

Finance Annex

Recent developments in financial markets

Contagion from the Euro area debt crisis to developing countries has emerged

Emerging markets have been engulfed by a wave of market volatility that had started with the August downgrade of U.S. sovereign ratings and sharply heightened with the increased uncertainty related to the resolution of the European debt crisis. In contrast with earlier episodes of market turmoil centered around high-spread European economies, this time contagion from high-income countries affected the risk premia, yields, stock markets, capital flows and currencies of developing countries.

Developing-country equity markets experienced significant sell-offs later in 2011...

As of early-January 2012, emerging equity markets (as measured by MSCI index) dropped 8.5 percent since the end of July (figure FIN.1). All developing regions experienced price declines—although these were much more marked (around 20 percent) in Eastern Europe. Among the worst country declines were for Argentina, Brazil, Egypt, India, Serbia, Bulgaria,

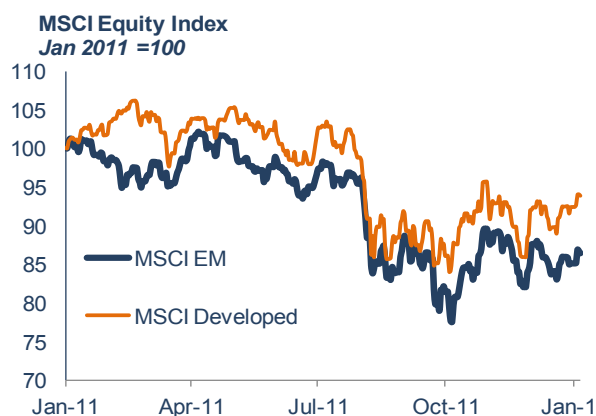
Ukraine, and Vietnam. In 2011, developing-country equities have fallen 15.6 percent compared with an 8.4 percent drop for mature markets.

Emerging market equity and fixed income funds experienced a sudden reversal of the positive inflows trend since early 2009. With many developing countries in a sweet spot both cyclically and structurally, the flows into these funds had gone up consistently since 2009, reaching a record volume in 2010. However, the turmoil of the second half of 2011 caused these flows to reverse. EM equity funds had registered an outflow of \$48.5 billion in 2011—in sharp contrast to the net inflow of \$97 billion for all of 2010. The reversal was less sharp for emerging market fixed-income funds, which posted net inflows of \$17.3 billion in 2011. Foreign selling was particularly sharp in Latin America, with Brazil posting large outflows.

...and bond spreads have widened rapidly

Reflecting this reversal in fortunes, developing-country composite spreads (EMBIG) widened by 152 basis points (bps) between July and early January (they had been broadly stable at around

Figure FIN.1 Emerging market equities fall by more than developed country equities



Source: Bloomberg.

Figure FIN.2 Contagion from Europe causes developing-country spreads to rise



Source: JP Morgan

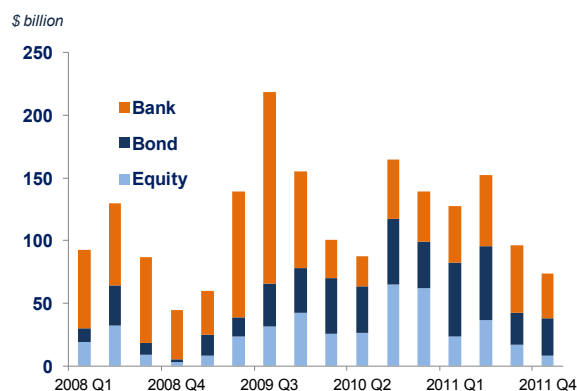
310 bps since late 2009) (figure FIN.2). The bulk of the deterioration in spreads occurred in the second half of September, with the EMBIG spread reaching a peak of 490 bps on October 4th—206 bps higher than July 2011. Spreads have narrowed after October 4th amid signs that EU policy action to address banking sector vulnerabilities would be forthcoming, but remained volatile reflecting the uncertainties about the size, funding and implementation of the Euro-zone rescue plan. By early-January, spreads were about 54 bps lower than their peak on October 4th.

Although significant, the deterioration of financial conditions in 2011 is much less marked than in the fall of 2008, when developing-country sovereign bond spreads widened by 385 bps and stock indexes dropped 40 percent between mid-September and mid-December 2008.

Gross capital flows to developing countries have been weak since September

The increased turmoil and risk aversion that drove the hike in spreads, was reflected in sharply weaker capital flows to developing countries in the second half of 2011. Gross capital flows (international bond issuance, cross-border syndicated bank loans and equity placement) totaled only \$170 billion between July and December 2011, 55 percent less than of \$309 billion received during the like period of

Figure FIN.3 Capital flows to EMs declined sharply in the third quarter



Source: Dealogic and World Bank Staff calculations

2010 (figure FIN.3). Equity issuance and bond flows were especially weak between September and December. The volume of equity issuance was 80 percent down at \$25 billion compared to the same period last year that had the record breaking level of equity issuance particularly through initial public offerings (see GEP 2010 Winter). After a mere \$2.6 billion in September—the lowest monthly level since December 2008, bond flows recovered slightly after October, following issuances by Venezuela (\$6.4 billion), Russia (\$2.4 billion), Indonesia and Turkey (both \$2 billion). Bond issuance was strong in the first weeks of 2012 as January tends to be one of the busiest months for bond issuance. Brazil, Chile, Mexico, and Philippines issued a total of \$6.6 billion combined in the first week of the month.

