# Overview

World growth is moderating, and financial markets are signaling a turn in the financing conditions facing the developing world. As these developments make themselves felt, 2007 is likely to be a year of adjustment for capital flows to developing countries.

After recovering from the sharp contraction of 2001–02, private flows weathered several episodes of global financial volatility and passed through a full cycle of global monetary easing and tightening to reach a record level of $647 billion in 2006, up 17 percent from 2005. Total capital flows, including lending by official creditors, leveled off at 5 percent of gross domestic product (GDP) in 2005–06, just below the 5.25 percent level reached in 1995–97, before the East Asian crisis.

Developing countries have come to account for a large share of the growth of world output and trade, a fact that is increasingly recognized by international investors. Their economies grew more than 7 percent in 2006—more than twice the 3 percent rate of growth in high-income countries. The expansion was particularly evident in China, where output increased 10.7 percent, and India, which grew 9.2 percent. But the strong performance was broadly based, with all developing regions growing at least 5 percent. Even oil-importing developing countries recorded robust growth of almost 5 percent, despite high oil prices for the third consecutive year.

Most developing countries have taken advantage of favorable external conditions to implement domestic policies designed to reduce their vulnerability to financial turmoil and reversals in capital flows. In particular, countries have reduced their external debt burdens and lengthened the maturity structure of their debt. Several have bought back large amounts of outstanding debt, using abundant foreign exchange reserves, and refinanced existing debt on more favorable terms. The market for sovereign debt has evolved significantly, as governments have turned from borrowing externally to borrowing domestically, usually in local currency. Creditors' assessment of the creditworthiness of developing-country borrowers remains positive, as reflected in spreads on emerging market bonds and bank loans, which have hovered near record lows.

By these measures, most developing countries have clearly improved their ability to deal with the moderate shocks that may accompany changes in the international credit environment. However, the buoyancy of financial markets, combined with the slowing of growth and the trend toward continued monetary tightening, provide grounds for caution. In particular, although the smooth adjustment toward slower, more sustainable, growth that is outlined in the baseline projection presented in this report is the most likely outcome, such turning points are risky in nature. The extent to which the U.S. housing-sector correction spreads to other sectors in the economy, the success with which those developing countries that are overheating are able to contain inflation and reduce current account imbalances, and the durability of financial markets' current benign assessment of long-term risks are all areas of uncertainty that could result in a more abrupt and disruptive adjustment toward slower growth.

## Strong growth in 2006 probably represents a cyclical peak

Global GDP expanded 4 percent in 2006, despite signs of a moderation of the current expansion. Tighter monetary policy, further emerging capacity constraints in many countries, and a generalized maturation of the investment cycle contributed to a slowing of industrial production toward the end of the year in the major high-income countries and China. The more marked slowdown in the United States has contributed to some easing of major tensions. U.S. housing prices have moderated or declined in some parts of the country, without (yet) triggering a disruptive sell-off. At the same time, U.S. savings have crept up, as the current account deficit fell to 5.9 percent of GDP in the last quarter of 2006.

Short- and long-term international interest rates have risen in response to policy actions and market-induced revaluations of long-term risks, while risk premiums, notably on subprime assets, have increased in recent months. Commodity prices also show signs of having reached cyclical peaks, with some easing of oil prices from the mid-2006 high point and a decline in the prices of copper and zinc, two of the metals whose prices had risen most rapidly. Financial conditions remain supportive by historical measures, however, and liquidity remains ample. As a result, the transition to slower growth is expected to be relatively smooth. The expansion of developing economies is projected to moderate gradually, from 7.3 percent in 2006 to about 6 percent in 2009, with all regions slowing but continuing to record strong results. At the same time, growth in the high-income countries is expected to ease in 2007 (mainly reflecting slower U.S. growth) before strengthening in 2008 and 2009, as the United States recovers and the economies of Japan and Europe continue to expand at close to their potential rates.

## The expansion in capital flows was led by equity, as private sources eclipsed official

The composition of capital flows continues its pronounced shift from debt to equity financing and from official to private sources of debt. Equity flows totaled $419 billion in 2006, accounting for almost three-quarters of capital flows, up from two-thirds in 2004, with strong gains in both portfolio equity and foreign direct investment (FDI). Equity prices in emerging markets continued to outperform mature markets by a wide margin while also exhibiting greater volatility. Worldwide FDI inflows reached $1.2 trillion in 2006, with about one-quarter of the total ($325 billion) going to developing countries.

