2

Financial Flows to Developing Countries: Recent Trends and Prospects

NET CAPITAL INFLOWS TO DEVELOPing countries surged to another record level in 2007, marking the fifth consecutive year of strong gains. Economic expansion in developing countries and ample liquidity in the first half of the year supported a $269 billion increase in net private flows, mainly reflecting continued rapid expansion in equity inflows and net bank lending, which both reached record levels.

But developing countries' easy access to global capital markets deteriorated in late 2007 and into 2008 in the wake of the U.S. subprime mortgage crisis. Uncertainty both about the identity of financial institutions with large exposures and about the potential magnitude of losses gave rise to a volatile financial environment, sparking a selloff across the entire spectrum of risky assets in mature and emerging markets. At the same time, major financial institutions that have taken sizable write-downs have curbed their lending to restore balance sheets, and further losses are expected over the balance of 2008. Besides reducing capital flows to developing countries, the turmoil has increased borrowing costs, although less so than in previous episodes, when emerging markets themselves were the primary source of difficulty.

This chapter reviews financial flows to developing countries, analyzing recent developments and assessing short-term prospects. The key messages are highlighted below.

- Net private flows to developing countries reached a record level for the year 2007 as a whole, even though economic and financial conditions deteriorated appreciably over the latter part of the year. *Turmoil in international financial markets has curbed private debt and equity flows in late 2007 and into early 2008.*
- Under our base-case scenario, where global growth moderates and credit conditions remain tight, *private flows are projected to decline modestly in the short term, stabilizing at levels above previous peaks (as a share of GDP) over the medium term.* Under an alternative scenario, where global growth declines abruptly and credit conditions tighten further, private flows are projected to exhibit a sharper decline in the short run, stabilizing at close to historical average levels (as a share of GDP) over the medium term.
- *The financial turmoil that began midyear had a marked impact on emerging debt and equity markets, although to a lesser degree than in previous crises.* Investors' reduced appetite for risk widened spreads on emerging-market sovereign bonds by about 150 basis points between mid-2007 and early 2008, a modest increase relative to previous episodes, such as the Mexican peso crisis in late 1994 and early 1995 and the Russian crisis in August 1998, when sovereign bond spreads widened by 800–1,000 basis points in just a few months. The widening of emerging-market bond spreads during the current episode, however, has coincided with a decline in benchmark U.S. Treasury yields, keeping yields on emerging-market sovereign bonds relatively stable. In contrast, yields on noninvestment-grade corporate bonds in mature and emerging markets rose significantly between mid-2007 and early 2008, suggesting that the turmoil has had a much greater impact on the cost of financing for corporations, particularly the

less creditworthy. Emerging-market equity prices peaked in late October 2007, followed by a sharp correction. However, equity returns in emerging markets showed strong gains for the year 2007 as a whole and continued to outperform mature markets by a wide margin, as in the previous four years.

- *The external financial position of many developing countries has deteriorated, leaving many of them more vulnerable to subsequent adverse shocks.* The external financial positions of a small number of countries strengthened. China, for example, accounted for $367 billion of developing countries' $426 billion current account surplus, and five major oil exporters (the Russian Federation, the Islamic Republic of Iran, Algeria, República Bolivariana de Venezuela, and Nigeria) ran a combined surplus of $280 billion. By contrast, almost a quarter of developing countries ran current account deficits in excess of 10 percent of GDP, and current account balances deteriorated in two-thirds of developing countries. The pace of foreign reserve accumulation by developing countries accelerated in 2007. Their reserve holdings expanded by over $1 trillion, more than double the value of their short-term debt and bank loans. However, three-quarters of the increase was concentrated in the BRICs (Brazil, Russian Federation, India, and China).
- *Aside from debt relief, donor countries have made slow progress in fulfilling their commitments to enrich development assistance.* Although private capital flows to developing countries have surged over the past few years, most of the flows have gone to just a few large countries. Many developing countries still depend heavily on concessionary loans and grants from official sources to meet their financing needs. In 2006 net disbursements of official development assistance (ODA) exceeded net private debt flows in almost two-thirds of developing countries. Those countries are less vulnerable to an abrupt downturn in the credit cycle, but many face the daunting challenge posed by the dramatic rise in food and energy prices over the past few years. ODA has increased by less than expected since the United Nations' Conference on Financing for Development in Monterrey, Mexico, in 2002. Participants at the Monterrey conference acknowledged dramatic shortfalls in resources required to achieve the internationally agreed development goals, and donors pledged that debt relief would not displace other components of ODA. Since then, ODA (excluding debt relief) has increased from 0.23 percent of donors' gross national income (GNI) in 2002 to only 0.25 percent in 2007, well below the 0.33 percent level attained in the early 1990s. Existing commitments by donors imply that ODA will increase to 0.35 percent of their GNI by 2010, only half of the UN target (0.7 percent). Meeting the 2010 commitments would require an average annual growth rate of over 14 percent in real terms over the balance of the decade, three times that observed since the Monterrey Consensus in 2002.

Capital market developments in 2007

Private capital flows continue to surge . . .