International syndicated bank loans, on the other hand, held up well even after the increased volatility, a reflection of several large loans to companies from natural resource related sectors in Russia and Mexico, the banking sector in Turkey and infrastructure sectors in Brazil and South Africa. The relative resilience of syndicated bank loans can be in part explained by the time that syndications take to be completed. In fact the decline in bank-lending was more gradual following the 2008 crisis compared to bond and equity flows.

As a result, gross capital flows in 2011 totaled \$450 billion, 9.6 percent below the 2010 level of \$498 billion reflecting the robust flows during the first half of the year.

Developing countries are vulnerable to mounting funding pressures in the European banking sector and loss of confidence in global financial markets

The volatility in high-income financial markets and the possibility that the situation deteriorates further represents a serious risk for developing countries (see discussion and scenarios in the main text). From a finance perspective, the main transmission channels from the ongoing crisis in high-income countries to developing countries have been through direct linkages with distressed

high-income European banks, and more generally through tightening up of global financial conditions that constrained developing-country access to high-income debt (bank and bond) markets. If conditions deteriorate further, FDI inflows might also contract spreading the negative effects of the crisis both to middle and low income countries.

Risks stemming from developing-country exposure to fragile high-income European banks...

Given the fragile state of high-income country banks, their extensive operations in some developing countries and regions are an important channel of contagion. As high-income European banks are forced through losses in their portfolio and regulatory changes to rebuild their capital stock, they are now engaged in deleveraging—either by calling or not renewing loans (thereby reducing loans to capital ratios); or by tightened credit conditions or selling assets or issuing new equity (thereby raising capital).¹

Starting in the early 2000s, European banks rapidly grew their exposure to developing countries, and now have \$2.4 trillion in outstanding foreign claims on actors within these countries.² The bulk of these claims lie in Latin America & the Caribbean (\$861 billion or 16 percent of GDP) and Europe & Central Asia (\$633 billion or 21 percent of GDP) regions. In

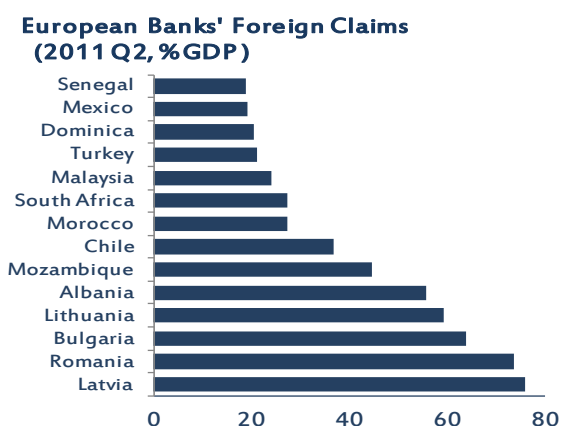
several Eastern European countries (Latvia, Romania, Bulgaria, Lithuania and Albania) as well as countries from other regions (Mozambique and Chile), these claims are quite significant as they are equal to more-than 25 percent of GDP (figure FIN.4).

European banks operate in developing countries also through their local subsidiaries and account for considerable shares of some countries' banking assets (figure FIN.5). In Latin American countries exposures are concentrated among Spanish banks, which own over 25 percent of bank assets in Mexico and Chile. In Europe and Central Asia, Austrian and Greek banks have played a significant role in Albania, Bulgaria and Romania, while the country source of holdings in other countries are more diversified. Portuguese banks account for almost one-third of banking assets in Angola and Mozambique.

...with the nature of the exposure determining its impact on domestic credit...

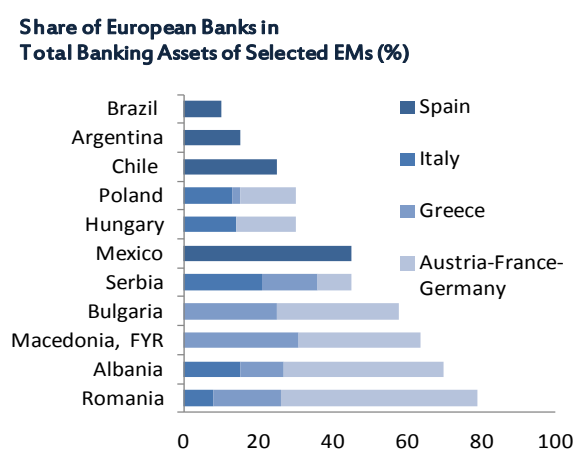
Despite their significant presence and high levels of foreign claims in Latin America, Spanish banks are mostly decentralized in their cross-border operation with independently managed affiliates in the region. Their claims are mostly in local currency/locally funded. Indeed, average loan to deposit ratios in the region are at or below 100%, with few exceptions including Chile (107%). Moreover, some countries (e.g.

Figure FIN.4 Developing countries with strong dependence on European Banks



Source: BIS

Figure FIN.5 Ownership position of European Banks in selected developing countries



Source: Citibank.

Brazil and Mexico) have regulations limiting the amount of inter-company loans between parent and daughter banks and limiting the ability of parent banks to reduce daughter bank's capital below prudential levels.

