vulnerable to growing fiscal pressures in donor countries, while private flows will come to reflect tightening global conditions. Keeping growth on a sustainable path as the global recovery evolves will therefore be a major factor in attaining the Millennium Development Goals embraced by the world's leaders at the UN Millennium Summit in 2000.

The theme of this year's edition of *Global Development Finance*—mobilizing finance and managing vulnerability—embraces three key challenges:

- Managing the vulnerability inherent in global economic and financial imbalances,

- Confronting the risks posed by the new complexities in developing country debt, and
- Mobilizing and diversifying sources of finance for low-income countries with more limited access to international capital markets.

Capital flows to developing countries continued to recover, but at a slower pace

The strong recovery of capital flows to developing countries that began in 2003 carried over to 2004, albeit at a reduced pace. Total private and official net debt flows totaled a record high of almost $325 billion, up significantly from $200 billion during 2000–2. The pickup is more modest after taking into account factors such as inflation, economic growth, and the sizable depreciation of the dollar against most major currencies. Net capital flows to developing countries equaled 4.5 percent of their gross domestic product (GDP) in 2004, up slightly from 4.3 percent in 2003, but significantly below highs exceeding 6 percent reached in the mid-1990s (chapter 1).

Developing countries continued to export capital and accumulate reserves

Drawing on healthy trade balances, developing countries have continued to generate large current account surpluses, a dramatic turnaround from past decades. Combined with expanding capital flows, the growing surpluses contributed to accelerating accumulation of foreign reserves by developing countries—from $292 billion during 2003 to $378 billion during 2004. Although the largest reserve accumulation was concentrated in Asia, the phenomenon was widespread. More than three-quarters of developing countries reporting reserve changes (101 of 132) accumulated reserves during the year. A sizable portion of this new accumulation is invested in U.S. Treasuries, indicative of the growing stake of developing countries in the global financial system.

FDI inflows increased modestly, but outflows surged

FDI inflows to developing countries increased during 2004, partly offsetting the decline during the previous two years. While the concentration of FDI flows remains high (five emerging market economies account for 60 percent of FDI and 88 percent of the increase), the share flowing to low-income countries reached 11 percent, the highest in 15 years. Reported FDI *outflows* from developing countries surged dramatically, reaching an estimated $40 billion in 2004 (from only $3 billion in 1991). The bulk of the FDI outflows originated in countries that have been major recipients of inflows in recent years. In response to greater foreign competition, domestic firms in those countries have launched an aggressive search for markets abroad—often elsewhere in the developing world.

Private debt flows showed strong gains from record levels of bond issuance

Net international bank lending continued to decline as net bond flows rebounded sharply, reaching a record high in 2004. Gross bond issuance surpassed gross bank lending for the first time, although bank lending remains available to a larger group of countries. The strong gains in bond issuance over the past two years reflect both supply and demand factors—ample global liquidity, low advanced-country interest rates promoting a "search for yield," and a broad-based improvement in credit fundamentals in many emerging markets. Apart from some short-lived volatility in April–May (as the tightening of U.S. monetary policy began), emerging-market bond spreads fell steadily during 2004, reaching a near-record low by the end of the year.

Official aid continued to shift from loans to grants

Recent figures confirm the continuing structural shift in official development assistance (ODA) from loans to grants over the last several years. While bilateral aid grants have risen annually since 2001, net official *lending*, largely multilateral, has declined dramatically, falling from $27 billion in net inflows to developing countries, to $25 in net outflows in 2004. The largest factor underlying this shift has been a $30 billion net decline in lending by the International Monetary Fund (IMF), reflecting repayment of sizable crisis-related disbursements made in 2001. But net lending by the World Bank also fell by $9 billion over the period, as several countries repaid large structural adjustment loans, and other Bank loans were repaid ahead of schedule.

