Global Development Finance

Striving for Stability in Development Finance

I: ANALYSIS AND STATISTICAL APPENDIX 2003

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EMBARGOED UNTIL 1:00 PM EST, APRIL 2, 2003 (18:00 GMT)

Table of Contents

Foreword ix

Acknowledgments x

Overview and Policy Messages 1

Chapter 1 Financial Flows to Developing Countries: Recent Trends and Near-Term Prospects 7
- Unprecedented weakness in debt flows 7
- Rotation from debt to equity 8
- When will it end? 11
- Official flows as buffers 11
- Trends in asset accumulation by developing countries 11
- Learning to live with less debt 13
- Notes 14
- References 14

Chapter 2 Battling the Global Headwinds of Financial Imbalances and Uncertain Geopolitics 17
- A hesitant recovery in the high-income countries 19
- Tracking corporate-sector adjustment 20
- Supportive monetary and fiscal policies 22
- Rising household debt in the United States 24
- The outlook for growth in high-income countries in 2003 and beyond 25
- Developing countries: A tortuous return to stronger growth in 2003 and beyond 26
- China becomes the engine of East Asia 28
- A peace dividend for South Asia 29
- Convergence in Eastern Europe and Central Asia 30
- The fallout from Argentina in Latin America 30
- Cross-currents facing the Middle East and North Africa 32
- Sub-Saharan Africa: Steady but subdued growth 32
- Outlook for commodity prices 33
- Is global deflation a threat? 34
- A bumpy takeoff in world trade 36
- Assessing the global flow of funds 37
- Notes 39

Chapter 3 Coping with Weak Private Debt Flows 41
- Debt-market developments in 2002 43
- Debt-market prospects for 2003 and beyond 45

EMBARGOED UNTIL 1:00 PM EST, APRIL 2, 2003 (18:00 GMT)

Debt flows partly reflect lower demand 45
Creditors focus on credit risk, not return 46
A new market in credit derivatives 47
Bank retrenchment in context 49
Basel II 50
The emerging bond market really is emerging 52
Sovereign debt defaults—past, present, and future 56
The search for better crisis management 63
Annex: Commercial Debt Restructuring 69
Notes 80
References 80

Chapter 4 Sustaining and Promoting Equity-Related Finance for Developing Countries 85
Direct investment flows in 2002 86
How sustainable is the current flow of FDI? 91
Portfolio equity flows in 2002 95
Why are portfolio equity flows so modest? 100
Forecasts for equity flows in 2003–2005 101
Methodological annex: FDI forecasting model 104
Notes 105
References 105

Chapter 5 Corporate Financial Structures and Performance in Developing Countries 109
Shifts in corporate-sector debt dependence 109
Short-term corporate debt vulnerability 113
The downward trend in corporate profits 113
Borrowing from abroad and corporate performance 115
Methodological annex 120
Notes 121
References 122

Chapter 6 Living Up to the Monterrey Commitments: Raising Aid—and Ensuring Its Effectiveness 125
The decline in official financing in 2002 126
The HIPC Initiative 132
The decline in official nonconcessional lending since the 1990s 134
Are aid levels to some countries “too high”? 137
Ensuring effectiveness in large aid programs 140
Annex: Debt Restructuring with Official Creditors 142
Notes 154
References 154

Chapter 7 Workers’ Remittances: An Important and Stable Source of External Development Finance 157
Trends and cycles in workers’ remittances in developing countries 158
A relatively stable source of foreign exchange 160
Economic effects of remittances 164
Strengthening the infrastructure supporting remittances 165
Facilitating international labor mobility 166
From limiting to managing migration 168

EMBARGOED UNTIL 1:00 PM EST, APRIL 2, 2003 (18:00 GMT)

Prospects for remittance flows to developing countries 169
Annex: Sources of remittance data 171
Notes 172
References 174

Statistical Appendix 177

Tables

1.1 Net capital flows to developing countries, 1997–2003 8
1.2 Developing countries' external debt-equity ratios, 1997 and 2001 9

2.1 The global outlook in summary 18
2.2 Real GDP growth in the major economies, 2001–2003 19
2.3 Growth in volume of manufactured imports 36
2.4 Current-account balances 37
2.5 Long-run trends in current account balances, 1980–2002 38

3.1 Private-sector debt flows to developing countries, 1991–2002 41
3.2 Gross market-based debt flows to developing countries, 2000–2002 41
3.3 Forecasts of private-sector debt flows, 2001–2004 42
3.4 Select bond exchanges, 1999–2001 62

