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Financial Flows to Developing Countries: Recent Trends and Near-Term Prospects

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NET CAPITAL FLOWS TO DEVELOPING countries were down last year for the second year in a row (see table 1.1 on page 8 and box 1.1 on page 10). In 2002, the sum of net private debt and equity and net official flows was $192 billion, or 3.2 percent of developing countries' nominal gross domestic product (GDP), down from $210 billion in 2001 (3.6 percent of GDP) and $215 billion in 2000 (3.7 percent of GDP).[1] The slide has been a steady one since 1997, when net flows to developing countries peaked at about $325 billion (5.5 percent of GDP).

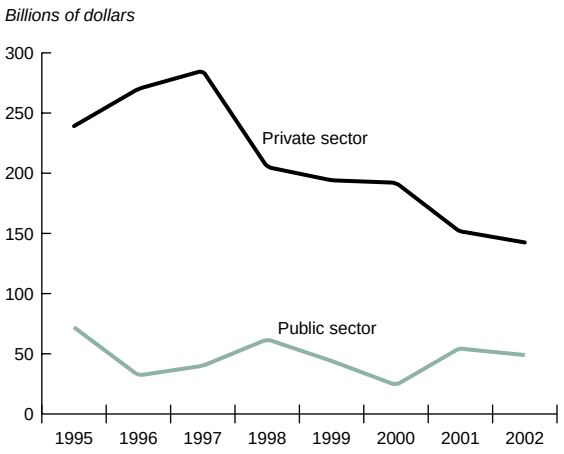
The decline since 1997 has occurred primarily in net capital flows from the private sector (figure 1.1), particularly in the debt component (both banks and bonds). From the peak years of 1995–96, when net debt inflows from the private sector were about $135 billion per year, they have dropped steadily (figure 1.2), becoming net outflows in 2001 and 2002.

Unprecedented weakness in debt flows

This weakness in the growth of private-sector debt flows is unprecedented in the post-1965 period (figure 1.3). Already strong debt growth to developing countries in the late 1960s exploded in the 1970s, as commercial banks furiously recycled oil surpluses from oil producers to other developing countries (Cline 1995).[2] In the decade of the 1970s, developing-country debt growth posted a compound annual growth rate of 24 percent (or 16 percent in real terms).

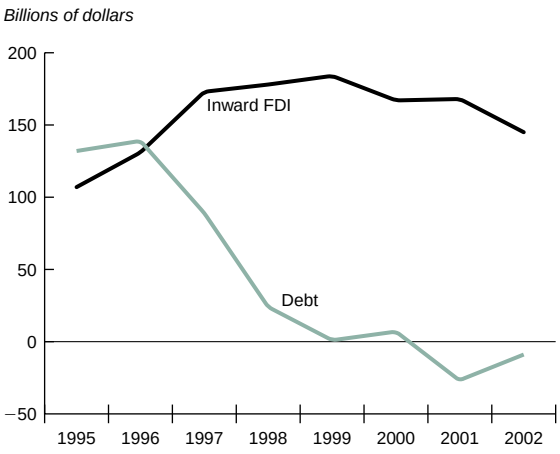
The debt crisis of the early 1980s slowed this growth but did not end it. The widespread efforts to

Figure 1.1 Net financial flows to developing countries, 1995–2002



Source: World Bank Debtor Reporting System and staff estimates.

Figure 1.2 Net financial flows to developing countries from the private sector, 1995–2002



Source: World Bank Debtor Reporting System and staff estimates.

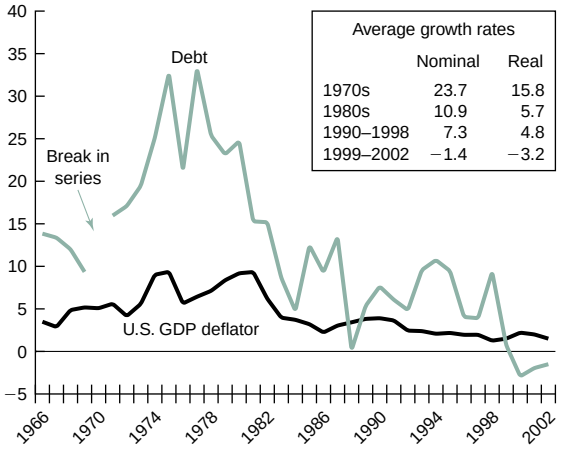
Table 1.1 Net capital flows to developing countries, 1997–2003
(billions of dollars)