While ODA figures for 2004 are not yet available, promising signs of expansion since the March 2002 Monterrey Conference on Financing for Development are evident, with an increase in 2003 of around $10 billion to $69 billion (although after accounting for inflation and exchange rate changes, the real increase was only 5 percent). Sub-Saharan Africa has received 60 percent of the increases in ODA disbursements over the five-year period from 1998 to 2003. However, with most of these funds allocated to postconflict situations, the increase in development aid has been small.

Five bilateral donors have increased disbursements to levels exceeding the United Nations (UN) target of 0.7 percent of GNI; four additional donors have specified explicit time tables for meeting the UN target over the next few years. ODA as a share of gross national income (GNI) in donor countries is projected to rise from 0.25 percent in 2003 to 0.30 percent in 2006—implying a 9 percent annual increase in ODA in real terms, well above that achieved over the past two years (6 percent).

The world economy is slowing

The growth cycle is peaking

The year 2004 was a record year for developing countries, with aggregate growth of 6.6 percent. While very strong growth in China (and to a lesser extent in Russia and India) contributed importantly to this result, growth was strong throughout the developing world. However, high-frequency data suggest that global growth began slowing in the second half of the year, and this trend is projected to continue into 2005 and 2006. Persistently high oil prices, rising interest rates as a result of monetary tightening, and a waning fiscal stimulus from efforts to address the 2000/01 recession are projected to dampen domestic demand and slow growth among high-income countries. These same forces, plus softening import demand in the developed world, are expected to slow the pace of expansion in low- and middle-income countries. Nevertheless, their growth should continue to outpace industrial economies by a wide margin—partly because of continued strong growth in China and India. Indeed, notwithstanding the slowdown, economic growth in low- and middle-income countries will remain above the rising trend for much of the past two decades. As a result, commodity prices are expected to ease only slowly, and inflation pressures will continue to build in a number of developing countries.

Global imbalances and major currencies are stabilizing

A combination of a somewhat tighter fiscal policy and higher interest rates in the United States is projected to halt and even reverse the widening current account deficit. Higher U.S. interest rates will increase the willingness of private-sector investors to hold dollars, and the two effects should slow the currency's tendency to depreciate. Co-movements among the currencies of developing countries and the compensating effect of an appreciation of the euro have left the real effective exchange rate of most developing countries broadly stable. However, the large swings in the bilateral exchange rates of the major industrialized economies impose adjustment costs on firms that are expected to augment trade growth.

Significant downside risks persist

A reduction in the pace at which central banks are accumulating dollars, a weakening in investors' appetite for risk, or a greater than anticipated pickup in inflationary pressures could cause interest rates to rise farther than projected, provoking a deeper-than-expected slowdown or even a global recession. If the dollar were to depreciate by more than projected, it would likely undershoot its long-run equilibrium level. Should it remain low for an extended period, this could induce a costly restructuring of world industry that would have to be undone in following years as the dollar returned to its equilibrium level. Finally, the slowdown in global growth could sap policymakers' desire to pursue further trade liberalization, which has been a major motor of the improved performance of developing countries over the past half decade.

Sensible policy can reduce the probability and severity of such adverse scenarios. Tighter U.S. monetary and fiscal policy, a relaxation of European monetary policy (relative to the United States), and a managed appreciation of some Asian currencies would reduce the likelihood of a sharp depreciation in the dollar or an abrupt hike in interest rates by reducing global imbalances, increasing demand for dollars, and lowering inflationary pressure in developing countries. To minimize the impact of a weaker-than-projected outcome, developing countries should ensure that debt and spending obligations will remain affordable, even if output and tax revenues slow substantially and interest rates rise. While a coordinated response would be ideal, the policies described above would be beneficial for each economic grouping—even if adopted unilaterally.

Growing global imbalances pose risks for emerging market economies

Despite recent strong performance, developing countries face substantial risks from trends in the global economy. The channels through which events in global financial markets affect developing countries reflect the changing character and growing significance of developing countries' international financial relationships. Not only is there concern about the traditional sensitivity of emerging-market finance to cyclical developments in international capital markets, but, for some countries, the carrying costs of large accumulations of foreign exchange reserves raise new challenges. Looking ahead, the possibility of "disorderly" adjustments of external payments imbalances in the global economy could pose acute risks to emerging markets.

