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PRIVATE CAPITAL FLOWS RETURN TO A FEW DEVELOPING COUNTRIES AS AID FLOWS TO POOREST RISE ONLY SLIGHTLY

Robust growth expected for Europe and Central Asia, dip in foreign direct investment may be shortlived

WASHINGTON, April 19, 2004 — Net private capital flows to developing countries as a whole rebounded to $200 billion in 2003, up from $155 billion in 2002, but most of the increase is concentrated in just a few relatively better-off countries, while official development assistance to poor nations increased only marginally, says the annual World Bank report, *Global Development Finance 2004.*

"The rebound in capital flows to some of the larger countries is encouraging, and reflects an improving global economic picture," said **François Bourguignon, the World Bank's Chief Economist.** *"But we are concerned about official aid flows, which are of critical importance to the poorest countries. They have increased only slightly, and last year remained well below the levels required to achieve the Millennium Development Goals (MDGs),"* he added.

The increase in net private flows — bonds and bank loans — most of which went to Brazil, China, Indonesia, Mexico and Russia, is the major factor in an overall increase in net capital flows to developing countries from all sources, public and private, to $228 billion in 2003 from $190 billion in 2002. Net private capital flows rose to all developing regions, except the Middle East and North Africa. Flows to Europe and Central Asia (ECA) of $63 billion (up from $55 billion in 2002) were particularly strong, as eight transition countries approached accession to the European Union in May 2004.

Despite the overall increase in capital flows to developing countries, however, net resource transfers from rich to poor countries remain negative. Also, net official development assistance (ODA) rose by only $6 billion to $58 billion in 2003, with half of this increase accounted for in debt relief and some administrative costs to donor agencies, rather than new resources to developing nations.

As a whole, the developing countries ran current account surpluses totaling $76 billion, or about 1.1 percent of GDP. These surpluses—concentrated in Russia, China and Saudi Arabia—now coincide with a large buildup of a few developing countries' reserves totaling more than $1.2 trillion. Reserves in Russia increased by $30 billion to reach $73 billion in 2003.

"This shows deepened interdependence in the world economy, with global capital flows, trade and exchange-rate policies more intricately linked than ever before," said **Mansoor Dailami**, lead author of the report. *"The challenge is to increase the flows to developing countries in a way that is sustainable, which requires channeling them to countries with good policies and into investments that spur long-term growth and poverty reduction."* With this in mind, the GDF outlines mechanisms to re-ignite slumping investment in infrastructure, as well as trade finance in developing countries.

The increase in capital flows reflects improved global economic growth, which rose from 1.8 percent in 2002 to 2.6 percent in 2003, and which is forecast to jump to 3.7 percent this year. Developing countries, as a group, grew by an estimated 4.8 percent in 2003, and are expected to register 5.4 percent growth in 2004, which would surpass their previous 5.2-percent record high in 2000.

A significant and growing new source of capital for developing countries is remittances sent home by migrants working in rich countries, which have climbed steadily since 1998, reaching $93 billion in 2003, up 20 percent from 2001. They are now the second most important financial flow to developing countries after FDI, and represent almost double the flows of official aid. In ECA, workers' remittances rose to $10.4 billion in 2003, up from $10.3 billion in 2002.

EU accession and oil shape the outlook for ECA

Led by a tripling in capital spending growth to 9 percent, the economies in the ECA region grew by 5.5 percent in 2003, up from 4.6 percent in 2002. Despite sluggish activity in the Euro area, growth in Central and Eastern Europe (excluding Turkey) accelerated from 3 per cent in 2002 to 4.1 percent in 2003, as several countries increased export-market shares in the European Union as part of the broader integration process. The Russian Federation and other countries of the CIS expanded from growth of 4.7 percent in 2002 to 6.6 percent in 2003, powered by a significant increase in consumer spending and domestic investment as a result of strong oil revenues. Russia grew by 6. 8 percent in 2003, up from 4.3 percent in 2002. Turkey grew by 5 percent in 2003, down from 7.8 percent in 2002.

The pace of integration of ECA into the global economy accelerated with a 27 percent increase in export revenues, the highest growth rate of all regions, and sharply higher than the 9.5 percent growth rate of 2002.

The outlook for 2004 and beyond is for continued robust growth in the region as a whole. Over the period 2004 to 2006 growth in Central and Eastern Europe is expected to be close to 4.5 percent, as effective implementation of EU-related structural reforms provides a stronger foundation for expansion. In the CIS, growth is projected to ease to 5 percent by 2005-06, due in large part to moderating oil prices.

Net private debt flows to the region strengthened markedly in 2003 and surpassed the net equity flows for the first time since 1999. Net private debt flows to the region reached $36 billion in 2003 compared to $22.7 billion in 2002. The increase reflects the improving credit quality in the region, especially for EU accession countries. Average credit quality in the region reached its highest point since 1997.

FDI flows into ECA fell sharply in 2003 to an estimated $26 billion from $33 billion in 2002. Few major privatization deals were completed, reflecting the end of privatization for some countries in the region. There was a sharp surge in FDI to the Russian Federation, mostly in the oil and gas sectors, however. Net portfolio flows to the region rose modestly to $0.7 billion.