4.1 Net inward FDI flows to developing countries, 1999–2002 86
4.2 Estimates of South-South FDI flows, 1995–2000 91
4.3 Net portfolio equity flows to developing countries, 1999–2002 96
4.4 Net inward FDI forecasts 101
4A.1 FDI forecasting model, regression results 104

5.1 Profitability of nonfinancial firms in emerging markets, 1992–2001 114
5A.1 Number of firms in sample 121

6.1 Net official financing of developing countries, 1995–2002 126
6.2 Net lending from multilateral sources, 1995–2002 126
6A.1 Paris Club agreements, January 1–December 31, 2002 143
6A.2 Multilateral debt-relief agreements with official creditors, January 1980–December 2002 145

7.1 Remittances received and paid by developing countries in 2001 157
7.2 Workers' remittances received by developing countries, by region, 1999–2002 160
7.3 Workers' remittance receipts in developing countries relative to key indicators 163
7.4 Remittances relative to growth rate by income group 163
7.5 Remittances by income group in Pakistan, 1986–87 to 1990–91 165
7A.1 Workers' remittance inflows to Pakistan, fiscal 1999–2002 171

Figures

1.1 Net financial flows to developing countries, 1995–2002 7
1.2 Net financial flows to developing countries from the private sector, 1995–2002 7
1.3 Developing countries' total external debt, 1966–2002 8
1.4 Developing countries' external debt and FDI stocks, 1980–2000 9

EMBARGOED UNTIL 1:00 PM EST, APRIL 2, 2003 (18:00 GMT)

2.1 Industrial production in the Euro Area, Japan, and the United States, 2000–2002 19
2.2 U.S. business debt, 1980–2002 20
2.3 U.S. business investment and change in nonfarm payrolls, 1972–2002 21
2.4 U.S. corporate profits and the financing gap, 1989–2002 21
2.5 Benchmark spreads for U.S. high-yield bonds, 1997–2002 21
2.6 Corporate profits in Japan and the United States 22
2.7 Federal Reserve (Fed) and European Central Bank (ECB) target rates, 2000–2003 22
2.8 U.S. and German fiscal balances, 1999–2003 23
2.9 U.S. household debt, 1980–2002 24
2.10 U.S. private- and public-sector financial balances and the current account, 1999–2002 25
2.11 OECD real fixed investment spending, 2000–2002 25
2.12 GDP growth for developing countries, 1990–2002 27
2.13 Industrial production in select regions, 2000–2002 28
2.14 Current-account balances for select regions, 1990–2002 28
2.15 Trends in industrial production, 1996–2002 29
2.16 Balance-of-trade positions for Argentina and Brazil, 1999–2002 31
2.17 Oil price and GDP growth in the Middle East and North Africa, 1990–2002 32
2.18 GDP growth of African non-oil exporters and commodity price index specific to Sub-Saharan Africa, 1990–2002 33
2.19 Output gaps in OECD centers, 2000–2002 34
2.20 Inflation rate in OECD and developing regions, 1990–2002 34
2.21 U.S. net borrowing as a share of rest-of-world savings, 1980–2004 37

3.1 Currency composition of new bond issues, 2001 and 2002 43
3.2 Debt-market issuance by low-income countries, 2001–2002 44
3.3 Breakdown of bond issuance by credit rating, 2002 44
3.4 Average regional credit quality, 1997–2003 44
3.5 Bond issuance and spreads, 2002 44
3.6 Secondary-market spreads on emerging markets, 1990–2002 45
3.7 Secondary-market spreads on Brazil and Mexico, 1991–2002 45
3.8a Spreads on benchmark bonds, Latin America, 1998–2002 46
3.8b Spreads on benchmark bonds, East Asia, 1998–2002 46
3.9 Net debt flows and G3 interest rates, 1984–2002 47
3.10 The shifting investor base of emerging-market bond markets 48
3.11 Performance of bank stocks, January 2002–January 2003 50
3.12 Volume of Brady swaps and buybacks, 1996–2002 53
3.13 Emerging economies: public debt stocks, 1996–2001 54
3.14 Share of sovereign borrowers in default on debt, 1820–2000 57
3.15 Composition of external debt to private creditors, 1970–2000 58
3.16 Ratio of debt to gross national income for select countries, 1982 and 1988 60
3.17 IMF disbursements, 1984–2002 61