Net lending from the international financial institutions and other official sources in the Paris Club of creditors dropped starkly over the past two years, while private lending surged. Several countries drew down abundant foreign exchange reserves to pay off debt owed to official creditors and to access financing from private sources on favorable terms. Principal repayments to the Paris Club and multilateral institutions (particularly the International Monetary Fund) exceeded disbursements by some $146 billion in 2005–06, as net private debt flows reached $432 billion.

The development of local and regional bond markets in low-income countries, as highlighted by the G-7 finance ministers at their meeting in February 2007, has the potential to improve financial infrastructure and provide an additional source of financing. Local bond markets in Kenya, Nigeria, Zambia, and elsewhere have already attracted the interest of foreign investors. While participation of foreign investors in these markets offers significant potential benefits, notably diversifying the investor base and enhancing liquidity, it also poses new risks, particularly in cases where segments of these markets are dominated by foreign investors, which makes them more vulnerable to a sudden swing in investor sentiment. Progress on improving the quality of institutions, governance, and economic policies will ultimately have a major influence on how effectively developing countries manage such risks. Given the high vulnerability of such countries to domestic and external shocks, governments are well advised to improve data collection and procedures for better monitoring of foreign investment flows.

## The globalization of corporate finance offers significant benefits for developing countries

In the making for many years, the globalization of corporate finance in the developing world has accelerated since 2002, as governments have liberalized capital controls and international portfolio managers have enhanced returns by diversifying into emerging corporate securities. With these changes, more companies based in developing countries have entered world capital markets to broaden their funding sources, borrowing at longer maturities and improving risk management through the use of sophisticated financing instruments. Private sector companies were behind much of the increase, accounting for more than 60 percent of total bank borrowing and 75 percent of new bond issuance during 2002–06. Financial corporations, particularly commercial banks from India, Kazakhstan, the Russian Federation, and Turkey, have been on the forefront of what may well be a major foreign-credit boom in the banking industry of these countries. Banks have tapped international debt markets to fund growing domestic loan portfolios and meet increasing capital-adequacy requirements. Faced with intensified competitive pressures and highly liquid markets, international banks have been willing to narrow margins, lengthen maturities, and relax credit standards.

Growing numbers of firms are opting to cross-list their shares on major world stock exchanges as a way of facilitating trading by foreign investors and building channels through which to meet future capital needs. Companies often gain value by bypassing underdeveloped local capital markets and committing to higher standards of accounting, reporting, disclosure, and corporate governance, as mandated by major financial centers. By meeting these standards, companies can lower their cost of capital. But overreliance on international sources of capital has drawbacks, too:

- As emerging-market corporations have increased in size and expanded their international operations, they have increased their exposure to interest-rate and currency risks. Despite advances in risk management by many firms, concerns remain in two particular areas. First, growing yen-denominated liabilities held by some corporations may not be adequately hedged against currency movements. Second, in many emerging-market corporations, the capacity to develop an enterprisewide risk management framework is hampered by underdeveloped derivatives markets, making it difficult to measure, aggregate, and hedge risk. Moreover, credit risk may be substantially underestimated at the current phase of the credit cycle.
- Banks' exposure to foreign-currency borrowing warrants special attention from policy makers, given banks' critical role in domestic monetary systems. Foreign borrowing by developing-country banks can help deepen and modernize the financial sector if underlying policy and regulatory frameworks promote healthy banking practices, sound credit allocation, and proper risk management. Where supervision is less than stringent, systemic risks can be considerable—and they are rarely confined to the country in which the risky borrower is based. Several countries, particularly in the transition economies of Europe and Central Asia, are now experiencing a credit boom, spearheaded by banks of untested financial health and stamina. Concerns are growing that some of these banks—particularly in Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Russia, and Ukraine—are increasing their foreign exchange exposure to levels that have the potential to jeopardize financial stability.