Exchange-rate volatility and higher interest rates could affect the cost and availability of capital

While the baseline outlook for the global economy (chapter 2) is for an orderly adjustment in global imbalances in external payments, less salutary outcomes are possible. One key implication of a more disorderly adjustment scenario for emerging market economies is that it would likely bring an end to the favorable economic and financial environment that has supported a strong rebound in capital flows over the last two years. The most likely consequence would be a widening of credit spreads on emerging-market bonds, which in turn could adversely affect the flow of debt.

On the positive side, a weaker dollar reduces the net external debt burden (measured in local currency) of countries with dollar-denominated debt. For example, in the 100 or so developing countries whose exchange rate is not pegged to the U.S. dollar, the dollar's slide since 2002 has reduced average ratios of debt to gross national product (GNP) and debt service to exports by about 1 percentage point.

Global tightening of monetary policy as major industrial economies move to a neutral stance will have an impact on market interest rates. Rising interest rates, in turn, will likely slow global economic growth, as increases in short-term policy rates lead to higher borrowing costs (although this effect has been modest to date, as long-term yields in the United States have not increased as in previous monetary tightenings).

How market interest rates respond to future changes in monetary policy—particularly in the United States—and how such reactions spill over to emerging bond markets is taking on considerable significance. With emerging-market bond spreads at record lows (which suggests that markets may be underestimating credit risks), an unexpected deterioration in global conditions could lead to a precipitous widening of those spreads as investors adapt their expectations and reduce their risk appetite. With gross bond financing surpassing bank financing in 2004 for the first time, the impact of sharply higher spreads on emerging markets would be substantial.

Borrowing costs would rise if such pressures lead credit-rating agencies to downgrade their rating of emerging-market borrowers. It is estimated, for example, that for the "typical" low-investment-grade borrower, a one-notch downgrade raises borrowing costs an average of 80 basis points. This effect could be accentuated for more vulnerable countries. For example, for countries with high external debt levels, a 200-basis-point increase in U.S. rates (the approximate increase currently anticipated) would bring an additional increase of 65 basis points (on top of the 200). For countries with low debt, the incremental impact is only around 6 basis points.

Excessive reserve accumulation has costs

Not all of the increase in capital inflows has been directed to productive domestic investment or consumption. Some has been channeled into foreign exchange reserves. Recent record levels of reserve accumulation across a broad range of developing countries reflect several motives: insuring against abrupt reversals of capital flows, liquidity considerations related to exchange-rate management and creditworthiness concerns, and, for some, relieving upward pressure on a fixed exchange rate to help maintain trade competitiveness.

Although these motives are justifiable under some conditions, one outcome is that current reserve levels in several countries exceed by a large margin the conventional measures of reserve adequacy. That excess leads to concerns over the cost and the sustainability of current policies, particularly (i) the quasi-fiscal cost associated with central banks' sterilized intervention operations to offset the expansionary monetary impact of higher reserves, and (ii) potential capital losses on dollar-dominated reserve assets (chapter 3).

The quasi-fiscal burden reflects the difference between what the foreign-currency reserve assets earn and what the central bank must pay on domestic securities issued to offset their expansionary monetary impact. This burden can be substantial—the gap between the two rates, under prevailing market conditions, can be as high as 6–8 percent, with each percentage point costing the central bank an additional $100 million annually for each $10 billion in reserves. Moreover, where domestic financial markets are still underdeveloped, there are institutional limits on central bank capacity to pursue such sterilized market operations. India has a shortage of available instruments to use in sterilization operations, Korea has run up against limits on the amount of securities it can issue, and state-owned banks in China have reached the limits of their capacity to purchase additional securities at below-market rates.