FDI in the region is expected to recover. The Czech Republic, Hungary, and Poland are expected to receive more FDI in services as their competitive cost structure encourages investors to set up headquarters and research & development facilities whereas light manufacturers may move to lower-cost accession countries such as Romania. Russia and Turkey are expected to receive higher levels of FDI in coming years.

Capital flows open opportunity

The increase in private capital inflows offers significant opportunities for developing countries to invest in infrastructure and facilitate trade finance to foster a self-reinforcing cycle of sustained capital flows, economic growth and poverty reduction. In ECA, gross market-based capital inflows jumped from $35 billion in 2002 to an estimated $58 billion in 2003.

Since 1997, every important measure of infrastructure finance to developing countries—total external finance, project finance, and investment with private participation—has declined by at least 50 percent. This downturn, led by the East Asia, Russia and Brazil crises of the late 1990s, has been accentuated by retrenchment by major commercial banks, and a weakening of the global infrastructure industry.

But infrastructure needs in developing countries are both pressing and largely unmet. About 1.1 billion people do not have access to safe drinking water, 2.4 billion do not have adequate sanitation, and 1.4 billion have no power. The cost of needed infrastructure investments in developing countries is estimated at $120 billion a year from now to 2010 in the electricity sector, and $49 billion a year up to 2015 for water and sanitation.

The World Bank report recommends that developing countries seek to tap international capital to meet this demand for infrastructure financing by, among others, establishing transparent rules with the assurance that contracts will be respected, strengthening local capital markets, developing public-private risk mitigation instruments, and helping public providers of infrastructure services achieve commercial standards of creditworthiness. It also calls on multilateral agencies to support countries in pursuing these reforms.

While the global economy is clearly on a track to recovery, the pace of the upturn and likely prospects is varied across developing regions. Some highlights:

- East Asia led the world with 7.7 percent growth, largely driven by China, as it represents two-thirds of the region's GDP, but also because it is becoming an important export market for other countries in the region.
- Buoyant growth propelled by domestic consumer demand and relief from drought in India helped South Asia reach 6.5 percent growth. Workers' remittances and growing FDI are also increasingly important factors in South Asia's growth and prospects.
- Despite the Iraq war, GDP in the Middle East and North Africa rose by 5.1 percent, up from 3.3 percent in 2002, with oil exporters leading the way.

- Despite a booming oil sector in West Africa, Sub-Saharan Africa's overall growth slowed to 2.4 percent, down from 3.3 percent in 2002.
- Latin America is experiencing a slow recovery, with regional GDP up 1.3 percent in 2003 and growth projected to reach 3.8 percent this year.

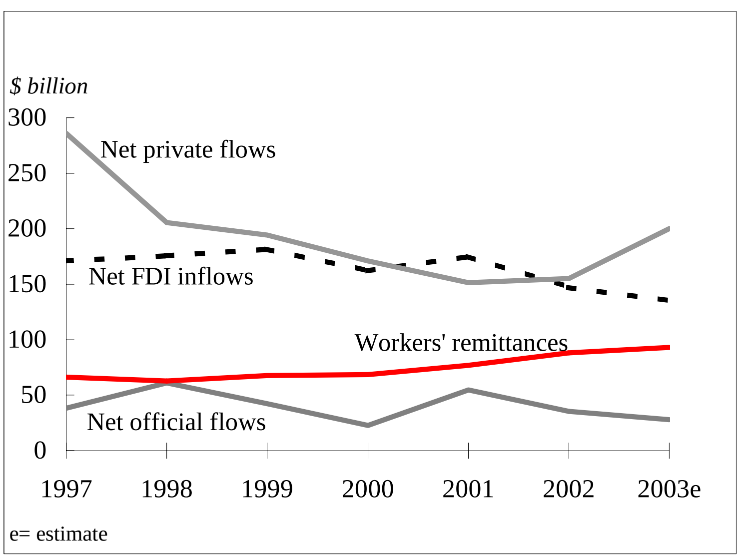
Global Real GDP Growth (in percentage rates)

	2002	2003e	2004f	2005f	2006f
World	1.8	2.6	3.7	3.1	3.0
High income countries	1.4	2.1	3.3	2.6	2.5
Developing countries	3.4	4.8	5.4	5.2	5.0
East Asia and Pacific	6.7	7.7	7.4	6.7	6.3
Europe and Central Asia	4.6	5.5	4.9	4.8	4.7
Latin America and Caribbean	-0.6	1.3	3.8	3.7	3.5
Middle East and N. Africa	3.3	5.1	3.7	3.9	4.0
South Asia	4.3	6.5	7.2	6.7	6.5
Sub-Saharan Africa	3.3	2.4	3.4	4.2	3.9

Financial Flows to Developing Countries (US$ billion)

	1997	1998	1999	2000	2001	2002	2003e
FDI	171	176	182	162	175	147	135
Net private flows	286	206	194	171	151	155	200
Net official flows	38	61	42	23	55	35	28
Workers' remittances	66	63	68	68	77	88	93

Net Financial Flows to Developing Countries



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