Global Development Finance

The Development Potential of Surging Capital Flows

I: Review, Analysis, and Outlook

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Table of Contents

Tables

Figures

Boxes

Foreword

ROBUST 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 (HIPCs), 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 responsibility 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. A companion online publication, Prospects for the Global Economy, is available in English, French, and Spanish at www.worldbank.org/globaloutlook.

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Selected Abbreviations

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