Net debt and equity inflows to developing countries increased by $269 billion in 2007, reaching a record $1.03 trillion (table 2.1). This marks five consecutive years of strong gains in net private flows, which averaged over 44 percent a year. However, much of the increase in dollar terms reflects the depreciation of the U.S. dollar against most other currencies (box 2.1). The increase in 2007 is much more modest when measured against the income (nominal GDP in U.S. dollars) of developing countries—rising from 6.7 to 7.5 percent.

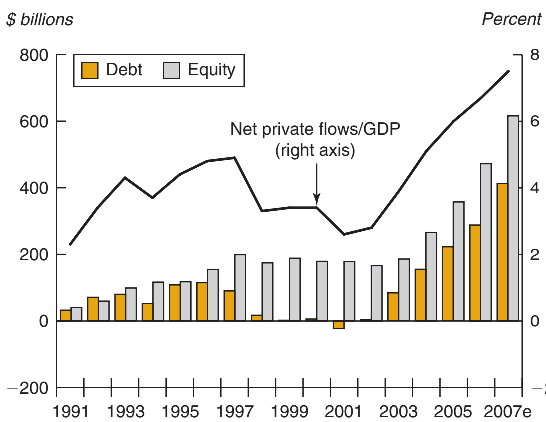
The rapid expansion in private flows reflects strong gains in both equity and debt components (figure 2.1). Net (foreign direct and portfolio) equity inflows reached an estimated $616 billion in 2007, equal to a record 4.5 percent of GDP, up from 4.1 percent in 2006.[1] Net private debt flows (disbursements less principal payments) reached an estimated $413 billion, rising from 2.5 to 3.0 percent of GDP.[2] Loan repayments by developing countries to official creditors exceeded lending for the fifth consecutive year, although the margin narrowed substantially, from approximately $71 billion in 2005 and 2006 to $4 billion in 2007.

Table 2.1 Net capital flows to developing countries, 2000–07
$ billions

Category	1999	2000	2001	2002	2003	2004	2005	2006	2007e
Current account balance	−17.7	36.3	12.8	62.0	116.9	164.3	309.5	431.0	425.9
as % of GDP	−0.3	0.7	0.2	1.0	1.7	2.0	3.2	3.8	3.1
Financial flows									
Net private and official flows	209.7	181.2	191.3	174.0	262.4	386.4	479.7	689.8	1025.0
Net private flows (debt + equity)	195.7	187.0	164.5	169.1	274.1	412.5	551.4	760.3	1028.9
Net equity flows	188.4	179.0	178.6	166.2	186.0	265.9	357.4	472.3	615.9
Net FDI inflows	177.0	165.5	173.0	160.7	161.9	225.5	288.5	367.5	470.8
Net portfolio equity inflows	11.4	13.5	5.6	5.5	24.1	40.4	68.9	104.8	145.1
Net debt flows	15.1	−0.4	4.5	8.9	72.8	128.8	152.4	217.5	409.1
Official creditors	14.0	−5.8	26.8	4.9	−11.7	−26.1	−71.7	−70.5	−3.9
World Bank	8.8	7.9	7.6	−0.4	−0.8	1.4	2.5	−0.7	3.0
International Monetary Fund	−2.2	−10.6	19.5	14.0	2.4	−14.7	−40.2	−27.1	−4.7
Others official	7.4	−3.1	−0.3	−8.7	−13.3	−12.8	−34.0	−42.7	−2.2
Private creditors	1.5	5.8	−23.0	3.8	84.4	155.2	222.7	288.0	413.0
Net medium- and long-term debt flows	18.9	12.2	1.9	0.7	30.9	87.7	133.1	193.8	283.3
Bonds	25.7	19.5	10.2	8.8	19.6	41.1	52.6	25.3	79.3
Banks	−5.5	−3.9	−2.0	−1.7	15.2	50.4	85.3	172.4	214.7
Others	−1.3	−3.4	−6.3	−6.4	−3.9	−3.8	−4.8	−3.9	−10.7
Net short-term debt flows	−17.4	−6.4	−24.9	3.1	53.5	67.5	89.6	94.2	129.7
Balancing item[a]	−153.1	−172.3	−115.5	−70.6	−83.2	−156.6	−417.5	−481.9	−391.0
Change in reserves (− = increase)	−32.8	−42.6	−80.4	−166.5	−292.4	−402.4	−390.8	−634.2	−1090.7
Memorandum item									
Workers' remittances	77.5	84.5	95.5	115.8	143.4	160.7	191.0	221.0	240.0

Sources: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate; FDI = foreign direct investment.
a. Combination of errors and omissions and transfers to and capital outflows from developing countries.

Figure 2.1 Net private flows to developing countries, 1991–2007



Sources: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate.

. . . despite the turmoil midyear

Global financial markets entered into an episode of heightened volatility beginning about midway through 2007 as the crisis in the U.S. subprime mortgage market spilled over into equity, currency, and bond markets worldwide. The turbulence in financial markets curbed investors' appetite for risk, resulting in a sell-off of risky assets in mature and emerging markets. Although the sell-off has had little impact on the cost of sovereign borrowing from abroad, it has increased the cost of corporate borrowing significantly, particularly for less-creditworthy borrowers. The turmoil has also increased volatility in equity prices, which peaked in October 2007 and have since undergone a sharp correction. Nonetheless, equity returns in emerging markets managed to post impressive gains for 2007 as a whole, and outperformed mature markets by a wide margin.