As a result, the financial systems in these countries would not be excessively exposed to a sharp reduction of inflows of funding from European banks (except through the trade finance channel). As long as this kind of deleveraging occurs gradually, domestic banks and non-European banks should be able to take up the slack – as appears to be taking place in Brazil.

In contrast, European banks operating in most of the Eastern European countries have relied heavily upon cross-border lending from their parents to support their loan portfolios, with loan-to-deposit ratios well over 100 percent in several countries: Latvia (240%), Lithuania (129%), Romania (127%) and Russia (121%). In addition, large portions of cross-border lending was short-term (see the next section) that can be easily reduced by simply not being rolled-over or renewed. As a result, these countries are extremely vulnerable to a cut off of lending by European banks. So far, deleveraging in the region has been orderly. In a worrying development, however, Austrian bank supervisors have instructed Austrian banks to limit future lending in their central and eastern European subsidiaries — while several high-income European banks have independently announced their intention to reduce operations in Europe and Central Asia.

Arguably, markets are already factoring in the risks from these connections. During the recent episode of elevated turmoil, developing-country CDS spreads rose most among those countries with close banking ties with troubled high-income European banks, for example, the spreads in Ukraine, Romania and Bulgaria rose by 422 bps, 231 bps and 203 bps, respectively versus an overall average for developing countries of 114 basis points.

...but the risk of rapid sales of bank assets is more widespread.

European banks have been trying to reduce exposure and/or raise capital also by selling stakes in developing country banks or fully-owned subsidiaries. The need to find a buyer forces Euro-area banks to disinvest from some of the better markets where they can have profitable exits. For example, Greek banks have started to sell Turkish bank assets.³ Any of such sales represent FDI outflows when the buyer is not foreign but local, which was the case in one of the sales in Turkey.

Developing countries with relatively high private debt levels would be most vulnerable to a generalized tightening of financial conditions

The recent market turbulence has already led to declines in capital flows to developing countries and substantial losses to developing-country equity markets. Should financial conditions deteriorate sharply, countries with high external financing needs (current account projections and amortization of external debt) would be most vulnerable to sudden reversals in capital flows, a drying up of credits or substantial increases in borrowing costs.

Many developing countries remain vulnerable to deterioration in credit conditions. Overall, the external financing needs of developing countries have risen slightly since the 2008/9 financial crisis (box FIN.1) from an ex ante estimate of \$1.2 trillion (7.6 percent of GDP) in 2009 to \$1.3 trillion (7.9 percent of GDP) in 2012.⁴ All regions except South Asia have reduced their external financing needs as a share of GDP since 2008. South Asia's estimated external financing requirements have increased from 5.8 percent to 8.4 percent mainly because of a sharp rise in India's external debt in 2011.

Nevertheless, ex ante external financing needs are very high for some countries and in some regions (figure FIN.6). As in the 2008/9 crisis, the Eastern Europe and Central Asia region remains the most vulnerable developing region with external financing need in the order of 17 percent of GDP. Several countries in the region

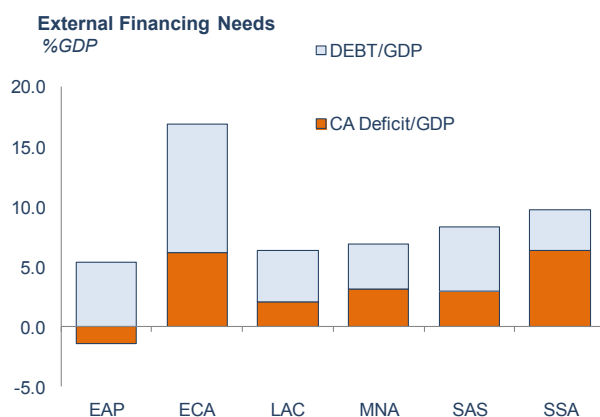
have high current account deficits as well as private debt coming due in 2012.

Among countries with access to international capital markets, estimated ex ante financing requirements in 2012 exceed 10 percent of GDP in 30 developing countries (table FIN.1).⁵ For many, the financing is unlikely to pose a problem, coming in the relatively stable form of FDI or remittances. For others, however, a significant proportion will have to be financed from historically more volatile sources (short-term debt, new bond issuance, equity inflows).

If international financial market conditions deteriorate significantly, such financing might become difficult to maintain. Some 25 developing countries have short-term debt and long-term debt repayment obligations equal to 5 or more percent of their GDP in 2012. Should financing conditions tighten and these debts cannot be refinanced, these countries could be forced to cut sharply into reserves or domestic demand in order to make ends meet. Indeed, following the sharp contraction in capital flows in 2008 and 2009, many developing countries were forced to close external financing gaps through current account adjustments, increased aid or depletion of foreign exchange reserves (box FIN.1).