	1997	1998	1999	2000	2001	2002e	2003f	For more detail
Current account balance	−91.4	−113.6	−10.7	61.9	27.6	48.3	26.2	→ Chapter 2
as % GDP	−1.5	−2.0	−0.2	1.0	0.5	0.8	0.4	
Financed by:								
Net equity flows	196.4	181.9	194.3	186.7	177.6	152.3	158.0	→ Chapter 4 Chapter 5
Net FDI inflows	169.3	174.5	179.3	160.6	171.7	143.0	145.0	
Net portfolio equity inflows	26.7	7.4	15.0	26.0	6.0	9.4	13.0	
Net debt flows	102.1	57.4	13.9	−1.0	3.2	7.2	5.0	
Official creditors	13.0	34.1	13.5	−6.2	28.0	16.2	0.0	→ Chapter 6
World Bank	9.2	8.7	8.8	7.8	7.5	1.5	—	
IMF	3.4	14.1	−2.2	−10.6	19.5	14.5	—	
Others	0.5	11.2	6.9	−3.4	1.0	0.2	—	
Private creditors	89.1	23.3	0.5	5.1	−24.8	−9.0	5.0	→ Chapter 3
Net M-L term debt flows	84.0	87.4	21.9	14.5	−8.6	2.9	—	
Bonds	38.4	39.7	29.6	17.4	10.1	18.6	—	
Banks	43.1	51.4	−5.9	2.6	−11.8	−16.0	—	
Others	2.5	−3.6	−1.8	−5.5	−7.0	−5.5	—	
Net short-term debt flows	5.3	−64.2	−21.4	−9.4	−16.2	−6.1	—	
Balancing item[a]	−153.8	−109.0	−160.1	−192.5	−128.2	−97.8	−81.2	
Change in reserves (− = increase)	−52.9	−16.6	−37.3	−55.1	−80.3	−110.0	−108.0	→ Chapter 1
Memo items:								
Bilateral aid grants (ex technical co-operation grants)	26.7	28.2	29.4	29.6	29.5	32.9	32.0	→ Chapter 6
Net private flows (debt+equity)	285.1	205.2	194.7	191.8	152.8	143.3	163.0	
Net official flows (aid+debt)	39.7	62.3	42.9	23.4	57.5	49.0	32.0	
Workers' remittances	62.7	59.5	64.6	64.5	72.3	80.0	—	→ Chapter 7

Note: e = estimate; f = forecast
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

Figure 1.3 Developing countries' total external debt, 1966–2002

Percent change over year earlier



Sources: World Bank Debtor Reporting System and staff estimates; U.S. Commerce Department.

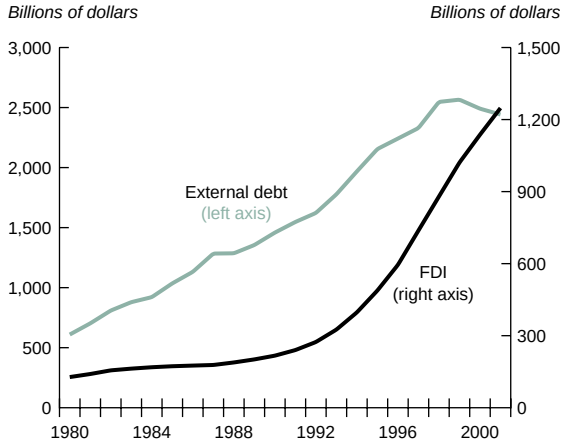
reschedule debt (and add new money) meant that exposures to problem debtors were generally maintained, while net new credits were extended in other parts of the developing world. When market confidence returned in the 1990s in the aftermath of the Brady Plan, real debt grew at a steady pace.

Since the middle of 1998, however, the whole context for development financing has shifted. As borrowers have chosen or been required by their creditors to pay down their debts, the external debt of developing countries has fallen in dollar terms, even as the cost of debt (as measured by OECD interest rates) fell and remained at very low levels.

Rotation from debt to equity

As debt is being repaid to private-sector creditors, net equity inflows to developing countries remain significant, mainly through the route of FDI. Net inward FDI flows did slow in 2002,

Figure 1.4 Developing countries' external debt and FDI stocks, 1980–2000



Sources: World Bank Debtor Reporting System and staff estimates; IMF *Balance of Payments Yearbook*.

with most of the slowdown occurring in Latin America. By contrast, flows to China picked up in response to strong growth and optimism following China's accession to the WTO.