Current account balances have worsened in most developing countries

Current account balances for developing countries as a group increased slightly in dollar terms in 2007 but declined as a share of GDP, falling from a record surplus of 3.8 percent in 2006 to 3.1 percent in 2007. The $426 billion overall surplus

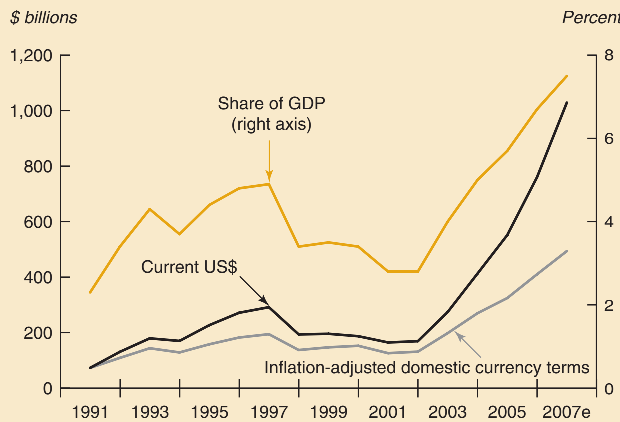
Box 2.1 The impact of exchange-rate movements on capital flows measured in U.S. dollars

Exchange-rate movements over the past few years have had a major influence on the magnitude of capital flows to developing countries (measured in U.S. dollars). In 2006, almost 40 percent of external debt outstanding in developing countries was denominated in currencies other than the U.S. dollar, mainly in euros (23 percent) and Japanese yen (10 percent). The convention used in this report is to measure all external borrowing in U.S. dollars as the common currency. The choice of common currency has implications for measuring capital flows over time. The surge in net private flows over the past few years is more moderate when euros are used as the common currency instead of U.S. dollars. In 2007, net private flows are estimated to have increased by 35 percent in U.S. dollars, compared with just 24 percent in euros, the difference reflecting the depreciation of the dollar against the euro.

The development potential of capital flows is better measured from the perspective of the recipient country. For this purpose, converting capital flows from U.S. dollars to domestic currency provides a better measure of the purchasing power. The U.S. dollar depreciated significantly against currencies in many developing countries in 2007, in many cases by more than 10 percent. The purchasing power of capital inflows is also eroded by inflation. Countries with currencies appreciating against the dollar and with high inflation rates require a higher level of capital flows (measured in dollars) in order to maintain purchasing power. For example, in the case of Brazil, the real appreciated by 17 percent against the dollar in 2007 and the consumer price index increased by 4.5 percent (in December year over year). Capital inflows to Brazil would have had to increase by over 20 percent in dollar terms just to maintain the same purchasing power.

Measuring the value of capital flows relative to nominal GDP takes into account exchange-rate and domestic price changes, along with real GDP growth. Nominal GDP growth in developing countries as a group averaged 18 percent in 2004–07, 11 percentage points above the average annual rate of real GDP growth. In contrast, nominal GDP growth averaged only 0.5 percent in 1998–2002, 3 percentage points below the average annual rate of real GDP growth. Capital flows to developing countries were quite stable throughout the 1990s, adjusting for exchange-rate changes and inflation (proxied using changes in GDP price deflators), and have increased at an average annual rate of about 31 percent over 2003–07, compared with 44 percent in dollar terms.

Net private capital flows to developing countries, 1991–2007

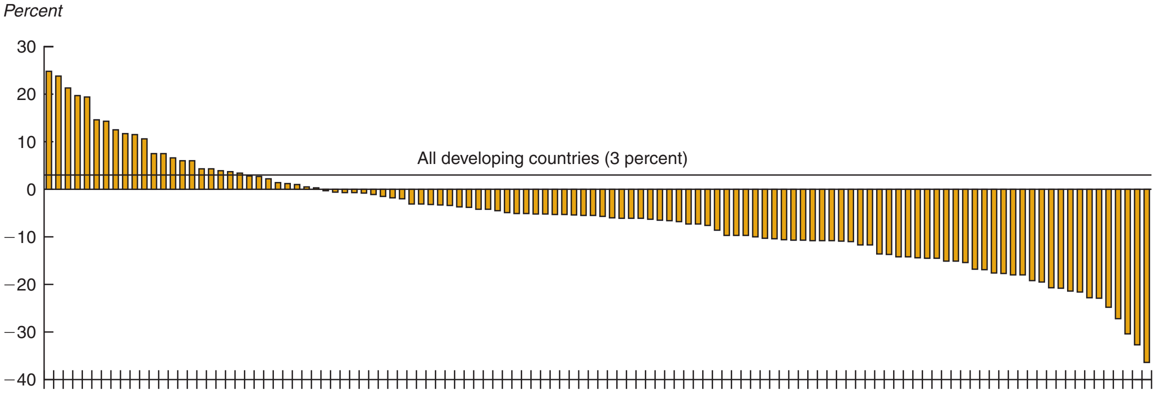


Source: World Bank staff estimates.
Note: e = estimate.

position was dominated by China, where the current account balance increased from $250 billion in 2006 (9.6 percent of GDP) to $360 billion in 2007 (11.7 percent of GDP), along with a number of leading oil exporters, notably Russia ($83 billion), the Islamic Republic of Iran ($49 billion), and Algeria ($27 billion). The overall surplus position for developing countries, however, gives a misleading impression of balances in most countries. One in five developing countries ran current account surpluses below 3 percent of GDP; one in two ran deficits in excess of 5 percent of GDP (figure 2.2).