Risks are particularly acute for countries like Turkey that combine large current account

Figure FIN.6 External financing needs of developing countries⁴



Source: World Bank, Debt reporting system

Table FIN.1 External Financing Needs Projections for 2012

	Account	Debt	EFN
	Deficit (share of	Repayment (share of GDP)	
Lebanon	20.6	14.5	35.1
Nicaragua	16.3	5.6	21.9
Albania	11.7	9.6	21.3
Jamaica	9.8	11.3	21.1
Georgia	12.7	8.2	20.9
Turkey	9.8	9.2	19.0
Lao PDR	14.0	4.7	18.7
Guyana	10.6	7.8	18.4
Belarus	10.5	7.7	18.2
Romania	4.5	13.5	18.0
Moldova	12.1	5.7	17.8
Latvia	0.4	17.2	17.6
Armenia	12.7	4.9	17.6
Bulgaria	-2.0	18.6	16.6
Lithuania	2.3	14.1	16.4
Ukraine	5.4	10.9	16.3
Panama	12.3	3.2	15.6
Mauritania	11.2	3.9	15.1
Macedonia, FYR	5.1	7.8	12.9
Jordan	8.5	4.0	12.5
Tanzania	9.1	3.0	12.2
El Salvador	3.8	8.2	12.0
Dominican Republic	8.2	3.4	11.6
Vanuatu	6.7	4.9	11.5
Vietnam	4.9	6.6	11.5
Chile	0.4	10.9	11.3
Kyrgyz Republic	6.9	3.7	10.6
Ghana	7.0	3.4	10.4
Tunisia	5.8	4.4	10.2
Peru	2.7	7.3	10.0

Developing countries' external financing needs, are defined as the current-account deficit (assumed to be a constant at its 2011 level as a percent of GDP) plus scheduled principal payments on private debt (based on information from the World Bank's Debtor Reporting System and Bank of International Settlements).

Source: World Bank.

deficits, high short-term debt ratios and low reserves. Indeed, Turkey's current account deficit in 2011 is estimated to be six times larger than its net FDI flows in 2011, and its short-term debt represents 80 percent of its reserves (which have been falling in recent months and already represent less than 4 months of import cover). In a similar fashion but to a lesser extent, Belarus

and Montenegro are also vulnerable to a freezing-up of global credit. Other countries have also significant vulnerabilities. Jamaica, for example, is at risk since it finances its current account deficit with flows other than FDI, which tend to be volatile. High levels of short-term debt to reserves ratios may put countries such as Chile, Albania and Egypt also at risk of roll-over despite their healthy current account balances (figure FIN.7).

The sensitivity of short-term finance to changes in financing conditions could pose problems for trade (box Fin.2). In China for example, as much as 75 percent of short-term debt is reported to be for trade-finance. Since 2010, there has been a 20 percent increase in short-term debt taken out by developing countries — with the total now equal to \$1.1 billion or 4.8 percent of developing-country GDP—or 15.7 percent of total developing-country exports. Should a financial crisis cause trade finance to freeze up as banks

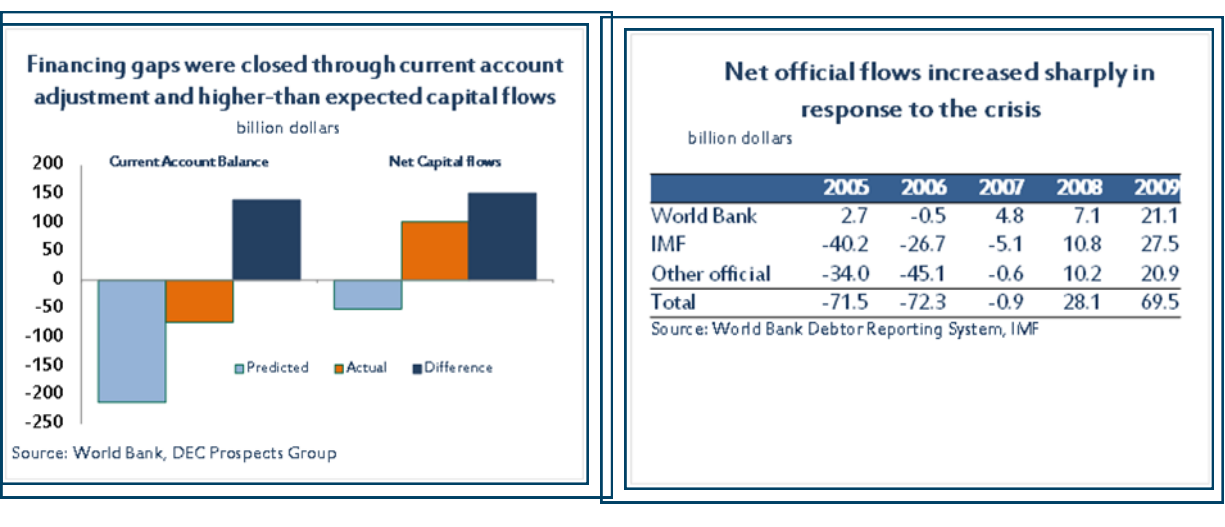
Box FIN.1 How did developing countries close the (ex-ante) external financing gap in 2009?*

When the global financial crisis hit in September 2008, developing countries’ external financing needs (current account projections and amortization of external debt) for 2009 were projected to be around \$1.2 trillion. With a projected sharp retrenchment in capital flows for 2009, the ex-ante external financing gap was estimated in the order of \$352 billion (Global Development Finance 2009, page 82). Financing gaps are ex-ante notions and ex-post, can be closed through the combination of reduced spending, official flows, and running down the reserves.

