

# Global Development Finance

The Development Potential  
of Surging Capital Flows

I: Review, Analysis, and Outlook



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of Surging Capital Flows

I: REVIEW, ANALYSIS, AND OUTLOOK

2006



THE WORLD BANK

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1 2 3 4 09 08 07 06

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Cover photo: Dennis Degnan/Corbis.  
Cover design: Drew Fasick.

ISBN-10: 0-8213-5990-8  
ISBN-13: 978-0-8213-5990-7  
eISBN-10: 0-8213-6480-4  
eISBN-13: 978-0-8213-6480-2  
DOI: 10.1596/978-0-8213-5990-7  
ISSN: 1020-5454

The cutoff date for data used in this report was May 17, 2006. Dollars are current U.S. dollars unless otherwise specified.

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# Foreword

**R**OBUST GLOBAL GROWTH AND A favorable financing environment provided the context for a record expansion of private capital flows to developing countries in 2005. These conditions now provide a unique opportunity for the international policy community to place development finance on a firmer footing before the tightening of global liquidity closes the window of opportunity.

Most of the record \$491 billion in net private capital bound for the developing world in 2005 went to a small group of middle-income countries. Many of those countries took advantage of the growing inflows to improve their external debt profiles and accumulate large holdings of official foreign exchange reserves.

By contrast, many low-income countries still have little or no access to international private capital, and instead depend largely on official finance from bilateral and multilateral creditors to support their development objectives. With a decade remaining to attain the Millennium Development Goals (MDGs), expectations of a “big push” in development assistance escalated during 2005. Donors enhanced their efforts by scaling up aid volumes and reallocating them to the poorest countries, particularly those in Sub-Saharan Africa. In addition, the Multilateral Debt Reduction Initiative (MDRI) will provide additional debt relief to qualifying heavily indebted poor countries (HIPC), reducing debt service and freeing up more fiscal resources for the MDGs.

At the same time, the development finance landscape is being transformed. A growing number of countries are issuing longer-term maturities in international capital markets, in some cases even denominated in local currencies. Domestic debt markets have become a major source of finance in some countries, attracting international investors in search of higher yields and potential gains from currency appreciation. Structured financial instruments such as credit default swaps allow investors to better manage exposure to

credit risks associated with emerging market external debt portfolios. Financial integration among developing countries continues to deepen with capital flows between developing countries (so-called South–South flows) playing a prominent role. The role of the euro has evolved, gaining importance both as an international reserve currency and for debt issuance by governments and the corporate sector in developing countries. The emerging market asset class has matured far beyond the earlier dominance of U.S. dollar-denominated, high-yield, sovereign-debt instruments—indeed the Brady bonds issued in the 1980s that once exemplified this category have all but disappeared.

Global growth has remained surprisingly resilient to the rise in world oil prices over the past few years. Developing countries led the way with GDP growth in 2005 of 6.4 percent, more than twice the rate of high-income countries (2.8 percent). While inflation has, on the whole, remained subdued, there are signs of a pickup in several rapidly growing countries, which raises the possibility of overheating and the need for a tightening of macroeconomic policies. More generally, current account balances in oil-importing countries have deteriorated significantly, leaving them more vulnerable to subsequent adverse shocks.

Looking forward, while many of the external factors that have supported strong developing-country growth are projected to weaken, economic growth is expected to remain relatively strong. However, downside risks predominate. Persistent global imbalances, elevated current account deficits in some developing countries, and asset price over valuation are potential sources of risks to growth prospects in developing countries. In addition, a sharp supply shock could send oil prices even higher, with serious consequences for the most energy-dependent developing economies. A fall in non-oil commodity prices could have similar consequences for some of the poorest countries, which have benefited from higher metals and mineral prices. Finally, the Doha Round stands at

a critical juncture; governments need to agree on the key elements of a deal by mid-2006, but positions on the central issue of market access for agricultural and nonagricultural goods remain far apart.

A key priority for developing countries going forward is to pursue policies that strengthen their capacity to weather whatever global storms may be brewing. Continued macroeconomic stability is vital to ensure effective management of capital flows to advance long-term investment and growth. Countries must preserve sound financial management, with monetary and fiscal policies working in tandem to maintain debt sustainability and price stability. They must also build a system of risk management robust enough to respond to the needs of a more flexible exchange rate and open capital markets. Regulators in developing countries need to build their capacity to monitor credit default swap transactions and define a clear line of responsibility and necessary expertise to better manage the associated risks. Oil exporters face the special challenges of managing the risks surrounding volatile export revenues and using those revenues productively.