In 2007 current account balances worsened in two-thirds of developing countries (as a share of GDP). The dramatic rise in imported food and energy prices over the past few years has worsened the trade balance in two-thirds of all developing countries. For example in the case of Lesotho, commodity price increases over the period 2003–07 worsened the trade balance by an estimated $550 million (an amount equal to 28 percent of Lesotho's GDP in 2007), a major factor underlying its current account deficit exceeding 25 percent of GDP in 2007. In the more extreme case of Seychelles,

Figure 2.2 Current account as a share of GDP in developing countries, 2007



Source: IMF International Financial Statistics.

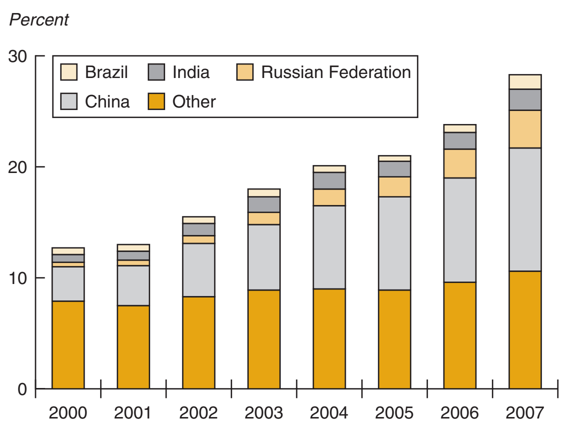
commodity price increases worsened the trade balance by an estimated $235 million (equal to 33 percent of GDP in 2007), while the current account deficit in Seychelles increased from around 2 percent of GDP in 2003 to almost 34 percent in 2007. Soaring commodity prices have also had a major impact on larger developing countries such as Morocco, where commodity price increases over the period 2003–07 worsened the trade balance by an estimated $10 billion (equal to 16 percent of GDP in 2007), while Morocco's current account balance deteriorated from a surplus equal to 3.5 percent of GDP to a deficit equal to 3.2 percent.

Foreign reserves continue to cumulate in the BRICs

Foreign exchange reserves rose by $1.03 trillion in 2007, up from $634 billion in 2006 and approximately $400 billion in 2004 and 2005. The BRICs accounted for over two-thirds of the increase: $462 billion in China, $169 billion in Russia, $96 billion in India, and $94 billion in Brazil. Reserve holdings by all developing countries increased from 23 percent of their GDP in 2006 to 27 percent in 2007 (figure 2.3). The share of reserves held by the BRICs rose from 40 percent in 2000 to about 65 percent in 2007. China's share of total reserves held by developing countries has been stable at about 40 percent over the past four years, while the share held by Russia increased from 7.5 percent to 12.5 percent.

Reserve holdings by all four of the BRICs greatly exceed levels required to provide adequate insurance against a sudden shift in private capital flows. At the end of 2007, the BRICs held $2.4 trillion in foreign reserves, an amount equal to 5.7 times the value of principal and interest payments due in 2008, compared with 1.8 times for other developing countries. In the case of India, the ratio has risen from 2.5 in 2000 to 8.4 in 2007 (figure 2.4).

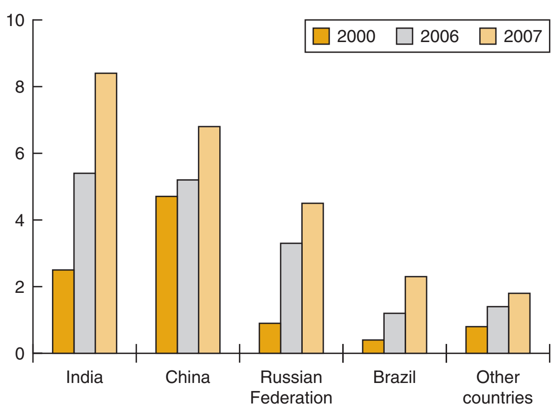
Figure 2.3 Foreign reserve holdings as a share of GDP in developing countries, 2000–07



Source: IMF International Financial Statistics.

Developing countries now account for almost 60 percent of global foreign reserve holdings, up from 40 percent in 2003 (figure 2.5). According to the Currency Composition of Official Foreign Exchange Reserves database maintained by the International Monetary Fund (IMF), the bulk of reserves held by developing countries and newly industrialized economies is denominated in U.S. dollars (60 percent) and euros (28 percent). The

Figure 2.4 Foreign reserves relative to principal and interest payments on debt outstanding, 2000–07

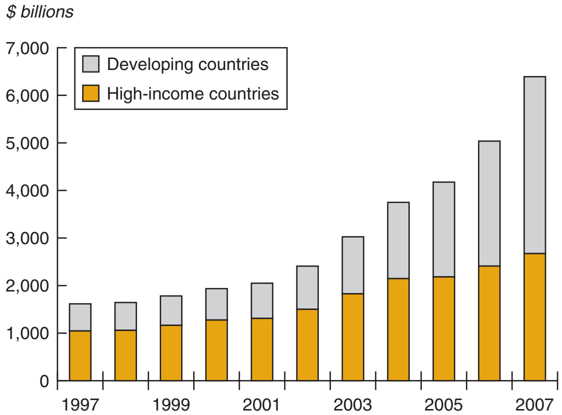


Sources: World Bank Debtor Reporting System; IMF International Financial Statistics.