As expected, high external financing needs in a time of sharp retrenchment in capital flows (40 percent actual decline in 2009) led to significant current account adjustments and slower growth in several developing countries in 2009. Current account adjustments reduced the ex-post gap by \$140 billion. Current account balances in deficit countries were almost halved from -\$283 billion to -\$128 billion in 2009. In particular, in several ECA countries, deficits narrowed by more than 50 percent. Net private capital flows (inflows-outflows-debt repayments/redemptions of debt) were \$152 billion higher than initial projections, while more-than doubled official flows and reserves depletion accounted for the remainder.

An important factor that helped developing countries with their 2009 external financing needs was official lending (including assistance from the IMF), which jumped to \$28 billion immediately after the crisis in 2008, and more than doubled in 2009, reaching \$70 billion. The World Bank Group tripled its lending to \$21 billion. Between September 2008 and February 2010, more than 20 countries entered agreements with the IMF, with four of the stand-by agreements (Romania, Pakistan, Hungary and Ukraine) larger than \$10 billion. The IMF also introduced a new flexible credit line that provided precautionary arrangements, but there have been no draws so far. Lending from other multilaterals as well as bilateral loans also increased in response to the crisis.

*Note: Some countries Croatia, Hungary, and Poland that were classified as developing countries for the earlier calculation are now classified as developed countries by the World Bank. The calculations referred here are based on 2008 classifications; hence the data might differ from the current capital flows tables.



Box FIN. 2: Sharp increase in short-term debt

Short-term debt in the developing world is highly concentrated: 15 middle-income countries account for 86 percent.¹ Most of the borrowing is done by banks and corporations to finance their growing trade as firms contracted short-term loans to finance imports and prepay for exports. For example, trade finance accounted for almost 75 percent of short-term debt in 2011 in China and almost all of India’s short-term debt.

Short-term debt flows have exhibited higher volatility than medium- and long-term flows, particularly during crises. During the Asian and 2008 financial crises, for example, short-term debt fell more sharply in developing countries than did other flows. One of the reasons is that banks can reduce their exposure quickly through short-term debt, which can be simply not renewed. The other reason may be that in times of crisis lenders tend to shift their portfolios to more creditworthy borrowers, which are in a better position to serve longer-maturity loans.

Some part of the decline in short-term debt following a crisis might be also due to demand factors, especially for trade credit portion of it. Several studies suggest that the sharp decline in trade volumes observed in 2008/9 caused trade finance to decline and not the reverse.² But others have argued that a more comprehensive analysis of the financial sector’s role in international trade including the concept of a ‘financial accelerator’, shows how export flows are actually significantly affected by financial shocks.³

¹ China, India, Brazil, Turkey, Russia, Indonesia, Mexico, Malaysia, Chile, Romania, Thailand, South Africa, Peru, Philippines, and Argentina.

² Levechenko A., L. Lewis and L. Tesar. 2010. “The collapse of International Trade during the 2008-2009 Crisis” NBER Working Paper 16006.

³ Amiti M and D. Weinstein. 2009. “Exports and Financial Shocks.” CEPR Working Paper 7590.

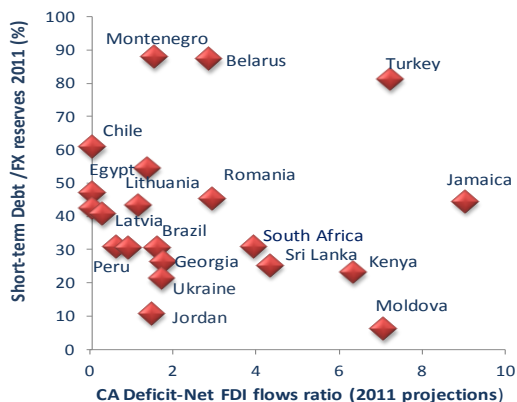
seek to deleverage (as it is reported to have happened for a short while in 2008) it could have serious consequences for global trade.

Foreign currency reserve accumulation has already declined sharply, even reversed in several developing countries

Large capital outflows in the second half of 2011 and ensuing currency fluctuations prompted several central banks to sell-off reserves (figure

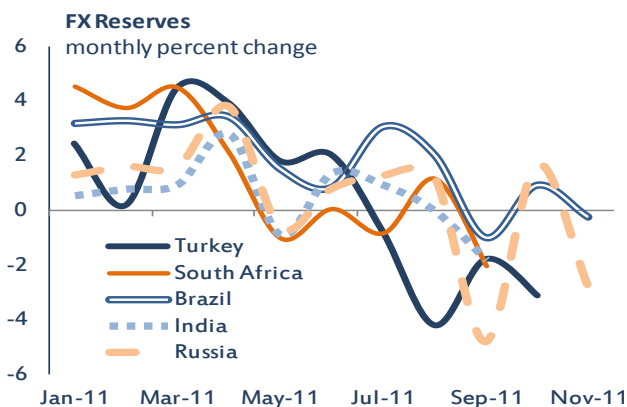
FIN.8). For example, in the first half of October, Turkey’s central bank intervened directly, selling an estimated \$0.5 billion of reserves, bringing the average monthly decline in reserves since end-July to \$2.7 billion. Turkey’s reserves currently are at \$84.8 billion, equivalent less than 4 months merchandise import-cover. Given recent reserve sell-offs, South Africa faces similar exposures, but Brazil, Russia and India’s

Figure FIN.7 Countries at risk should capital flows reverse



Source: World Bank, IMF IFS

Figure FIN.8 Depletion of FX reserves accelerated in recent months in selected economies