4.1 Net equity flows to developing countries, 1989–2002 85
4.2 Net FDI inflows to developing countries, 1994–2002 86
4.3 Privatization and M&A in developing countries, 1994–2002 86
4.4 FDI as a share of GDP in developing countries, 1994–2002 87
4.5 Private and foreign direct investment into the telecom sector of developing countries, 1990–2000 88
4.6 FDI to developing countries, by source, 1995–2000 91
4.7 Major North-South investors 91
4.8 Proportion of FDI funded by reinvested earnings, by region, 1996–2001 92

EMBARGOED UNTIL 1:00 PM EST, APRIL 2, 2003 (18:00 GMT)

4.9 Proportion of FDI earnings reinvested, by region, 1996–2001 93
4.10 Average annual rates of return on inward FDI, by region, 1993–2000 94
4.11 Rate of return on FDI and GDP growth, 1995–2000 95
4.12 Portfolio equity investment in emerging markets, 1989–2002 96
4.13 Investment profile for equity placement in Malaysia 96
4.14 Brazilian stock market (Bovespa) versus CVRD, January–November 2002 99
4.15 Performance of equity markets 99
4.16 Emerging stock market performance by region 99
4.17 Returns in emerging stock market by sector, 2001 and 2002 99
4.18 Risk and return by asset class 100

5.1 Corporate debt relative to GDP in East Asia, 1990–2001 110
5.2 Foreign debt relative to total corporate debt in East Asia, 1990–2001 110
5.3 Dependence on Bank debt in East Asia, 1990–2001 110
5.4 Corporate debt-equity ratios in East Asia, 1990–2001 111
5.5 Corporate debt in select regions, 1995, 1997, 2001 111
5.6 Leverage ratios in East Asia and Pacific and Latin America and the Caribbean, 1992–2001 112
5.7 Foreign lending to emerging-market corporations, select regions, 1990–2001 112
5.8 External borrowing as a share of corporate sector debt in select regions 112
5.9 Corporate foreign debt in select regions, 1990–2001 112
5.10 Short-term debt and current liabilities, 1995, 1997, and 2001 113
5.11 Corporate profitability in developing countries, 1992–2001 114
5.12 Ratios of net income to sales in nonfinancial firms in select countries, 1985–2001 115
5.13 Debt as a percentage of total assets of market participants and nonparticipants, 1998–2001 116
5.14 Interest paid relative to debt by market participants and nonparticipants, 1992–2001 116
5.15 Corporate profit rates in major emerging markets, 1992–2001 117
5.16 Profit rates by region, 1998–2001 117
5.17 Profit rates by type of market participant, 1992–2001 117
5.18 Profit rates of market participants and nonparticipants, 1993–2001 118

6.1 Official development assistance, 1990–2001 128
6.2a Aid flows relative to scale of all developing economies, 1960–2000 129
6.2b Aid flows relative to scale of all low-income economies, 1960–2000 129
6.3 Proposed aid increases by nine EU countries 130
6.4 Sources of IDA resources 130
6.5 Net official nonconcessional lending, 1990–2001 134
6.6 Gross flows to and from bilateral creditors, 1990–2001 136
6.7 Gross flows to and from multilateral creditors, 1990–2001 137
6.8 Aid/income ratios for low-income countries, 1990–1995 and 1996–2000 137
6.9 Bilateral aid to large recipients by type of aid, 1990–2000 138
6.10 IDA commitments by type, 1990–2002 139
6.11 Tax effort by aid recipients as measured by tax/GNP ratio 139
6.12 Tax effort by aid recipients 139

7.1 Workers' remittances and other inflows, 1998–2001 158
7.2 Remittances as a share of GDP and of imports, 2001 158
7.3 Top 20 developing-country recipients of workers' remittances, 2001 159
7.4 Top 20 developing-country recipients of workers' remittances, 2001 159

EMBARGOED UNTIL 1:00 PM EST, APRIL 2, 2003 (18:00 GMT)

7.5 Top 20 country sources of remittance payments, 2001 160
7.6 The top two sources of remittance payments, 1970–2001 160
7.7 Remittances and private capital flows to the Philippines, 1978–2001 162
7.8 Remittances and private capital flows to Turkey, 1978–2001 162
7.9 Volatility of remittances in the 1990s 163
7.10 India's remittance receipts, 1985–2001 164
7.11 Average transfer fee and exchange-rate commission for sending $200, February 2000 165

Boxes

1.1 Sources of information on capital flows 10
1.2 Developing countries' reserves in context 13

2.1 Limits to fiscal stimulus 23
2.2 Disinflation is a global phenomenon 35
2.3 Developing countries and the dollar 39

3.1 International versus local-currency bank claims 51
3.2 Local 10-year bond markets 55
3.3 Brazil's experience in 2002 56
3.4 Sovereign debt restructuring and domestic bankruptcy law 65
3.5 The cost of default 67