currency composition has been stable over the past five years.[3]

Several developing countries have shifted a higher proportion of their foreign currency earnings from official foreign currency reserves to sovereign wealth funds. There is wide diversity among sovereign wealth funds, partly because they have been set up for a variety of purposes (see IMF 2008b). These funds have an estimated $600 billion in assets under management in developing countries,[4] dominated by China ($200 billion held by the Chinese Investment Corporation and $68 billion held by the Central Huijin Investment Company) and Russia ($130 billion held in the Reserve Fund and $33 billion held by the Fund of Future Generations). This amount pales in comparison to the total level of reserves held by developing countries ($3.7 trillion at end 2007), but in a few countries the value of assets managed by sovereign wealth funds is sizable relative to reserve holdings. For instance, the Kazakhstan National Oil Fund has assets valued at around $19 billion, exceeding the $15.5 billion in foreign reserves held at end 2007. Sovereign wealth funds also play a prominent role in Azerbaijan, Botswana, Chile, Libya, Oman, and República Bolivariana de Venezuela, where the value of assets under management is estimated to be equal to between one-half and two-thirds of reserve holdings. The value of assets managed by sovereign wealth funds worldwide is dominated by high-income countries. The range of estimates varies considerably (between $2 trillion and $3.5 trillion), implying that sovereign wealth funds in developing countries manage around 20 to 30 percent of the total. The wide range of estimates largely stems from uncertainty about the value of assets managed by the Abu Dhabi Investment Authority and Corporation (estimated at between $250 billion and $875 billion at end 2007), the Government of Singapore Investment Corporation ($100 billion to $330 billion), Temasek Holdings ($66 billion to $160 billion), and the Kuwait Investment Authority ($160 billion to $250 billion).

Figure 2.5 Global foreign reserve holdings, 1997–2007



Source: IMF Statistics Department COFER database.

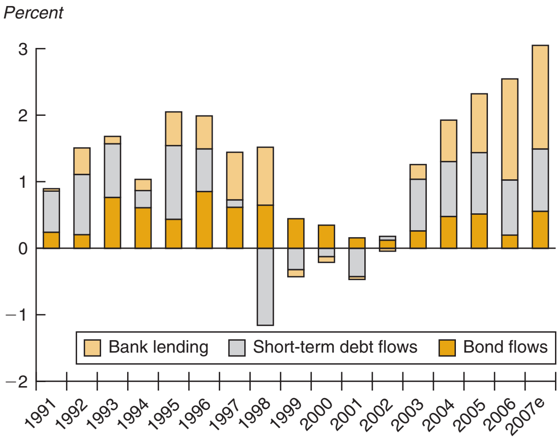
Private debt market developments

Bank lending showed strong gains over the year 2007 as a whole . . .

The expansion in net private debt flows in 2006–07 has been concentrated in net bank lending (figure 2.6), which accounted for over half of private debt flows in 2007, up from less than 40 percent in 2004. As a share of GDP, net bond flows rebounded in 2007 to levels attained in 2004 and 2005, while short-term debt flows remained relatively constant.

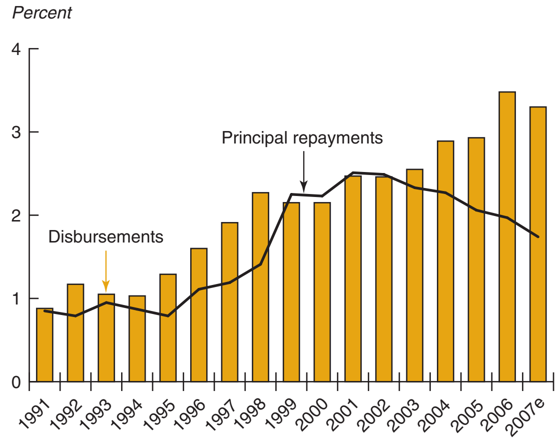
Disbursements of cross-border loans by commercial banks rose by $58 billion in 2007, reaching a record level in dollar terms ($455 billion), with strong gains in East Asia and the Pacific ($23 billion), South Asia ($21 billion), and Sub-Saharan Africa ($14 billion). These gains were partly offset by an $8 billion decline in Europe and Central Asia (table 2.2). Loan disbursements as a share of

Figure 2.6 Net private debt flows as a share of GDP, 1991–2007



Sources: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate.

Figure 2.7 Bank lending as a share of GDP, 1991–2007



Sources: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate.

GDP declined slightly to 3.3 percent in 2007, from a record 3.5 percent in 2006, while principal repayments continued to decline, reaching 1.75 percent of GDP in 2007, down from 2.5 percent in 2001 and 2002 (figure 2.7).