Source: IMF, Central Banks, World Bank

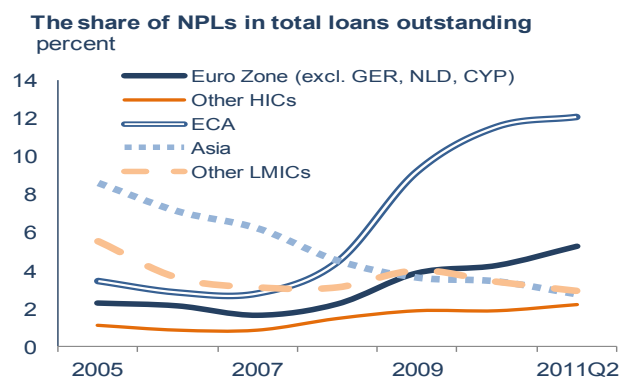
larger reserve-buffers offer more scope for extended currency support.

Following the strong domestic credit growth since the crisis, domestic banking sectors may also be vulnerable to a sharp increase in non-performing loans in the event of a slowdown in growth.

Although non-performing loans (NPLs) remain low in most developing regions so far, they could shoot up in the event of a sharp slowdown in growth (figure FIN.9). Given rapid credit expansion in recent years (loans to GDP ratios increased by more than 10 percentage points between 2005 and 2011 in several countries), commercial banks could see a marked deterioration in loan performance in the face of slowing growth, heightened risk aversion and restricted access to finance. In some countries, NPLs and provisioning are already an issue. The share of NPLs in outstanding bank lending in the Europe and Central Asia region lofted to 12 percent in 2010 from 3.8 percent in 2007. Available data indicates that NPL ratios have continued to deteriorate in 2011 in Kazakhstan (32.8%) and Romania (14.2%).

With the possibility of further economic slowdown, the need for macro-prudential reforms and stress tests have risen to ensure that banks are best placed to deal with deterioration in credit quality and much tighter liquidity conditions.

Figure FIN.9 Possible resurgence in NPLs with slower growth...a danger to banking



Source: IMF Financial Soundness Indicators

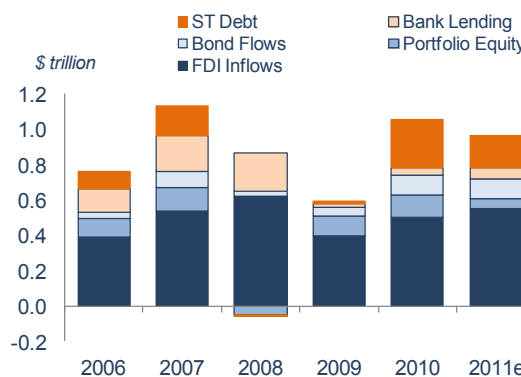
Some countries have undertaken steps to slow down the credit growth with limited success. China, for example, has raised interest rates and increased the required reserve ratios (RRR) five times in 2011. As a result, the credit growth in China has eased significantly but remains high compared to previous credit booms and busts. Similarly, credit growth in Brazil and Turkey has remained buoyant in 2011 despite the RRR hikes. Unlike China, however, Turkey lowered its key policy rate to deter volatile international portfolio flows and stimulate economic growth.

More recently concerns about the deteriorating global outlook and its potential adverse impact on output growth have caused a shift in policies. China, for example, cut its RRR by 0.5 percentage point in December, the first such cut since December 2008.

International capital flows to developing countries are expected to decline slightly in 2011 after a strong rebound in 2010

Net private capital flows (earlier data referred to gross flows) to developing countries are estimated to have declined to \$0.95 trillion (4.3 percent of GDP) in 2011 from \$1.1 trillion (5.4 percent of GDP) in 2010 (figure FIN.10).⁶ The increased global market volatility of the second half of 2011, and associated equity-market sell-offs caused portfolio equity flows to decline by 60 percent, from \$128.4 billion in 2010 to an estimated \$51.4 billion in 2011. Overall, short-

Figure FIN.10 International capital flows fell in 2011



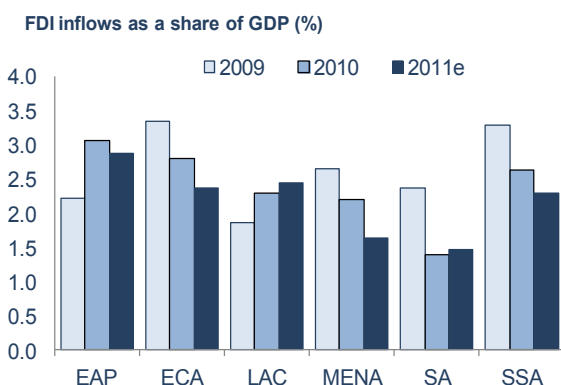
Source: World Bank.

term flows for the year as a whole also declined despite their strong performance in the first half of the year – partly because of slower trade growth (and therefore less trade finance) in the second quarter due to disruptions emanating from Tohoku. In addition, prudential measures taken by developing countries (such as China) to limit the risk associated with short-term flows also played a role. This year's fall in short-term debt flows is in sharp contrast with last year's surge, when these flows led the recovery in net capital inflows (box FIN.2).