4.1 Understated FDI in developing countries 88
4.2 The resilience of FDI during a crisis 89
4.3 Outward flows of FDI from developing countries tend to be underestimated 90
4.4 Cemex and South-South FDI 92
4.5 Corporatization and FDI in China 94
4.6 Revision of the World Bank's data series on portfolio equity investment 97
4.7 Concentration of portfolio equity flows 98
4.8 FDI can reduce portfolio equity flows: Repsol-YPF 101
4.9 Surveys of FDI 102

5.1 The effect of leverage on firm profit rates 118

6.1 Defining aid 127
6.2 Is debt relief to HIPCs additional? 135

7.1 Securitizing future flows of workers' remittances 161
7.2 Mexican matrículas consulares boost remittances 166
7.3 Financial fairs to promote remittances and good banking habits among migrants 167
7.4 World migration pressure is high—and rising 170

EMBARGOED UNTIL 1:00 PM EST, APRIL 2, 2003 (18:00 GMT)

Foreword

G*LOBAL DEVELOPMENT FINANCE* IS THE World Bank's annual review of global financial conditions facing developing countries. The current volume provides analysis and a statistical appendix. A separate volume contains detailed, standardized external debt statistics for 138 countries.

The background to this year's report is a difficult one. The global economy has been struggling to recover from a recession in 2001. Even though macroeconomic policies in the major economies have been very supportive, the recovery that has been underway for almost 18 months remains disappointingly anemic. A key hindrance to global recovery has been the financial imbalances that built during the expansion of the 1990s, and there has been a wide incidence of debt difficulties across both developed and developing countries. On top of this already challenging environment, current geopolitical uncertainties add an overlay of uncertainty for both financial markets and policymakers.

Against this difficult backdrop, developing countries are struggling to adjust to a major shift in the pattern of external financing that has been underway since the middle of 1998. Since that time, the flow of private sector *debt* finance to developing countries has plunged. At the same time, however, the flow of private sector *equity* finance—primarily foreign direct investment (FDI)—has remained remarkably robust. Countries that have adjusted in order to live with less debt and that have opened themselves to the flow of FDI funding have been the relatively strong performers in recent years. In turn, this solid economic performance has translated into tangible benefits in the area of poverty alleviation.

Creating the right conditions to benefit, rather than suffer, from the shifts in private-sector financing for developing countries is primarily the responsibility of developing countries. This means building conditions that both promote domestic productivity and investment, and attract FDI. And it has become all the more important for governments to run prudent debt-management policies, especially in nascent local-currency debt markets.

However, the high-income countries also have an important role to play if the pattern of international development finance in coming years is to be more stable than the volatile, growth-inhibiting one of recent years. With private capital flows low, raising the flow of official development assistance—as agreed to at the Monterrey Conference in 2001—is of key importance to the poorest countries. Moreover, the rich countries need to foster an open, competitive world-trading system, especially in goods such as textiles and agricultural products, in which developing countries have an obvious comparative advantage. Not only would this give countries that are under pressure to pay down debt the opportunity to generate the necessary export revenue (through export growth, rather than by relying on import compression), but it would also help create conditions fostering the continuation of a steady and significant flow of FDI to developing countries.

Nicholas Stern
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March 12, 2003

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Overview and Policy Messages: Striving for Stability in Development Finance

ALTHOUGH 2002 WAS A YEAR OF HESITANT global recovery, financial conditions facing many developing countries were once again challenging, especially for those countries (mainly middle-income countries) dependent on international financial markets. Conditions have improved a little in the early months of 2003, although the uncertainties surrounding Iraq have cast a shadow over both the global economy and financial markets.

Concern over the recent pattern of financial flows for global development that has prevailed in recent years is widespread—and understandably so.

Since 1998, developing countries have repaid external debt to private creditors in developed countries. In some cases these net repayments of debt have been required by timorous capital markets grown wary of overexposure to developing-country debt. In others they reflect reduced demand for debt by countries that have either found alternative forms of external finance or have reduced their overall demand for external investment funds. Combined with developing countries' steady accumulation of financial assets in high-income economies, however, these debt repayments mean that the developing world has become a net capital *exporter* to the developed world.

On a net basis, therefore, capital is no longer flowing from high-income countries to economies that need it to sustain their progress toward the Millennium Development Goals. The shortage is compounded in the poorest countries by a significant drop in official development assistance from bilateral donors.