The shifting pattern of private flows—debt down, equity up—has had an important implication for the associated stocks of debt (figure 1.4). While the stock of developing-country external debt outstanding from all sources has fallen since 1998, the stock of equity capital owned and controlled by foreigners has risen sharply over the past decade.

The drop in what might be called the external debt-equity ratio, from more than 300 percent at the end of 1997 to less than 200 percent at the end of 2001, has been spread across all regions of the developing world (table 1.2). The relative dependence on external equity is highest in East Asia and the Pacific, mainly reflecting the influence of China, where the external debt-equity ratio has now fallen below 50 percent—China's external FDI liabilities are double its external debt liabilities.

Table 1.2 Developing countries' external debt-equity ratios, 1997 and 2001
(percent)

	1997	2001	Ext.liabs. % GDP[a]
East Asia and Pacific	218	134	65.0
Europe and Central Asia	505	293	66.8
Latin America and the Caribbean	284	162	67.7
Middle East and North Africa	394	371	42.5
South Asia	968	613	30.5
Sub-Saharan Africa	515	303	90.6
All developing countries	316	196	61.7

a. Sum of total external debt and FDI liabilities as a percentage of 2001 GDP.
Sources: World Bank Debtor Reporting System and staff estimates; IMF, *Balance of Payments Yearbook*.

The total external liabilities, relative to GDP, of the three largest regions of the developing world (East Asia and the Pacific, Europe and Central Asia, and Latin America and the Caribbean) are all remarkably similar at about two-thirds of GDP. The region of Europe and Central Asia has the highest share of debt-based liabilities, reflecting the simple fact that equity ownership in much of this region was off limits to foreign investors until the end of the Cold War, although these countries could and did borrow on international markets. The surge in FDI in the region through the 1990s drove down the external debt-equity ratio sharply, although it remains high relative to East Asia and Latin America, which have been open to FDI much longer.

Much of the rest of this report focuses on why this external debt-equity shift is occurring, what its implications are, and how much further it has to run. Three aspects of the shift are worth noting up front:

- *The shift is partly driven by investor preferences.* Debt investors (both banks and bondholders) have become more wary of holding debt claims on developing countries, whereas nonfinancial corporations have come increasingly to believe that the developing world offers significant growth opportunities both as an export platform and as a source of domestic consumption.
- *The shift is partly driven by the preferences of developing country policymakers.* One very important lesson that many countries drew from the crises of the 1990s was that dependence on external debt financing can lead to sharp, sudden reversals of capital flows. To protect against such reversals, countries have strengthened their precautionary reserve holdings and shifted their liabilities to more stable forms of investment, especially FDI. The latter trend has been especially true of countries in East Asia (Crockett 2002), but it also has allowed Mexico, for example, to absorb the capital market shocks of the last few years much better than it could have done before 1995.

Box 1.1 Sources of information on capital flows

The World Bank's data on flows of capital and other financing to developing countries comes from several sources. Most data on FDI, portfolio equity, and workers' remittances are found in the balance-of-payments data set compiled by the IMF, although there are important exceptions (see box 4.6 and the data annex to chapter 7). Data on debt-related flows come from the Bank's Debtor Reporting System (DRS), which forms the backbone of the data set in volume 2 of *Global Development Finance*.

The DRS has its origins in the Bank's need to monitor the financial position of its borrowers. Since 1951 borrowers have been required to provide statistics, loan by loan, on their external debt and any private debt for which they have issued a guarantee. With the growth of nonguaranteed private borrowing, the Bank expanded the DRS to cover this form of debt, although these data are generally provided in a more aggregated form, not loan by loan.

Three aspects of the DRS are unique:

- *It has a long, continuous history*. As most market participants, official and private, are painfully aware, debt tends to flow in cycles, and the DRS enables analysts to study all the postwar cycles.
- *Its coverage is broad and consistent*. The same methodology is applied to data from 138 countries, large and small. Volume 2 presents a consistent array of data for all countries.
- *The loan-by-loan detail allows analysts to identify important debt characteristics* such as the currency composition of debt, terms of new debt commitments, and amortization and disbursement schedules.

An alternative to the DRS, focusing on the creditor side of the relationship, became popular in the 1980s. No single institution maintains a creditor reporting system, however, although data on banks provided by the Bank for International Settlements can be combined with data from other sources—including the DRS for data on multilateral financial institutions.