Cross-border syndicated loan commitments provide an alternative measure of bank lending to developing countries (box 2.2). According to this measure, loan commitments to developing countries increased by a substantial $118 billion in

Table 2.2 Cross-border bank lending to developing countries, by region, 2000–07
$ billions

Indicator	2000	2001	2002	2003	2004	2005	2006	2007e
Gross bank lending								
Total	116.5	137.6	146.0	175.3	235.2	285.5	397.0	454.7
By region								
East Asia and Pacific	14.9	20.7	27.3	37.2	34.8	43.7	42.4	65.1
Europe and Central Asia	37.9	46.9	61.5	76.3	128.4	170.1	260.3	252.1
Latin America and the Caribbean	56.7	62.9	46.3	47.0	53.3	48.2	76.6	77.9
Middle East and North Africa	2.3	1.9	2.7	2.5	1.9	4.5	3.1	9.4
South Asia	1.5	3.2	5.6	8.7	11.8	11.0	10.7	32.1
Sub-Saharan Africa	3.2	2.1	2.6	3.7	4.9	8.0	3.9	18.1
Principal repayments								
Total	120.4	139.6	147.8	160.1	184.7	200.1	224.6	240.0
By region								
East Asia and Pacific	26.2	32.5	37.5	45.6	34.6	42.1	31.3	36.0
Europe and Central Asia	28.5	39.6	45.6	55.8	81.9	94.1	120.8	136.2
Latin America and the Caribbean	56.1	57.2	52.3	48.4	52.4	49.6	57.0	50.9
Middle East and North Africa	2.1	2.3	3.2	3.7	2.6	3.3	3.9	4.0
South Asia	3.5	4.3	4.6	4.2	10.7	6.8	6.1	7.0
Sub-Saharan Africa	3.8	3.7	4.6	2.4	2.5	4.2	5.5	6.0
Net bank lending (gross lending less principal repayments)								
Total	−3.9	−2.0	−1.7	15.2	50.4	85.3	172.4	214.7
By region								
East Asia and Pacific	−11.3	−11.8	−10.2	−8.4	0.2	1.6	11.1	29.1
Europe and Central Asia	9.3	7.2	15.9	20.4	46.5	76.0	139.5	115.9
Latin America and the Caribbean	0.6	5.6	−6.0	−1.4	0.8	−1.4	19.6	27.0
Middle East and North Africa	0.2	−0.4	−0.5	−1.2	−0.6	1.2	−0.9	5.4
South Asia	−2.0	−1.1	1.0	4.4	1.1	4.1	4.6	25.2
Sub-Saharan Africa	−0.7	−1.6	−1.9	1.2	2.4	3.8	−1.5	12.1

Sources: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate.

Box 2.2 Alternative measures of cross-border bank lending to developing countries

Cross-border bank lending by developing countries reported in table 2.2 is based on annual data collected by the World Bank Debtor Reporting System (DRS). The DRS provides a comprehensive coverage of loan disbursements, commitments, and principal and interest payments but is not available on a timely basis. Currently only preliminary data for 2007 are available for a subset of countries. Estimates are generated for total borrowing by all developing countries and the regional aggregates using various data sources, including monthly data on cross-border syndicated loan commitments collected by Dealogic Loan Analytics (reported in table 2.3). The timeliness of the Dealogic data provides a more up-to-date perspective on emerging trends. The monthly frequency is of particular interest for analyzing the impact of the financial turmoil (which began in mid-2007) on bank lending over the course of the year 2007 and into early 2008.

There are, however, a few important differences between the two data sources that limit their comparability. First, Dealogic only reports data on loan commitments (loan agreements made), which may not be a good indicator of the net bank lending (loan disbursements less principal repayments) component of net private capital flows. Second, the Dealogic data do not include intrabank lending (loans made from a parent bank to a subsidiary or branch operating in a foreign country), which has played a prominent role in some countries, particularly those in the Europe and Central Asia region. Bank loan disbursements to the Europe and Central Asia region (reported by the DRS) exceeded loan commitments (reported by Dealogic) by $163 billion in 2006, compared with only $15 billion in 2000.

Third, the Dealogic data mostly entail lending by bank syndicates, whereas the DRS also includes loans made by a single bank. Taken together, these factors can explain why the estimate of cross-border bank loan disbursements to developing countries (reported in table 2.2) for 2007 exceeds syndicated loan commitments (reported in table 2.3) by $74 billion.

2007, most of which was concentrated in just three countries: Russia ($50 billion), India ($18 billion), and China ($17 billion) (table 2.3).

Cross-border syndicated loan commitments are dominated by the corporate sector. Governments accounted for only about 3 percent over the past few years, down from about 15 percent in the early 1990s, while private corporations received just over 70 percent, up from an average level of about two-thirds over the previous 10 years (figure 2.8).

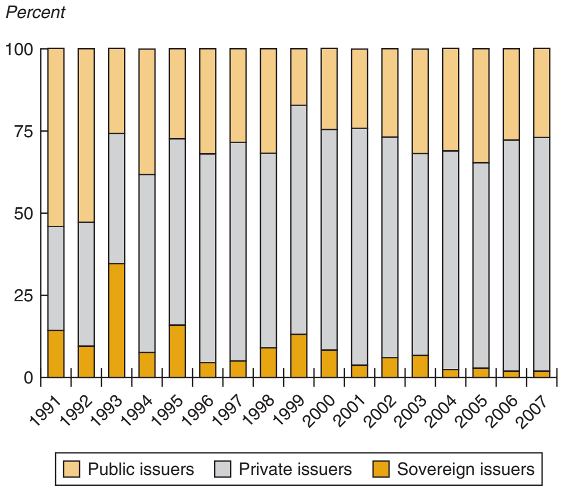
In 2007 there was a dramatic increase in the proportion of bank lending to developing countries denominated in domestic currency. The domestic-currency share increased from under 5 percent in 2005–06 to 11 percent in 2007, led by South Africa