What can or should be done to promote access by developing countries to external capital? What can be done to prevent growing economies from the disruptive effects of sharp reversals in financing? These are the central concerns of this year's *Global Development Finance*.

On the bright side, the steady drop in external debt financing has been cushioned by resilience in foreign direct investment (FDI). A further positive sign is the growth of local-currency bond markets in several emerging economies and the development of several promising innovations to manage credit risk. These issues, too, are covered in this report.

The developing world is learning to live with less external debt

The supply of debt capital to the developing world, which swelled in the early 1990s, was first reduced by the shock of the East Asian crisis of 1997–98, then by the turmoil in global fixed-income markets in the summer of 1998, and most recently by the problems in global high-yield markets in the aftermath of the 2001 slowdown. However, this broad-based decline in debt flows, first evident in East Asia and the Russian Federation, is now focused on Latin America.

Some early signs of improvement in the external-debt market cropped up as 2002 came to a close. The forecasts in this publication point to a further, gradual rise in debt flows in 2003 and 2004 (see chapters 1 and 3). It is unlikely, however, that private debt flows to developing countries will return to the levels of the 1990s. Nor would such a rebound necessarily be desirable.

While external bond and bank financing should continue to play an important role in the financing strategies of governments and private-sector borrowers in developing countries, the fixed

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commitments of debt service are not well suited to the swings in nominal income experienced by many developing countries, especially those dependent on primary commodities. Market reactions to debt-servicing strains add a whole new layer of volatility that can be severely damaging to growth and poverty reduction.

The movement from debt to equity has been underway in private financial markets since 1998. Policymakers should recognize the consequences of this important shift—and respond to the opportunities and policy challenges it poses.

Measures to promote the inflow of foreign equity capital are critical

FDI is less volatile than external debt. Its focus on long-term returns makes it clearly more appropriate for developing countries. And it can bring advantages both in technology and in operational and financial management. In this context, the resilience of FDI in the face of the sustained weakness in debt flows is a hopeful sign (see chapter 4).

In contrast to debt investors, companies have been willing to raise their exposures in the developing world, in part because their holdings in developing countries are a relatively small part of their overall capital stock, and in part because many mature companies now expect a large portion of their revenue growth and cost reduction (and thus their profit growth) to come from operations in developing countries, whether they are producing for export or for local sale.

FDI usually brings with it important benefits such as access to markets and transfers of technology and skills. In a world of volatile private capital flows, however, it is the financial aspects of FDI that are particularly desirable. Companies tend to invest in developing countries for the long haul. They see their returns rise and fall with the overall performance of the host economy and generally keep a significant share of earnings in the country.

A solid flow of FDI to developing countries should not be taken for granted, however. Indeed, net FDI to developing countries has already fallen from its peak of $179 billion in 1999 to $143 billion in 2002. With the bulk of net cross-border capital flows now coming in this form, it becomes increasingly important for policymakers and market participants to focus on sustaining FDI—and that depends critically on improvements in the investment climate. A healthy operating environment for the corporate sector—including a sound domestic institutional framework—is a necessary condition for profitable investment and the mitigation of risk, and therefore for the attraction of FDI (see chapter 5). It is also required to promote productivity, entrepreneurship, and investment for domestic firms and farms, the sources of 90 percent of developing-country investment and the main drivers of growth. Finally, it is the key determinant of whether domestic capital stays at home or flees abroad.

Growth and poverty reduction depend on prudent management of sovereign financial risks

Financial markets react swiftly to adverse news, making it all the more important to plan carefully to mitigate risk. Fortunately, bond markets in developing countries have moved in recent years toward issues denominated in local currency, although such issues tend to have shorter maturities, at least in the early years of market development. During such a transition, it is all too easy for a sovereign borrower to shift, rather than mitigate, its risk, with currency risks giving way to the rollover risks that occur when domestic debt is linked to a foreign currency (see chapter 3). The fact that the epicenter of most middle-income debt problems in recent years has been the local short-term money and bond markets serves as a graphic reminder of the case for prudent debt management.

Workers' remittances are an increasingly important source of external financing

An under-recognized trend in the external finances of developing countries—especially some of the smallest and poorest—is the steadily growing importance of workers' remittances (see chapter 7). Such flows now rank second in importance only to FDI in the overall external financing of developing countries (see chapter 1). At $80 billion in 2002, remittances were about double the level of official aid–related inflows and showed a remarkably steady growth through the 1990s. The strong U.S. labor market was especially important

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in fueling the growth of remittances, and the United States is now by far the largest source of remittance flows.

