Global Development Finance

The Globalization of Corporate Finance in Developing Countries

I: Review, Analysis, and Outlook

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THE WORLD BANK

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Foreword

THE ECONOMIC ENVIRONMENT facing developing countries remained highly favorable in 2006. Global gross domestic product (GDP) expanded by 4 percent, although signs of moderation emerged toward year-end. Developing economies grew by 7.3 percent, and international financial markets remained supportive of their financing needs despite several episodes of heightened volatility. Oil prices appear to have peaked, while markets for most other commodities produced by developing countries remained high—or rose still further. Combined, these conditions created the context for the continued expansion of private capital flows to developing countries, which reached a record $647 billion in 2006—5.7 percent of the aggregate GDP of these countries.

Strong private capital flows to developing countries reflect both these cyclical elements and improvements in the fundamentals of these economies. A wide range of middle-income countries has benefited from these flows, but access to private capital in many low-income developing countries remains limited and is dominated by trade financing and the resource sector. Sub-Saharan Africa, for example, was the destination of only 6 percent ($292 billion) of the $4.9 trillion in private capital that flowed to developing economies between 1990 and 2006. Low-income countries, benefiting from recent international debt-relief initiatives, must face the challenge of adopting prudent borrowing practices to ensure long-term growth and debt sustainability. Complementary efforts to increase aid flows have stalled—the amount of official development assistance provided by the 22 members of the Development Assistance Committee of the Organisation for Economic Co-operation and Development declined by almost $3 billion in 2006, following a large $27 billion increase in 2005. Donors must enrich development assistance significantly over the next few years in order to meet their commitments, notably the pledge made by G-8 and other donor countries to double the amount of aid provided to Sub-Saharan Africa by 2010.

Although oil import bills have risen, the past five years have presented a highly favorable mix of economic and financial conditions for most developing countries: low international interest rates, ample global liquidity, and strong global demand for exports. Many middle-income countries have taken advantage of this opportunity to enhance their creditworthiness by accumulating foreign exchange reserves, improving current account balances, reducing external debt burdens, and improving debt management by issuing longer maturities. Several large borrowers have bought back significant amounts of outstanding debt using abundant foreign exchange reserves. Many governments have turned from external to domestic markets, where most debt is denominated in local currency. Partly as a consequence, creditors' assessment of developing countries is very positive, as reflected in near record-low spreads on emerging-market bonds and bank loans.

These favorable conditions and the gains that have accrued are not grounds for complacency in assessing future risks. History suggests that market conditions and sentiment can shift with dizzying speed. Sustaining the discipline and sound policy that have contributed to the current favorable phase must remain in the forefront of decision makers' objectives.

The increasing share of corporate finance in emerging-market economies' external borrowing has introduced its own risks. For much of the postwar era, foreign borrowing by sovereigns has been the dominant feature of development finance. Since 2002, however, a different picture has emerged. The past few years of strong developing-country growth has brought the leading companies of the developing world to the attention of an ever-wider set of investors. Together with the liberalization of capital controls and the pressures facing international portfolio managers to enhance returns, the globalization of corporate finance is now reaching a larger segment of the developing world. This in turn strengthens the case for a more coherent and global approach to regulating cross-border public offerings and securities listings. Domestic regulators must pay greater attention to the transparency and stringency of accounting standards, the credibility of financial reporting, and the integrity of corporate governance. In all cases, there must be a balance between official regulations and market incentives for enhancing the efficiency of global capital allocation.

The globalization of corporate finance also points to other challenges. As emerging-market corporations have expanded their international operations, they have increased their exposure to interest rate and currency risks. Concerns are growing that several countries in emerging Europe and Central Asia are experiencing a credit boom engendered by cross-border borrowing by banks of untested financial health and stamina. Some of these banks have increased their foreign exchange exposure to worrisome levels, a concern that warrants special attention from national policy-makers. Given banks' critical role in domestic monetary systems, policy makers should step up their regulation of foreign borrowing by banks.

The projected slowdown in global growth and tighter monetary policy in high-income countries are expected to make financing conditions for developing countries somewhat less favorable in coming years. While a soft landing is the most likely outcome, there are risks. For example, if the economic downturn in the United States is deeper than forecast, demand for developing economies' exports (and commodity prices) may fall enough to contribute to reduced confidence and induce financial sector disruption. Conversely, should growth fail to moderate, financial stability in some fast-growing developing economies could be threatened by rising inflation and high current account deficits.

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 raised by developing country based corporations. A separate volume contains detailed standardized external debt statistics for 136 countries as well as summary data for regions and income groups. More information, including additional material, sources, background papers, and a platform for interactive dialogue on the key issues, can be found at http://www.worldbank.org/prospects. A companion online publication, "Prospects for the Global Economy," is available in English, French, and Spanish at http://www.worldbank.org/globaloutlook.

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Selected Abbreviations

ADR	American Depositary Receipt
ASW	Asset swap
CDS	Credit default swap
DAC	Development Assistance Committee
EMBI Global	JPMorgan Emerging Markets Bond Index Global
EU	European Union
FASB	Financial Accounting Standards Board
FDI	Foreign direct investment
G-7	Group of Seven (Canada, France, Germany, Italy, Japan, United Kingdom, United States)
GAAP	Generally Accepted Accounting Principles
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GDR	Global Depositary Receipt
HIPC	Heavily indebted poor countries
IASB	International Accounting Standards Board
ICRG	International Consulting Resources Group
IFRS	International Financial Reporting Standards
IFS	*International Financial Statistics* (IMF)
IMF	International Monetary Fund
IPO	Initial public offering
LSE	London Stock Exchange
M&A	Mergers and acquisitions
MDRI	Multilateral Debt Relief Initiative
MSCI	Morgan Stanley Capital International
mbpd	Million barrels per day
NYSE	New York Stock Exchange
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of Petroleum-Exporting Countries
PPP	Purchasing power parity
SIC	Standard Industrial Classification
UN	United Nations
WDI	*World Development Indicators* (World Bank)
WTO	World Trade Organization