Protecting the benefits of globalization for developing countries and their corporations will require appropriate policies, both macroeconomic and regulatory, by governments in the developing world. While corporate decisions to raise capital on overseas markets should depend primarily on market forces, pubic authorities must not shy away from addressing situations in which corporate financial distress could spill over to the banking sector, raising systemic risk. Policy makers must keep two realities in sharp focus. The first is that the globalization of firms based in developing countries is driven by powerful market forces and trends that are inseparable from the broader globalization of the world economy. This is a secular trend that shows no signs of abating. On balance this is a positive trend, worthy of continued support from policy makers and regulators. The second is that governments must also keep their eyes on managing short-term fluctuations and risks. Market-determined exchange rates, far greater corporate transparency, and government regulation of foreign borrowing by banks are needed to reduce the likelihood of excessive corporate foreign borrowing and financial distress.

International financial institutions and supranational organizations (notably those in the securities and accounting fields) can help by establishing clear and consistent rules for access to the financial markets of the industrial world. National and regional systems of securities regulation embrace different standards, rules, and systems. For firms, complying with multiple sets of rules can be very costly. Market pressures and action by international regulators have brought about some degree of convergence in certain areas, notably accounting rules, but the need remains to strike a balance between official regulations and market incentives in managing cross-border offerings and listings on major exchanges. Doing so will require more progress in streamlining and harmonizing national regulation of corporate governance practices, disclosure rules, financial accounting standards, and enforcement mechanisms.

## Little progress has been made in scaling up aid

The wave of private finance in the developing world may represent a powerful secular trend, but it has not reached all shores. Sixty percent of all developing countries (79 of 135) never accessed the external bond market between 1980 and 2006; just eight countries did so frequently.

Most low-income countries lack ready access to private debt markets, and many continue to depend very heavily on concessional loans and grants to meet their financing needs. At the UN Conference on Financing for Development in Monterrey in 2002, official donors pledged to increase the amount of new aid they provided, over and above the substantial amounts of debt relief then being planned. Donors subsequently made commitments to enhance aid substantially over the balance of the decade, particularly to low-income countries in Sub-Saharan Africa.

Little progress was made toward meeting these objectives in 2006. Excluding debt relief, net disbursements of official development assistance were static, after growing at an average annual rate of 16 percent over the three previous years.

Several new aid donors have emerged in the past few years. Some, such as Brazil, China, India, and Russia, are now both donors and recipients of development assistance. Not much is known about the aid provided by most of the new donor countries, because their activities are not reported in a comprehensive manner. But the emergence of new players on the aid agenda has increased the need for greater coordination among donors and better monitoring of aid flows, so that aid can be directed where it is most needed and most likely to be effective.

## Good policies need to be sustained and extended in managing the upcoming adjustment

Never before have conditions been so well aligned for a major push toward sustainable growth and poverty reduction. Developing countries stand to reap substantial benefits from the access their enterprises have gained to the world's major financial centers, with their deep and liquid financial resources, broad investor bases, and modern trading platforms. For the fourth consecutive year, growth in developing countries, including those in Sub-Saharan Africa, was strong. Low-income countries' ability to access private debt markets has been considerably enhanced by recent debt-relief initiatives, which have significantly reduced their debt burdens and improved their creditworthiness. These hard-won gains are worth protecting.

The key requirement for doing so is to sustain and extend the solid policies and frameworks that have provided fertile ground for developing countries' growth and that have brought emerging markets to the attention of an ever-wider set of investors. Underway in many countries since the early 1990s, these fundamental improvements include progress toward flexible exchange rates; a phased easing of capital controls, in line with improvements in institutional and regulatory capacity; and privatization of public enterprises. Greater efforts are also needed to spur the development of well-regulated and liquid local capital markets, which provide developing countries with sound protection against external shocks, and to ensure prudential regulation of foreign borrowing by domestic banks and other regulated financial entities. Such structural improvements would greatly reduce the likelihood of corporate financial distress and vulnerability while promoting the orderly growth of new market institutions and the regulatory capacity needed for effective macroeconomic management of the increasingly open economies of the developing world.

These improvements notwithstanding, the cyclical component of financial flows to developing countries means that the newly enhanced access of emerging market sovereigns and corporations to global finance could reverse itself. Global financial markets are notoriously sensitive to bad news during downturns in the global business cycle, and the possibility of an abrupt market reaction to unexpected events, economic or political, cannot be ruled out. The outlook is further clouded by large current account deficits in several middle-income developing countries (especially those in Europe and Central Asia) and uncertainty surrounding the functioning of exotically structured financial products and their ability to sustain a major reversal in investor sentiment.

These are the themes and concerns of this year's edition of *Global Development Finance*.