Demographic trends suggest that remittance flows from high-income countries will grow over the medium term, with the demographic dependency ratio falling in poor countries and rising in rich ones. However, heightened security concerns and a softening labor market in the high-income economies will probably check these flows over the next year or two. This prospect highlights the importance of the issues of trade in services and migration.

The international community must help borrowers manage pressures to reduce debt

Intense pressures to pay down external debt have placed many countries under severe stress in recent years, usually with particularly adverse consequences for poor people. There is now a growing consensus that the mechanisms available to cushion these debt pressures are in need of reform.

For low-income economies, significant progress has been made in providing debt relief under the Heavily Indebted Poor Countries Initiative. However, continued weakness in commodity prices, and thus in the export earnings of many poor countries, means that several countries will require additional resources before their debt can be considered sustainable (see chapter 6).

For highly indebted middle-income countries, the International Monetary Fund (IMF) has proposed the creation of a sovereign debt restructuring mechanism that would provide an orderly framework for restructuring external sovereign bond debt (see chapter 3).

The proposed framework is intended to be useful not only *after* a sovereign default, but also ahead of such an event, as its existence would make both debtors and creditors act in a more measured fashion, avoiding some of the extreme actions that have complicated recent defaults on sovereign debt.

The discussion of this proposal reminds us that the current set-up has not worked well and that the debt difficulties of middle-income countries are likely to persist in a world of low nominal income growth (see chapter 2).

Policymakers in the industrial countries can help stabilize development financing—

—by improving aid and trade policies—

Although much of the policy and many of the institutional reforms needed to stabilize development financing must come from governments in developing countries, the authorities in the developed world can play an important role. The major economies can support development most directly through coherent aid and trade policies that promote development. The commitments made in advance of the United Nations Conference on Financing for Development in Monterrey in March 2002 promised a modest increase in aid flows. These point to a welcome reversal of the downward trend through most of the 1990s, but their scale is incommensurate with the commitment to reach the Millennium Development Goals by 2015.

The effectiveness of aid can be improved by reallocating funds to poorer countries that have the policies, institutions, and governance that can be expected to reduce poverty. In those same countries, aid is also likely to be more productive if channeled through government institutions, with the close involvement of civil society, rather than through project-oriented institutions with intrusive management by donors.

Most important of all, industrial countries can spur development by reducing agricultural subsidies and trade barriers that discriminate against developing countries' exports. Industrial countries spend more than $300 billion each year in agricultural subsidies, about six times the amount they spend on foreign aid. Unless progress is made on agricultural protection and subsidies, negotiations within the World Trade Organization (WTO) are likely to be stalled, to the detriment of growth and development.

—and by ensuring broader macroeconomic stability

The major economies also play an important role through their macroeconomic policies and performances, which shape the global opportunities open to developing countries (see chapter 2). Developing countries benefit most when the major economies achieve steady, sustainable growth, avoiding booms and busts. Central banks in the

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major economies have established conditions favorable for the growth of global liquidity. With nominal interest rates within the Organisation for Economic Co-operation and Development (OECD) at their lowest levels in 50 years and real short-term interest rates generally close to zero, the core condition for reversing the flow of capital from developing to developed countries is in place. Through the 1990s, the countries of the OECD made important gains in reducing budget deficits, but much of this progress has been reversed in the past two years. The expectation of large, continuing budget deficits may further reduce developing countries' access to funds, while fiscal stimulus packages, which provided an important near-term boost to growth, have now generally reached their limits of effectiveness.

The widespread debt difficulties of the corporate sector in the United States and Europe were an important feature of the global downturn in 2001, contributing not only to a pronounced, sustained downturn in capital spending, but also to a rise in spreads in high-yield debt markets. Given the large number of investors who are active in both industrial and emerging markets, the rise in spreads on high-yield debt helped lift interest-rate spreads in markets for the external debt of developing countries (see chapter 3). In Japan, corporate-debt woes and their effects on the banking system held back growth throughout the 1990s and added to deflationary pressures throughout the economy.

Japan serves as a graphic example of the costs of delaying necessary corporate adjustments. By contrast, the high-profile corporate bankruptcies in other mature economies—especially the United States—in 2002 can be seen as a mixed blessing. On the one hand, they underlined the severity of the downturn and the magnitudes of the necessary adjustments in corporate spending. On the other, they served to highlight that corporate restructuring is proceeding.

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