FDI inflows to developing countries continued to increase modestly in 2011

Foreign direct investment (FDI) inflows to developing countries rose by an estimated 10.6 percent in nominal terms, reaching \$555 billion (2.5 percent of GDP) in 2011 (figure FIN.11). Most of the gains in FDI came in the first half of the year, with flows slowing in the third quarter. The largest increase was in the Latin America and Caribbean region, which attracted investment due to relatively robust growth, rich natural resources and a large consumer base. The East Asia Pacific and South Asia regions remain attractive destinations for multinationals, with investors drawn to the fast growing regional economies of China, India, Indonesia and Malaysia. FDI inflows declined in other regions but for different reasons. The fall in FDI inflows

Figure FIN.11 Despite the nominal increase, FDI flows as a percent of GDP to most developing regions were flat or declined in 2011



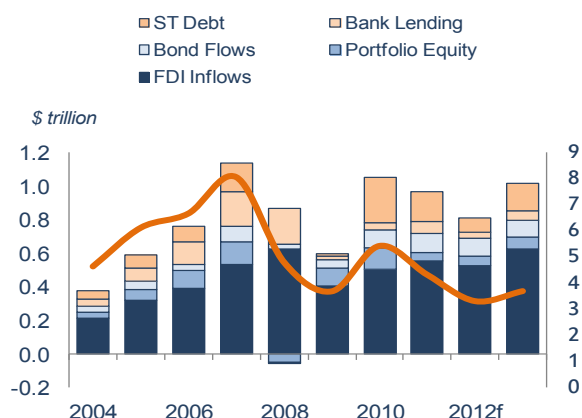
Source: World Bank

in the Eastern Europe and Central Asia region was mainly driven by the economic problems in Europe, which weighed both on the capacity of high-income European firms to invest and on the attractiveness of developing countries in the region as destinations for FDI due to reduced growth prospects. Inflows to the Middle East and North Africa region suffered because of political turmoil associated with the Arab Spring, while the decline in Sub Saharan Africa is mainly due to net dis-investment from Angola. Despite the nominal increase, however, FDI inflows as a percent of GDP were flat or declined (figure FIN.11).

Prospects: Uncertain in the short-term but strong in the medium-term

The outlook for 2012 has become more challenging as the world economy has entered a very difficult period. The likelihood that the sovereign debt crisis in Europe deteriorates further resulting in a freezing up of capital markets and a global crisis similar in magnitude to the Lehman's crisis remains very real. The increased risk-aversion among global investors has reduced global financial flows including those to developing countries since mid 2011. The actual impact of the current turmoil on developing countries, in terms of international financial flows and the real economy, are not yet fully apparent but suggest a generalized slowing in global growth (see the main text) and reduced capital flows.

Increased risk aversion and banking-sector deleveraging are expected to continue cutting into capital inflows to developing countries in early 2012. As a result, net private debt and equity flows, which comprise net debt flows (incoming disbursements less principal repayments) and net equity flows (FDI and portfolio inflows net of disinvestments) are projected to decline further by 18 percent to \$0.8 trillion (3.3 percent of GDP) in 2012, with sharp contraction in cross-border debt flows. Even FDI inflows to developing countries are expected to level out by 6 percent next year because of the uncertainly in global financial markets. The projected decline in FDI inflows is relatively

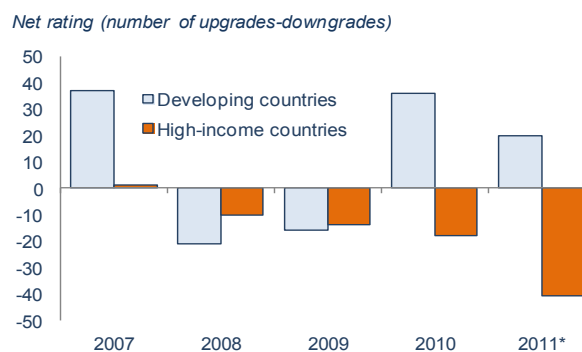
Figure FIN.12 Overall capital flows to remain a stable share of GDP

Source: World Bank

small compared to the 40 percent contraction of 2009. The impact on capital flows is expected to be disproportionately higher for the developing Europe and Central Asia region, whose economies are more closely tied to those in high-income Europe.

Under the assumption that the ongoing turbulence in Europe will be resolved to market's satisfaction towards the end of 2012, net capital flows to developing countries are expected to have a sharp rebound in 2013 with the growth in global economy, reaching \$1.02 trillion in 2013 (3.7 percent of GDP) (figure FIN.12). By 2013, all flows are expected to increase. Bond issuance is expected to level down slightly as bank lending picks up the pace supported by South-South flows.

The rebound should be supported by the fact that conditions that underpin the capital flows to developing countries remain strong. Emerging markets entered 2012 with an improved risk profile, higher growth prospects and higher interest rates than in high-income countries. Despite the recent downward revision, developing-country growth (between 5 and 6 percent) is expected to continue to be much higher than in developed countries (around 2 percent) in the medium-term.