The capital loss costs relate to the valuation and management of the central bank's portfolio of reserve assets. While most central banks are engaging professional asset managers, an estimated 70 percent of reserves are held in dollar-denominated assets (individual country estimates are generally not available), implying that a sharp drop in the dollar could translate into a corresponding drop in the domestic value of the reserve holdings.

Looking ahead, countries accumulating substantial excess reserves will have to reconcile the benefits of higher reserves with the potential for capital losses and growing quasi-fiscal carrying costs. Even when costs are hidden (for example, by requiring banks to hold domestic assets at below-market yields), the domestic macroeconomic consequences are very real, as countries reach the limit of their ability to sterilize the impact of large reserve accumulations.

Clear policy challenges are emerging

For developing countries, the greatest challenge is to continue taking advantage of current favorable financing conditions, while pursuing the necessary domestic macroeconomic and structural reforms necessary to promote long-term stability in their external financing sources. This would involve:

- Renewed commitment to macro stabilization and structural reforms that have laid the foundation for the recovery and vigorous expansion of capital flows since 2002.
- In high-reserve countries, reevaluation of the sustainability and costs of rapid reserve accumulation, both in terms of domestic macroeconomic management and increased vulnerability to changing external conditions. These countries need to consider how to manage appreciation of their currencies against the major currencies, to share the global adjustment burden.
- Continuing efforts to improve asset and liability management, especially by lengthening borrowing maturity, retiring high-cost debt, diversifying the currency composition of debt, and hedging currency exposure as much as possible.
- Pushing forward with efforts to strengthen the health and soundness of the domestic financial system through measures to improve prudential regulations, enhance banks' capitalization, develop local bond markets, and remove incentives for excessive foreign currency intermediation.

The complexity of developing-country debt poses new challenges

Much has changed since the wave of financial crises rocked emerging market economies and disrupted global financial markets from the mid-1990s up until 2002. Many countries that were at the center of earlier crises have made significant progress in improving prudential and regulatory policies and structures whose weaknesses contributed to the crisis. Fiscal policies have generally been more prudent, although concerns persist about the sustainability of public debt in several countries. Inflation has fallen. Greater exchange rate flexibility has reduced the likelihood that an exchange-rate crisis will become a debt crisis and raised awareness of the risks inherent in currency mismatches. Since 1996, 19 developing countries have shifted to floating exchange-rate regimes. Overall, the improved disposition of investors toward developing countries has been reflected in the trends in average credit quality, which has risen steadily since early 2002. The number of countries carrying formal credit risk ratings (around 60) is now almost four times higher than in the mid-1990s.

The dynamics of external debt have been transformed

The debt-related crises of the 1990s, which were concentrated in a small group of emerging market economies, have induced changes in debt dynamics in many developing countries. A rapid expansion in bond finance, pursued most aggressively in countries that experienced severe debt pressures or crises in the 1990s, has increased vulnerability to changing market conditions in global markets (over which individual countries can exercise little control) and domestic circumstances, which can quickly translate into higher borrowing costs through their impact on spreads (chapter 3) or reduced capital availability. Furthermore, the enormous increase in the number of stakeholders that has accompanied the shift into bonds has complicated the resolution and management of crises.

International capital markets today are more attuned to, and more discriminating about, development finance than in the past. This in turn imposes a degree of discipline on borrowing through greater transparency, a more substantial flow of information, increased market research, and finer distinctions in credit risk. Overall, these developments have reduced the systemic risk in market-based emerging market finance.

Similarly, the international financial architecture, which aims to prevent defaults and facilitate orderly debt restructuring, has been strengthened. Collective action clauses have been introduced in some bond financing transactions, and discussions over a code of conduct continue. The Capital Adequacy Accord (Basel II) offers the potential to strengthen the banking sector and enhance the ability of banks to take on and sustain riskier lending, through measures to mitigate and manage risk. Joint international efforts on statistics and monitoring are improving the quality and quantity of information available for use in managing approaching crises.