The organization that led the development of the creditor-side methodology was the Institute of International Finance (IIF), set up in 1983. Though it lacks its own data sources, the IIF combines those of other institutions (including the World Bank) to present the creditor's perspective on the external debt stocks and capital-account flows of developing countries (IIF 2003). This approach has become something of an industry standard, and the World Bank's own database is now typically analyzed from a creditor's perspective—as it is in this publication. The IMF also provides its estimates of capital flows to developing countries on a creditor basis in its semiannual *World Economic Outlook* (IMF 2002).

The latest World Bank, IIF, and IMF estimates of capital flows to developing countries are presented in the table below.

Differences in the series arise for three reasons:

- *Country coverage*. The World Bank covers 138 countries; the IMF, 125; and the IIF, 29. Note also that the IIF survey is not a subset of the World Bank coverage. The Republic of Korea, for example, is part of the IIF survey but is no longer considered by the World Bank as a developing country.
- *Different concepts*. The World Bank counts net inward FDI, whereas the IIF and IMF count net inflows less net outflows (and are thus smaller).
- *Different reporting systems*. Further discrepancies in the three institutions' measures of net capital flows occur because of differences in reporting systems. In a world of large, unregulated capital flows, measuring capital flows is as much an art as a science.

Estimates of external financing flows to developing countries, 1999–2003

(billions of dollars)

	1999	2000	2001	2002	2003
Current account					
World Bank	−11	62	28	48	26
IMF	−10	67	40	19	1
IIF	30	48	33	52	34
Net equity flows[a]					
World Bank	194	187	178	152	158
IMF	149	145	147	129	132
IIF	164	150	145	102	117
Net private debt (bonds, banks, and other)					
World Bank	0	5	−25	−9	5
IMF	−1	2	−32	1	13
IIF	−16	36	−19	11	21
Net official debt flows					
World Bank	14	−6	28	16	0
IMF	28	18	35	31	34
IIF	12	−3	15	12	10

a. IMF and IIF count net inflows less net outflows.

Sources: World Bank Debtor Reporting System and staff estimates; IMF 2002; IIF 2003.

- *On balance, the shift is a positive development*. For many countries, the fundamental rotation in capital flows is proving to be quite a challenge. For one thing, the current-account balance must move into or at least toward surplus in order to generate the foreign exchange to pay down external debt. Nevertheless, the rotation is best seen as a constructive development because it puts development finance on a stable footing. The problem with overreliance on debt financing for development is that the downside to adverse global developments has to be borne completely by developing countries: they must either pay in full or default. When macroeconomic conditions move against the country, debt markets rightly factor in more risk and thus end up charging more for debt capital.[3] The result is increased strain on the country and a greater likelihood of crisis and default. By contrast, the financing of growth and development through direct equity participation builds shock absorbers into a process that is bound to be somewhat uneven. The benefit of FDI is not just that its returns are "state contingent"—that is, they pay off for the investor when the country does well but absorb some of the hit when the country does badly—but that an adverse shock to the country does not typically produce a sudden rush for the exits. FDI investors generally emphasize that they are committed for the long haul and can absorb and tolerate a certain amount of near-term adversity.

When will it end?

This rotation in the pattern of development finance from private-sector sources has further to run under almost any scenario:

- If the global economy expands robustly in the years ahead, then foreign direct investors are likely to continue to build their holdings in developing countries. In such a scenario, debt investors would probably also return in earnest to developing countries, and the main challenge facing policymakers would be to avoid the excesses of near-term debt growth that have often led to problems in the past.
- If the global economy is weak, then FDI investors are liable to pause, but debt investors are liable to continue, and possibly accelerate, their retrenchment. This scenario is perhaps most plausible in a situation where current geopolitical tensions turn out to be a lot more severe and protracted than currently assumed (see chapter 2).
- If, as the current forecast assumes, the perfomance of the global economy is middling, then both FDI and debt investors will remain cautious. Net FDI inflows are likely to pick up in 2003–04, in line with a modest revival in global fixed investment. Net debt flows will remain subdued, although they should turn positive in 2003. The gains will be led by bond investors, for whom the high yields offered by developing country debt will be relatively attractive. By contrast, net debt repayments to commercial banks are likely to persist, as banks in the Bank for International Settlements (BIS) area remain under pressure, and are generally making strenuous efforts to reduce their risk exposures.

Official flows as buffers

Official funding for developing countries—defined as foreign aid plus debt financing from official sources—fell back in 2002, mainly because the IMF made fewer disbursements. Net official flows to developing countries, which tend to play a buffer role, are thus negatively correlated with net private flows and global growth (Ratha 2000). Indeed, with net private debt flows to developing countries likely to be once more positive in 2003, it is likely that net official flows to developing countries will fall sharply, in line with a diminished need for emergency financing. The other components of official flows are less susceptible to swings than IMF funding (see table 1.1 and chapter 6).

