# Global Development Finance

## The Role of International Banking

I: Review, Analysis, and Outlook

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I: REVIEW, ANALYSIS, AND OUTLOOK 2008

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# Foreword

The world economy has entered a period of financial market turmoil, slowing growth, and heightened inflationary pressures, a reality that poses complex policy challenges for the international community. Although developing countries have weathered the storm well thus far, they cannot afford to be complacent, particularly with unusually high uncertainty in the global macroeconomic outlook and with their growing trade and investment linkages with high-income countries. It is imperative that policy makers in both developing and high-income countries take firm actions to alleviate the impact of soaring food and energy prices on the poor while they address the longer-term challenges of financial globalization and economic interdependence.

An important consequence of this growing interdependence is that developing countries are now a locomotive of world economic growth, serving to cushion the impact of the slowdown in the United States. Global growth is projected to drop to 2.7 percent in 2008, from 3.7 percent in 2007, with much of the weakness originating in high-income countries. Developing-country growth is projected to decline—from 7.8 percent in 2007 to 6.5 percent in 2008—but remain well above the average of the 1980s, 1990s, and even the recent period of 2000–05, indicating that improved underlying structural factors are influencing overall economic performance.

The emerging-market asset class has moved into the mainstream in the wake of deepening financial integration across high-income and developing countries and much improved macroeconomic management in many developing countries. Private capital inflows to developing countries surged to an all-time high of $1 trillion in 2007, the fifth consecutive year of strong gains. It is important to keep in mind, however, that the bulk of private capital flows go to relatively few of the largest economies. Although some developing countries have recently gained access to the international bond market, many will continue to depend heavily on concessionary loans and grants from official sources to meet their financing needs. Thus, in the lead-up to the implementation review conference on the Monterrey Consensus of 2002 in Doha late this year, it is essential that donor countries reaffirm their commitment to fulfill the goals laid out in that consensus and make concrete progress to honor their commitments over the balance of the decade.

Concurrent with the ongoing globalization of financial markets, the world is confronting dramatic increases in commodity prices. Indeed, no other issue captures the complexity of the current policy agenda facing the international community than rapid inflation in food prices, particularly for such basic items as wheat and rice. For both food and agricultural commodities, the dominant drivers of higher prices are increased demand for biofuels in the United States and Europe, the weak dollar, and increased prices of fertilizer and energy inputs. Low inventories of grains and export restrictions by a number of countries have exacerbated the problem and contributed to the price increases. Additionally, weather patterns have reduced agricultural output in some countries, and speculation by commodity market investors has also pushed up prices. The increases have been largest for grains, which during the first months of 2008, were twice as expensive as a year earlier. High food prices are now the major force behind increased inflation across developing countries—and worryingly, they are hitting the poorest people the hardest.

Demand for international banking services in developing countries has evolved over time in response to their changing position on the global economic and financial stage. Attracted by the prospects of asset growth and risk diversification, foreign banks have expanded their business in developing countries through both cross-border and local market activity. The benefits of a growing international bank presence—enhanced sources of credit to firms and households, greater provision of sophisticated financial services, knock-on efficiency improvements in domestic banks, and in the long run, contributions to economic growth—are significant. Efforts to reap these benefits, though, require greater attention to bank soundness at entry through closer coordination with home-country regulators, and improved safeguards against the risk of financial contagion in the international banking system. A high premium should also be placed on parent banks' compliance with international standards and regulations regarding capital adequacy, corporate governance, and transparency. There is no room for complacency, as today's increasingly globalized financial system has the potential to speed the transmission of negative financial shocks throughout the world; in recent months, this potential has played out primarily through troubles in the banking industry.

Tackling these challenges requires collective resolve and clear thinking. That the magnitude of the credit turmoil was not on financial regulators' radar screens, however, reveals a critical shortcoming in the current framework of financial market supervision and regulation. In developing countries, it is vital that policy makers maintain their commitment to the sound macroeconomic and financial policies of the recent past while recognizing changes in the international financial climate and differences in their monetary framework, exchange-rate regime, regulatory and supervisory capability, level of financial sector development, and nature of exposure to foreign capital. In high-income countries, recent collaboration between major central banks on the provision of liquidity has been a positive step in calming market volatility. And reworking financial market supervision and regulation in several major financial centers could help avert another credit crisis, as could enforcing more transparency in complex financial instruments and institutions' exposure to them. In general, greater coordination between high-income and developing countries will contribute to greater international financial stability in the long run.

*Global Development Finance* is the World Bank's annual review of global financial conditions facing developing countries. The current volume provides analysis of key trends and prospects, including coverage of the role of international banking in developing countries. A separate volume contains detailed standardized external debt statistics for 134 countries, as well as summary data for regions and income groups. Additional material and sources, background papers, and a platform for interactive dialogue on the key issues can be found 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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The principal author was Mansoor Dailami, with direction by Uri Dadush. The report was prepared under the general guidance of Alan Gelb, Acting World Bank Chief Economist and Senior Vice President. The principal authors of each chapter were:

| | |
|---|---|
| Overview | Mansoor Dailami, with contributions from the International Finance Team |
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| Chapter 2 | Douglas Hostland, Dilek Aykut, and Eung Ju Kim, |
| Chapter 3 | Mansoor Dailami, Dilek Aykut, Robert Hauswald, and Haocong Ren |

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# Selected Abbreviations

| | |
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| ADB | Asian Development Bank |
| ATM | automated teller machine |
| BIS | Bank for International Settlements |
| BRICs | Brazil, Russia, India, and China |
| CDOs | collateralized debt obligations |
| CIS | Commonwealth of Independent States |
| DAC | Development Assistance Committee |
| EC | European Commission |
| ECB | European Central Bank |
| EU | European Union |
| FDI | foreign direct investment |
| GDP | gross domestic product |
| Gemloc | Global Emerging Markets Local Currency Bond Program |
| GNI | gross national income |
| HIPC | heavily indebted poor country |
| IBRD | International Bank for Reconstruction and Development |
| ICRG | International Country Risk Guide |
| IDA | International Development Association |
| IFC | International Finance Corporation |
| IFS | International Financial Statistics database (IMF) |
| IMF | International Monetary Fund |
| IPO | initial public offering |
| IRAI | IDA Resource Allocation Index |
| LDC | least developed country |
| LIBOR | London interbank offered rate |
| M&A | mergers and acquisitions |
| M2 | broad money |
| NAFTA | North American Free Trade Agreement |
| OECD | Organisation for Economic Co-operation and Development |
| OPEC | Orgaization of Peteroleum Exporting Countries |
| saar | seasonally adjusted annual rate |
| *WGI* | *Worldwide Global Indicators* |
| WTO | World Trade Organization |