But while efforts to strengthen the international framework for dealing with financial distress have started to yield results, much remains to be done. For example, the adoption of collective action clauses can help facilitate debt restructuring, but their impact is still quite limited, as they apply only to bond debt, are not adopted in all new issues, and do not apply to pre-2002 debt.

External debt burdens have eased for some, but not for most

Developing countries' burden of external debt (public and private) declined from a peak of 45 percent of GNI in 1999 to an estimated 39 percent in 2003. This improvement occurred despite an increase of almost $207 billion in the nominal value of external debt. It therefore reflects the impact of stronger developing country performance: since the late-1990s, GNI has grown three times faster than external debt. Other indicators of developing countries' vulnerability to interest and exchange rates have improved as well: ratios of debt to exports dropped from 135 percent in 1997 to 125 percent in 2003.

Amid the overall improvement, the debt circumstances of individual countries differ considerably. The reduction in aggregate debt burden has been driven by large improvements in a few countries (representing about 30 percent of outstanding debt). But in two-thirds of middle-income countries, the debt burden *increased* between 1997 and 2002. For nine emerging market economies in this group (Argentina, Brazil, Indonesia, Philippines, Poland, Russian Federation, South Africa, and Turkey), the average deterioration in the debt/GNI ratio was 21 percentage points. Currency revaluation effects also loom large for countries with large dollar-denominated debts (chapter 3), more than offsetting the underlying reduction in debt stocks through repayment for some countries.

The share of foreign direct investment (FDI) and portfolio equity in the finance mix of many developing countries has grown in recent years—a trend that enhances stability. Equity flows accounted for 80 percent of total external financing during 1999–2003, compared with just 60 percent during 1993–98.

The composition of external debt has changed, with an increase in private borrowing

Developments in international capital markets and developing countries, as well as expansion in the investor base, have helped facilitate the private sector's access to international capital markets. As a result of greater private borrowing, the share of public sector debt in total external debt declined from 82 percent during 1990–95 to 69 percent during 1996–2003. At the same time, the public sector's emphasis on domestic sources of financing has increased.

The reduction in the public debt share might appear to lower sovereign vulnerability, but as the Asian crisis demonstrated, excessively risky private sector behavior can precipitate a crisis—and the subsequent cleanup often blurs the lines between public and private.

The rise in domestic debt partly offsets the reduced burden of external debt

Debt from domestic sources has grown rapidly in emerging market economies, largely through the development of domestic bond markets. In many countries where external debt burdens have stabilized or fallen, domestic public debt burdens have *increased* (chapter 4). As a result, in many developing countries, the burden of public sector debt remains high, calling into question the apparent improvement associated with falling external indebtedness.

The extent of the shift from external to domestic debt has varied across regions. In Asia, following the market-forced retrenchment of credit that occurred during the crisis, the switch was rapid and intentional—the ratio of domestic to external debt rose from close to parity in 1997 to 3 to 1 in 2002. Initial domestic debt buildup was driven by crisis responses (often bailouts or recapitalizations of failing banks), while more recent increases have been driven by conscious policies to reduce reliance on external debt (and, for many, a buildup in foreign exchange reserves). Elsewhere, the picture is more mixed—in Latin America, for example, the decline in external financing since 1999 has not been matched by as large an increase in domestic financing.

Greater domestic borrowing by the private sector also poses dangers. High levels of domestic credit to the private sector have been the precursor to many financial crises. The risk is particularly great when *perceptions* of risk motivate swift changes in global asset allocations, beyond what is warranted by underlying fundamentals. The burden imposed by private sector bailouts, especially in the financial sector, can lead to a buildup of debt for the public sector as well. In addition, the corporate sector's engagement in derivative-type transactions can pose contingent liabilities that are at times unanticipated, often for lack of information.