Trends in asset accumulation by developing countries

Although the liability flows of developing countries are important, the evolution of their external financial assets is also significant. In recent

years, asset accumulation has picked up strongly and in a remarkably broad-based fashion. When combined with changes in liabilities, the net result is that developing countries overall have become net capital *exporters* to the developed world, running a modest current-account surplus in most years since 1998 (see chapter 2 for a broader discussion of the global flow of funds).

The pick-up in the acquisition of foreign assets by developing countries is evident on three dimensions, the first two of which are captured by the "balancing item" line in table 1.1.

- *An increase in FDI*. Just as globalization is leading companies in high-income countries to invest in the developing world, so many developing-country companies are investing both in high-income countries and in other developing countries. Estimates of such "South-North" or "South-South" investment vary, but it is no doubt substantial (see chapter 4).
- *An increase in private investment in other assets*. This catch-all category is difficult to measure, in part because it includes flows seeking to evade controls and taxes as well as more legitimate outward investment flows from the resident private sector.
- *An increase in official reserves*. The gross official foreign-exchange reserves of developing countries rose by about $110 billion in 2002. In the past four years, the stock of developing countries' reserves has risen by an average of about $70 billion per year to reach about $888 billion at the end of 2002.

The acquisition of substantial foreign assets by individuals, companies, and governments in developing countries has some positive features. Most significant is the opportunity to diversify away from local business cycles and other risks. Maintaining high levels of foreign-exchange reserves gives governments a cushion that can allow them to better ride out shocks in the international system. The high level of East Asian foreign-exchange reserves built up in the aftermath of the Asian financial crisis in 1997–98 helps explain why these countries were able to avoid some of the stresses and strains suffered by many Latin American countries during the most recent global downturn.

There are, however, a number of more troubling aspects to the acquisition of substantial foreign assets by the private and public sectors in developing countries.

- *Developing countries need to mobilize their savings*. Leakage of capital abroad diminishes the savings available to fund economic activity. While substantial investment abroad by the private sector is not necessarily a sign of problems, it *can* be a signal of domestic investors' distrust in their country's policies and institutions, which potential foreign investors are likely to see as a negative signal. High external reserve holdings also come with a significant interest-rate carrying cost. Most countries invest their foreign-exchange reserves in relatively safe, short-term assets, such as U.S. Treasury bills. The yields on such instruments are currently very low—well below the interest rates that developing countries pay on their debt.
- *High foreign-exchange reserves imply a fear of floating*. The move from pegged exchange rates to floating exchange rates has been generally greeted as a move to greater flexibility that gives developing countries more breathing room. While a floating-rate system does offer many advantages, especially as it avoids countries having to defend arbitrary exchange rates against speculative attack (often through extreme hikes in domestic interest rates), the move to a floating-exchange-rate regime has been accompanied by what might be called an increased precautionary demand for foreign-exchange reserves. Current holdings of foreign-exchange reserves by developing countries are generally well above benchmarks often used as guides to assess the adequacy of reserves (box 1.2). Calvo and Reinhart (2000) have highlighted that the current exchange-rate policies of many developing (and developed) countries is far from a free float in the textbook sense. For countries in East and South Asia, policy has been geared toward avoiding exchange rate appreciation through the purchase of substantial reserves.[4]
- *Accumulation of assets is a sign of global disequilibrium*. The rapid accumulation of external assets can be viewed as a stock-adjustment process. For many developing countries in Asia, for example, the determination to insulate themselves from the shocks of 1997–98 has raised the precautionary demand for official

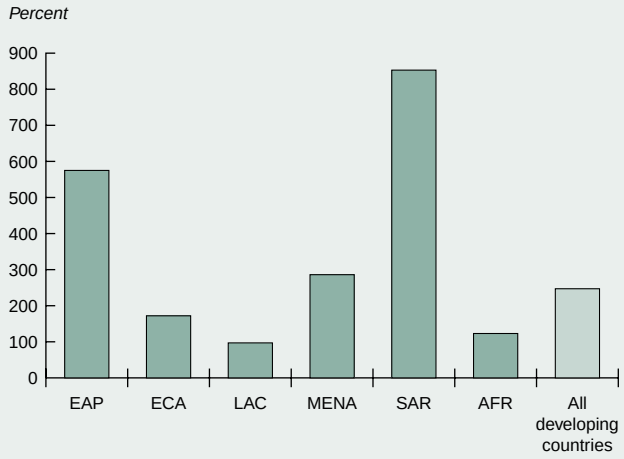
Box 1.2 Developing countries' reserves in context