Figure FIN.13 Improving credit quality for emerging market sovereigns

* Includes rating actions by Moody's, S&P, and Fitch

Source: Bloomberg and DECPG staff calculation

At the same time, credit quality for developing countries has been improving, and the gap between mature and emerging markets sovereigns is narrowing (figure FIN.13). The wave of sovereign rating downgrades across Europe, the United States, and Japan stands in sharp contrast with the improved creditworthiness in emerging markets as measured by sovereign credit ratings. The ratio of emerging market rating upgrades to downgrades is six to one this year. Since the 2008 financial crisis, 47 developing countries have received 117 upgrades by major rating agencies, while the last rating upgrade for a developed country occurred in 2007, when Japan's sovereign debt was upgraded. Many developing countries currently have a positive outlook assigned to their sovereign debt, signaling that additional upgrades are possible.

Table FIN.2 Net capital flows to developing countries (\$ billions)

	2006	2007	2008	2009	2010	2011e	2012f	2013f
Current account balance	379.8	384.9	354.5	276.7	221	190	99	32
as % of GDP	3.4	2.7	2.1	1.7	1.1	0.9	0.4	0.1
Financial flows:								
Net private and official inflows	686.5	1129.7	830.3	673.8	1126.8	1004.4		
Net private inflows (equity+debt)	755.5	1128.2	800.8	593.3	1055.5	954.4	807.4	1016.4
Net equity inflows	495.2	667.1	570.7	508.7	629.9	606.2	583.7	697.1
..Net FDI inflows	387.5	534.1	624.1	400.0	501.5	554.8	521.6	620.6
..Net portfolio equity inflows	107.7	133.0	-53.4	108.8	128.4	51.4	62.1	76.5
Net debt flows	191.2	462.6	259.6	165.1	496.8	398.2		
..Official creditors	-69.0	1.5	29.5	80.5	71.2	50.0		
....World Bank	-0.3	5.2	7.2	18.3	22.4	12.0		
....IMF	-26.7	-5.1	10.8	26.8	13.8	8.0		
....Other official	-42.0	1.5	11.5	35.4	35.0	30.0		
..Private creditors	260.2	461.1	230.1	84.6	425.6	348.2	223.7	319.3
....Net M-L term debt flows	164.9	292.8	234.4	69.9	157.1	168.2		
.....Bonds	34.3	91.7	26.7	51.1	111.4	110.1		
.....Banks	135.0	204.7	212.5	19.8	44.1	68.0		
.....Other private	-4.4	-3.5	-4.8	-1.1	1.6	0.1		
....Net short-term debt flows	95.3	168.3	-4.4	14.7	268.5	180.0		
Balancing item /a	-473.1	-486.4	-786.1	-273.0	-596.0	-611.9		
Change in reserves (- = increase)	-636.9	-1085.3	-452.5	-681.9	-752.0	-578.4		
Memorandum items		292.8						
Net FDI outflows	-130.4	-150.5	-214.5	-148.2	-217.2	-238.1		
Migrant remittances /b	221.5	278.2	323.8	306.8	325.3	351.2	376.7	406.3
As a percent of GDP								
	2006	2007	2008	2009	2010p	2011f	2012f	2013f
Net private and official inflows	6.1	8.1	4.9	4.2	5.8	4.5		
Net private inflows (equity+debt)	6.7	8.0	4.8	3.7	5.4	4.3	3.3	3.7
Net equity inflows	4.4	4.8	3.4	3.1	3.2	2.7	2.4	2.5
..Net FDI inflows	3.4	3.8	3.7	2.5	2.6	2.5	2.1	2.2
..Net portfolio equity inflows	1.0	0.9	-0.3	0.7	0.7	0.2	0.3	0.3
..Private creditors	2.3	3.3	1.4	0.5	2.2	1.6	0.9	1.2

Source: The World Bank

Note:

e = estimate, f = forecast

/a Combination of errors and omissions and transfers to and capital outflows from developing countries.

/b Migrant remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers

Notes

1. The European banking sector remains under a significant funding pressure (see main text) as concerns about exposure to stressed sovereign debt have affected their liquidity. They were squeezed out of the USD interbank market as US money market funds reduced their exposure to banks in Euro area in late 2011. Also, European interbank lending has also been deteriorating, as Euribor-Eonia spreads have been rising to their beginning of 2008 crisis (September 15th 2008) levels.
2. Foreign claims by BIS reporting banks comprise cross-border claim, local claims of foreign affiliates in foreign currency, and local claims of foreign affiliates in local currency.
3. According to Bloomberg news on December 9th 2011, EU lenders including Deutsche Bank AG and France's Societe Generale SA have announced plans to shed more than \$1 trillion (€750bn) of assets over the next two years to bolster capital. On top of selling loans, the banks put at least 50 businesses up for sale in markets spanning the globe. (See <http://www.bloomberg.com/news/2011-12-07/bargain-bank-values-in-europe-fail-to->

lure-buyers-as-debt-crisis-deepens.html)

4. Developing countries' external financing needs, are defined as the current-account deficit (assumed to be a constant at its 2011 level as a percent of GDP) plus scheduled principal payments on private debt (based on information from the World Bank's Debtor Reporting System).
5. Countries with the debt repayment to GDP ratios that are less than three percent are excluded from this list. These countries are mostly aid dependent and their vulnerabilities are mostly related with official flows.
6. The capital inflows numbers are revised up for 2010. Our June estimate for total inflows was \$930 billion, compared to \$1129 billion (almost the same levels of 2007). Major revision in ST debt for 2010: from \$120 billion to \$268 billion, mostly because of the upward revisions for China and India.