But the deepening of local bond markets brings many benefits. Local bond markets help finance government deficits, compensate for the effects of holding large, low-yield reserves, and facilitate domestic monetary policy by providing a liquid debt market to facilitate operational aspects of monetary policy. They also strengthen the domestic financial system—bond markets complement structured financing and stimulate competition, while the infrastructure required to support them (clearing and settlement systems, regulatory and legal frameworks) makes the entire financial system more efficient. Domestic debt markets also offer an increasingly attractive destination for foreign investors and have encouraged an important catalytic role for international financial institutions, which have often taken the lead in initiating borrowing in developing-country currencies.

The need to balance external and domestically financed debt has created new challenges

With the shift in the balance of external and domestic debt, new challenges have emerged. On the positive side, lower external debt reduces vulnerability to external shocks (related to exchange rates or interest rates), which in turn builds confidence among international investors. It also can relieve pressure on exchange rates and raise credit ratings, leading to lower external borrowing costs and even increased asset demand as the economy moves into a risk class more open to institutional investors.

But the switch to domestic debt heightens other risks—notably the uncertainties of rolling over short-term debt (because maturities of domestic debt are generally shorter than those of external debt), and associated interest-rate risks. To minimize risk, domestic borrowing, like external borrowing, must be based on sound measures for managing public debt, a capable tax system, and effective regulatory and legal environment for domestic financial activity. Exchange-rate management remains particularly crucial, because international demand for domestic assets will be critically affected by perceptions of the soundness of exchange-rate policy and concerns over volatility and convertibility. Finally, any temptation to borrow excessively from domestic sources needs to be resisted. A debt crisis sparked by excessive domestic borrowing can be just as devastating as one created through external borrowing, and a domestic debt problem can quickly grow to affect external debt.

Despite the growing sophistication of international capital markets and a steady growth in the capacity of central banks and monetary authorities in developing countries, significant weaknesses remain both in the international architecture that has evolved to regulate those markets and in the quality of data available on the fast-growing domestic debt markets in many emerging market economies. Improving the monitoring and dissemination of information on public and private domestic debt flows should remain a priority for international institutions and national authorities.

Meeting poor countries' financing needs requires recognition of the countries' special challenges

Poor countries are operating in an external financing environment of growing complexity. Although ODA is still the major resource flow for many countries, many others now receive growing private capital flows (FDI and private debt flows, sometimes originating in other developing countries) or other nontraditional private resource flows (workers' remittances and grants from nongovernmental organizations [NGOs]). Understanding the differential availability of the new mix of financing resources to individual poor countries will be essential to efforts to maximize aid effectiveness and achieve development objectives—notably the MDGs (chapter 5).

Sources of external finance have changed

Since the early 1990s, the relative importance of ODA as a source of external financing for poor countries has declined, in part due to the end of the Cold War and waning support for client states, but also because of growing global integration through the liberalization of financial flows, trade, and migration. Aggregate figures mask enormous variation among the 28 countries considered in this study: ODA dependence ranges from a high of 36 percent of GDP in Mozambique to 2.2 percent in Bangladesh.

But other forces were at work as well. While ODA was declining, other sources were rising: FDI rose from only 0.4 percent of GDP to 2.7 percent of GDP in 2003, reflecting improving performance and a sounder investment climate. FDI has been of considerable importance for many poor countries—including Lesotho, Mauritania, Moldova, and Mozambique. Nonetheless, much FDI to poor countries still flows to enclave mining and natural resources projects, which may limit benefits and add to volatility.

While not technically a capital flow, private transfers (including NGO grants and workers' remittances) have become relatively more important in poor countries than in other developing countries. Both are large, stable sources of foreign exchange for poor countries and may be more likely than other capital flows to reach poor households. In addition, the size and stability of such current account flows (especially workers' remittances) over time may facilitate poor countries' access to capital markets through securitization.

Flows from other developing countries have grown

The traditional view of developing countries as reliant solely on financing from industrial economies is increasingly outdated. While the final report from Monterrey mentioned the importance of cooperation between developing countries only briefly, the available data suggest a different perspective: with respect to poor countries, other developing countries (especially larger ones such as Brazil, China, India, Saudi Arabia, and South Africa) are increasingly important financial players.