Table 2.3 Top 10 developing countries receiving cross-border syndicated loan commitments, 2000–07
$ billions

Category	2000	2001	2002	2003	2004	2005	2006	2007
All developing countries	114.1	83.9	75.6	98.9	124.0	202.0	262.8	380.3
Top 10 countries								
Russian Federation	4.7	2.9	5.8	7.4	13.9	39.9	38.8	89.1
India	3.0	2.1	1.8	3.0	6.9	11.7	18.0	36.3
China	6.8	3.3	10.2	13.0	9.3	18.6	14.6	31.7
Turkey	11.3	4.6	3.7	4.7	8.4	14.6	26.4	28.8
Mexico	12.8	11.3	7.5	13.9	15.7	18.1	28.4	28.0
Brazil	15.0	11.9	5.4	3.1	9.8	12.7	33.5	27.5
South Africa	8.1	5.5	3.0	3.7	2.5	5.6	15.5	13.4
Malaysia	7.5	4.1	5.6	5.8	7.7	4.4	7.4	12.6
Kazakhstan	0.0	0.6	0.6	1.9	3.9	4.7	8.5	11.9
Ukraine	0.4	0.2	0.0	0.1	0.4	1.5	2.7	7.2
Memorandum item								
BRICs	29.5	20.1	23.2	26.5	40.0	82.9	105.0	184.6

Source: World Bank staff calculations based on Dealogic Loan Analytics data.
Note: BRICs = Brazil, Russia, India, and China.

Figure 2.8 Share of cross-border loan commitments, by debtor, 1991–2007



Source: Dealogic Loan Analytics.

Table 2.4 Currency composition of cross-border syndicated bank loan commitments to developing countries, 2003–07

Share of total (percent)

Currency	2003	2004	2005	2006	2007
U.S. dollar	78.0	85.5	81.7	84.4	77.9
Euro	17.1	8.5	12.8	9.3	9.5
South African rand	0.0	0.0	0.0	0.8	2.5
Brazilian real	0.0	0.0	0.2	0.3	2.2
Russian ruble	0.0	0.0	0.1	0.2	1.8
Chinese renminbi	0.1	0.1	1.0	0.4	1.8
Memorandum items					
Advanced-country currencies	97.4	97.9	95.8	95.7	88.9
Developing-country currencies	2.6	2.1	4.2	4.3	11.1

Source: Dealogic Loan Analytics.

(60 percent), China (36 percent), Brazil (24 percent), and India (20 percent) (table 2.4). The sharp rise in bank loans denominated in Brazilian reals and Mexican pesos in 2007 reflected a single transaction in each case, but this was not the case for bank loans denominated in South African rand and Chinese renminbi, which involved 10 and 20 separate loan agreements, respectively.[5]

. . . as private bond flows rebounded

Net bond flows increased by $54 billion in 2007, after declining by some $27 billion in 2006 (table 2.5). The rebound reflects a combination of more issuance and lower principal repayments

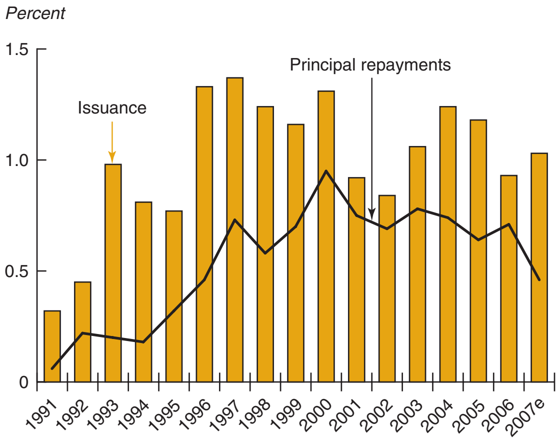
Table 2.5 Private bond flows to developing countries, by region, 2000–07