All countries would be affected by a disorderly unwinding of global imbalances, which would destabilize international financial markets and curtail global growth. But developing countries would suffer disproportionately, particularly if the imbalances were to foster a backlash of trade protectionism. With deepening economic and financial integration, all countries share responsibil-

ity for ensuring that policies are pursued that permit imbalances to unwind in an orderly and timely manner. This requires cooperation. The key policy prescriptions are well-known—the challenge is to make meaningful progress in implementing those policies. Policy makers in the major economies understand the importance of a coordinated approach and therefore have endorsed the proposal for the International Monetary Fund to play a more prominent role in coordinating the required collective action.

*Global Development Finance* is the World Bank's annual review of global financial conditions facing developing countries. The current volume provides analysis of key trends and prospects, including coverage of capital originating from developing countries themselves. A separate volume contains detailed standardized external debt statistics for 136 countries as well as summary data for regions and income groups. More information on the analysis, including additional material, sources, background papers, and a platform for interactive dialogue on the key issues can be found at [www.worldbank.org/prospects](http://www.worldbank.org/prospects). A companion online publication, *Prospects for the Global Economy*, is available in English, French, and Spanish at [www.worldbank.org/globaloutlook](http://www.worldbank.org/globaloutlook).

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# Acknowledgments

**T**HIS REPORT WAS PREPARED BY THE International Finance Team of the World Bank's Development Prospects Group (DECPG). Substantial support was also provided by staff from other parts of the Development Economics Vice Presidency, World Bank operational regions and networks, the International Finance Corporation, and the Multilateral Investment Guarantee Agency.

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Preparation of the commercial and official debt restructuring appendixes was managed by Eung Ju Kim, with inputs from Haocong Ren and Gholam Azarbayejani. The financial flow, debt estimates and the statistical appendix were developed in a collaborative effort between DECPG and the Financial Data Team of the Development Data Group (DECDG), led by Ibrahim Levent and including Nevin Fahmy, Shelly Fu, and Gloria R. Moreno. Background notes and papers were prepared by Paul Masson (University of Toronto), Michael Pomerleano (Operations and Policy Department of the Bank's Financial Sector), and Ivan Zelenko (Banking, Capital Mar-

kets, and Financial Engineering of the Bank's Treasury). The main macroeconomic forecasts were prepared by the Global Trends Team of DECPG, led by Hans Timmer and including John Baffes, Andrew Burns, Carolina Diaz-Bonilla, Maurizio Bussolo, Betty Dow, Annette de Kleine, Fernando Martel Garcia, Don Mitchell, Mick Riordan, Cristina Savescu, Shane Streifel, and Dominique van der Mensbrugghe. Gauresh Rajadhyaksha managed and maintained the modeling and data systems. Mombert Hoppe, Denis Medvedev, Sebnem Sahin, and Shuo Tan provided research assistance and technical support.

Contributors to regional outlooks included Milan Brahmhatt (East Asia and Pacific); Asad Alam, Cheryl Gray, and Ali Mansoor (Europe and Central Asia); Ernesto May and Guillermo Perry (Latin America and the Caribbean); Mustapha Nabli (Middle East and North Africa); Ejaz Syed Ghani (South Asia); and Delfin Go (Sub-Saharan Africa).

The online companion publication, *Prospects for the Global Economy*, was prepared by Andrew Burns, Sarah Crow, Cristina Savescu and Shuo Tan with the assistance of Roula Yazigi and Shunali Sarkar and the Global Trends team. Technical help in the production of that Web site was provided by Reza Farivari, Sarubh Gupta, David Hobbs, Shahin Outadi, Raja Reddy Komati Reddy, Malarvizhi Veerappan, Cherin Verghese, and Kavita Watsa.

The report also benefited from the comments of the Bank's Executive Directors, given at an informal board meeting on May 4, 2006.