Two common benchmarks are used to assess the adequacy of foreign-exchange reserves. Applied to the most recent data on reserve holdings, these benchmarks produce the following results:

Short-term debt. For all developing countries, net foreign-exchange reserves are currently about two-and-a-half times short-term external debt. The distribution varies considerably across regions, however. Reserves are very high in East and South Asia as a consequence of the traumatic financial events in Asia in the late 1990s. Latin America's net foreign-exchange reserves are below its short-term debt.

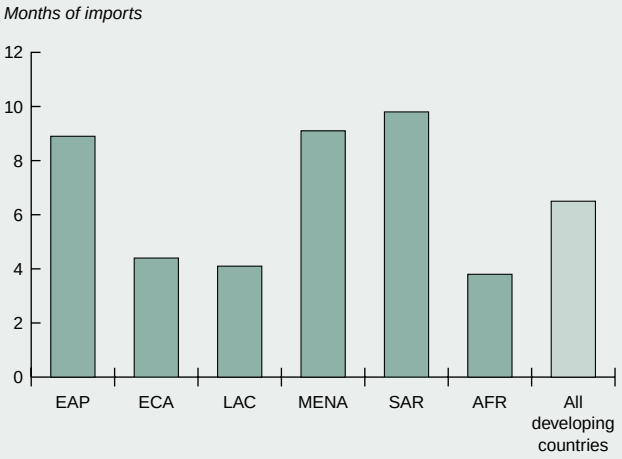
Imports. For all developing countries, net foreign-exchange reserves are equivalent to about six months of merchandise imports. In all six regions, reserves are above the commonly assumed "safe" level of three months of imports—they are especially high in Asia and the Middle East and North Africa.

Ratio of net foreign-exchange reserves to short-term debt in World Bank regions



Note: EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MENA = Middle East and North Africa, SAR = South Asia, and AFR = Sub-Saharan Africa.
Sources: World Bank Debtor Reporting System and staff estimates; IMF International Financial Statistics.

Ratio of merchandise imports to foreign-exchange reserves in World Bank regions



Note: EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MENA = Middle East and North Africa, SAR = South Asia, and AFR = Sub-Saharan Africa.
Sources: World Bank staff estimates; IMF International Financial Statistics.

reserves. At some point, however, this process will be complete and give way to pressures for the real exchange rate to rise. In the meantime, there is also a risk of overinvestment in sectors, such as the tradable goods sector in East and South Asia, that are currently benefitting from official policies to hold down the real exchange rate.

Learning to live with less debt

The pattern of overall capital flows to developing countries did not change much in 2002 over 2001. Developing countries, in aggregate, were net lenders to developed countries. They remained heavily reliant on FDI to finance both their debt repayments to private creditors and their acquisition of foreign assets, both private and official.

This relative stability is neither inevitable nor necessarily desirable, however. Key flows are adjusting to shifts in conditions that occurred in the later 1990s. The stock adjustments expressed by the changes in flows—notably the paydown of private-sector debt—continued apace in 2002, but they will have a finite life. When they are completed, capital flows will naturally move to a different pattern, probably one that again favors higher debt flows relative to equity flows. This shift is

likely to begin to happen in 2003, with net debt flows to the developing world from private sources turning modestly positive once again. These shifts will not be dramatic, however, and the overall pattern of external financing for developing countries is projected to be little changed from 2002 (see table 1.1).

Meanwhile, a key role of policy will be to ensure that current shifts involve the least pain possible, and that the pattern of flows that emerges from the process of stock adjustment is one that puts development finance on a more stable footing than it was in the volatile years of the 1990s.

Notes

1. These financial flow totals are the sum of net private flows and official flows, including aid.

2. There is a discontinuity in the World Bank's Debtor Reporting System in 1970, when it was expanded to include private, nonguaranteed long-term debt.

3. For all the turbulence in emerging debt markets in the 1990s, emerging-market bonds provided the highest absolute return of any major asset class (including equities) from December 1990 to August 2002. See figure 4.18.

4. At the end of 2002, East and South Asian reserves, combined, accounted for 50 percent of total developing-country reserves, up from 45 percent at the end of 2000. See the Statistical Appendix, table A.50.

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