With wealth increasing and administrative capital controls being eased in the 1990s, developing countries have also emerged as significant sources of FDI outflows, in the form of investments by developing country firms—usually in other developing countries. Because of proximity, cultural similarities, and similar cost structures, developing country firms may have advantages in certain FDI projects. Companies from other developing countries bought assets in a broad range of privatization deals during the 1990s, in sectors ranging from mining to agro-business to telecommunications.

Similarly, although aggregate numbers are still small (and available data limited), ODA providers are becoming more diverse. With the emergence of new donors such as China, Brazil, South Africa, and India, the scope of South-South development assistance is growing, with innovative approaches such as triangular cooperation (developed-country financing of South-South technical cooperation) receiving greater emphasis.

Finally, the South is the primary destination for poor-country migrants—a large portion of poor-country migrants in Africa and South Asia migrate to another developing country. As a result, other developing countries (not industrial economies) are the major source of workers' remittances to the poor countries. The countries with the highest remittance shares are all adjacent to larger, wealthier developing countries, an interdependence that creates both opportunities and risks.

An agenda for financing the Millennium Development Goals

As other sources of finance grow, the development community must continue to play the leading role in mobilizing the external resources on which developing countries are depending to achieve the MDGs. Action is needed on four fronts.

First, donors must fulfill commitments already made (at Monterrey and afterwards) to substantially increase ODA and other resources needed to achieve internationally agreed development goals. Meeting those commitments will require overcoming mounting fiscal pressures in many donor countries and avoiding distractions surrounding shifting strategic considerations—so that aid can be channeled to the places that need it most. Much of the enhanced aid effort must be directed toward Africa, where the MDGs will only be met by 2015 if rates of progress increase considerably. The Commission for Africa recently urged a doubling of aid to Sub-Saharan Africa. And in February 2005, the G-7 finance ministers reaffirmed their countries' commitments to helping the developing world, particularly Africa, achieve the MDGs by 2015. That goal is one of two main themes for discussion at the G-8 leaders' summit scheduled for July 2005.

Second, donors should pursue efforts to make aid flows more reliable. Recognizing that aid is more effective when it is allocated preferentially to countries that demonstrate a capacity to absorb additional aid and to use it well, and that aid cannot be expected to stabilize economic fluctuations in recipient countries, volatility *per se* is inimical to aid effectiveness. Aid has been observed to be more volatile than GDP in recipient countries, and more volatile than some other sources of foreign exchange. Efforts to make it less volatile (through vehicles such as the International Financing Facility, for example) could enhance its effectiveness.

Third, donors (both developed and developing) and recipients should press for better donor coordination, selectivity, and country ownership to improve the effectiveness of aid, and increase the focus on results. Significant progress has been made on this agenda over the last decade, but there is still enormous duplication among donors and a wide variation among them in terms of selectivity. As efforts are made to scale up interventions to achieve the MDGs, the relevance of initiatives targeting coordination and effectiveness will grow even further.

Fourth, the development community should support policies that could facilitate better market access for poor countries and encourage investment through expanding risk-mitigation instruments to stimulate and build on private-sector participation. Most important, poor countries themselves need to pursue effective economic and pro-poor policies. There is clear and growing evidence of a link between reforms in governance, an improved investment climate, and growth in resource inflows of all types—FDI, official flows, and even remittances. Poor countries should continue their efforts to improve the investment climate not only to attract more resources, but also to ensure their effective use.

As a final point, the question of whether robust growth in developed and developing countries can be sustained over the medium term has potentially important implications for attaining the MDGs. A central concern underlying the global economic outlook over the medium term is whether the current large external payments imbalances will unwind in an orderly manner. Collective policy actions by developed and developing countries alike will continue to play a prominent role. A multifaceted, cooperative approach involving all countries is essential to rebalance the world economy on a path of sustainable growth.