Many others provided inputs, comments, guidance, and support at various stages of the report's preparation. Charles Collyns (International Monetary Fund), Ishrat Husain (Former Governor, State Bank of Pakistan), Mark Sundberg, Michael Klein, and Stijin Claessens were discussants at the Bankwide review. In addition, within the Bank, comments and help were provided by Alan Gelb, Alan Winters, Ali Mansoor, Asli Demirguc-Kunt, Barbara Mierau-Klein, Anderson

Caputo Silva, Angela Gentile (MIGA), Brian Pinto, Cheryl Gray, Dan Goldblum, Deepak Bhattasali, Doris Herrera-Pol, Ekaterina Vostroknutova, Ellis Juan, Eric Swanson, Francis Jean-Francois Perrault, Frannie Leautier, Gianni Zanini, Jeffrey Lewis, Joseph Battat (IFC), Marilou Uy, Muthukumaras Mani, Punam Chuhan, Sergio Schmukler Shahrokh Fardoust, Sona Varma, Ulrich Zachau, and Vikram Nehru.

Outside the Bank, several people contributed through meetings and correspondence on issues addressed in the report. These include Hiro Ito (Portland State University), Boubacar Trore (African

Development Bank), Joyce Chang (JPMorgan Chase Bank), and William Cline (Institute for International Economics).

Steven Kennedy edited the report. Maria Amparo Gamboa provided assistance to the team. Araceli Jimeno and Dorota Agata Nowak managed the production of the report, while communication guidance and support for the report were provided by Christopher Neal and Cynthia Carol Case McMahon. Book design, editing, production, and printing were coordinated by Susan Graham and Andres Ménèses of the World Bank Office of the Publisher.

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# Selected Abbreviations

ABF	Asian Bond Finance	IABs	interest arrears bonds
ABMI	Asian Bond Market Initiative	IDA	International Development Association (World Bank Group)
ADB	Asian Development Bank	IDB	Inter-American Development Bank
ADRs	American Depositary Receipts	IMF	International Monetary Fund
AfDF	African Development Fund	IPO	initial public offering
ASEAN	Association of Southeast Asian Nations	LDCs	least developed countries
ASW	asset swap	mbpd	million barrels per day
BIS	Bank for International Settlements	MDGs	Millennium Development Goals
CDS	credit default swap	MDRI	Multilateral Debt Reduction Initiative
CPIA	Country Policy and Institutional Assessment	MERCOSUR	Southern Cone Common Market (Mercado Común del Sur)
DAC	Development Assistance Committee (OECD)	MIGA	Multilateral Investment Guarantee Agency
DRC	Democratic Republic of Congo	NAFTA	North American Free Trade Agreement
DSF	Debt Sustainability Framework	NDF	nondeliverable foreign exchange forward market
EBRD	European Bank for Reconstruction and Development	ODA	official development assistance
ELMI	Emerging Local Markets Index	OECD	Organisation for Economic Co-operation and Development
EMBI	Emerging Markets Bond Index	OPEC	Organization of Petroleum-Exporting Countries
EMBIG	Emerging Markets Bond Index Global	PAIF	Pan-Asian Bond Index Fund
EMCDS	emerging market credit default swap	PPP	purchasing power parity
EMEAP	Executives' Meeting of East Asia and Pacific Central Banks	ROSCs	reports on the observance of standards and codes (IMF and World Bank)
EU	European Union	SAARC	South Asian Association for Regional Cooperation
FDI	foreign direct investment	SADC	Southern African Development Community
FLIRBs	Front-Loaded Interest Reduction Bonds	SBI	State Bank of India
FoBF	Fund of Bond Funds	SME	small and medium enterprise
G-3	Group of Three (European Union, Japan, United States)	SOE	state-owned enterprise
G-7	Group of Seven (Canada, France, Germany, Italy, Japan, United Kingdom, United States)	UAE	United Arab Emirates
G-8	Group of Eight (G-7 plus Russian Federation)	UNCTAD	United Nations Conference on Trade and Development
G-90	Group of Ninety (developing countries)	WDI	<i>World Development Indicators</i> (World Bank)
GDF	<i>Global Development Finance</i> (World Bank)	WDR	World Development Report (World Bank)
GDP	gross domestic product	WHO	World Health Organization
GEP	<i>Global Economic Prospects</i> (World Bank)	WTO	World Trade Organization
GNI	gross national income		
HIPCs	heavily indebted poor countries		