$ billions

Indicator	2000	2001	2002	2003	2004	2005	2006	2007e
Bond issuance								
All developing countries	69.4	54.6	49.2	68.2	102.8	115.1	105.9	142.2
By region								
East Asia and Pacific	5.6	6.7	8.0	6.6	16.3	14.4	14.4	12.5
Europe and Central Asia	12.1	7.7	11.6	21.2	35.4	46.1	45.1	68.4
Latin America and the Caribbean	42.5	32.7	20.8	34.7	36.4	42.6	35.1	42.6
Middle East and North Africa	2.1	5.1	6.2	2.8	6.5	4.4	3.6	4.6
South Asia	5.5	0.0	0.1	1.6	7.1	6.3	5.9	8.0
Sub-Saharan Africa	1.5	2.5	2.5	1.4	1.0	1.3	1.9	6.1
Principal repayments								
All developing countries	49.9	44.4	40.4	48.6	61.7	62.5	80.6	62.9
By region								
East Asia and Pacific	6.4	6.3	7.9	4.8	6.6	6.6	8.8	6.0
Europe and Central Asia	6.6	6.6	8.0	12.3	11.8	17.9	11.2	16.4
Latin America and the Caribbean	35.4	29.9	21.6	23.7	36.7	26.6	54.1	34.5
Middle East and North Africa	0.9	0.7	1.2	2.1	3.2	2.1	3.0	1.9
South Asia	0.1	0.4	0.8	4.7	3.0	9.1	1.6	3.8
Sub-Saharan Africa	0.5	0.5	0.9	1.0	0.4	0.0	1.7	0.3
Net bond flows (bond issuance less principal repayments)								
All developing countries	19.5	10.2	8.8	19.6	41.1	52.6	25.3	79.3
By region								
East Asia and Pacific	−0.7	0.4	0.1	1.8	9.7	7.8	5.5	6.5
Europe and Central Asia	5.5	1.1	3.6	8.9	23.6	28.2	33.9	52.0
Latin America and the Caribbean	7.1	2.8	−0.8	11.0	−0.3	16.0	−19.0	8.1
Middle East and North Africa	1.2	4.4	5.0	0.7	3.3	2.3	0.6	2.7
South Asia	5.4	−0.4	−0.7	−3.1	4.1	−2.9	4.3	4.2
Sub-Saharan Africa	1.0	1.9	1.5	0.4	0.6	1.3	0.1	5.8

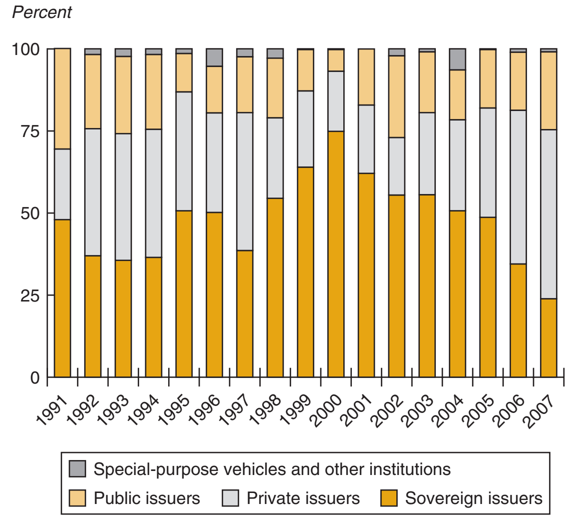
Sources: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate.

Figure 2.9 Private bond flows as a share of GDP, 1991–2007



Sources: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate.

Figure 2.10 Share of private bond issuance, by debtor, 1991–2007



Source: Dealogic DCM Analytics.

(figure 2.9). Bond issuance as a share of GDP also increased in 2007, although it remains below levels attained in 2003–05. Europe and Central Asia accounted for almost half of total issuance in 2007, up from less than 30 percent in 2003, while issuance by countries in Latin America and the Caribbean declined from just above 50 percent to 30 percent over the same time period. Principal repayments by countries in Latin America and the Caribbean declined by $20 billion in 2007, following record-high repayments in 2006 resulting from sovereign debt buybacks by Brazil, Colombia, Mexico, and República Bolivariana de Venezuela totaling almost $30 billion.

Private and public corporations continue to dominate issuance in international bond markets. The sovereign share of bond issuance shrank to below 25 percent in 2007, down from a peak of 75 percent in 2000, while the private corporate share rose to just over 50 percent, up from less than 20 percent in 2000 (figure 2.10).

The volume of emerging-market debt traded worldwide remained constant at $6.5 trillion in 2007 (Emerging Markets Traders Association 2008). Trading volumes in the first three quarters of 2007 outpaced those of 2006. The fourth quarter, however, represented the lowest quarterly volume in more than two years and was 16 percent below the same quarter of 2006. Local instruments accounted for nearly two-thirds of total trading volume, up from less than half in 2005, reflecting the shift by sovereign borrowers from external to domestic debt markets. Sovereign Eurobond trading declined from $2.1 trillion in 2006 to $1.4 trillion in 2007, while corporate Eurobond trading increased from $458 billion to a record $676 billion in 2007.

As in the case of bank lending, developing countries increased the proportion of external bond issues denominated in domestic currency over the past few years. The domestic-currency share has increased from less than 0.5 percent in 2003 to almost 9 percent in 2007 (table 2.6). In the case of Brazil, external bonds denominated in reals increased from three corporate issues totaling $0.3 billion in 2004 to eight corporate issues totaling $1.4 billion and four sovereign issues totaling $1.9 billion (a total of $3.2 billion) in 2007. Domestic-currency issues accounted for one-quarter of Brazil's total external bond issuance in 2007, the highest proportion among developing countries, followed by Mexico (11 percent), and Russia (5 percent).

Governments in several developing countries have continued to shift more of their financing needs into domestic debt markets where bond issues are mainly denominated in local currency, reducing their exposure to exchange-rate risk. Expanding public debt issuance in the domestic market also helps satisfy the growing needs of institutional

Table 2.6 Currency composition of bond issuance by developing countries, 2003–07
Share of total (percent)

Currency	2003	2004	2005	2006	2007
U.S. dollar	76.9	71.1	69.4	71.8	65.2
Euro	21.0	24.6	21.8	19.7	19.8
British pound sterling	0.8	2.1	1.0	0.9	3.2
Brazilian real	0.0	0.3	1.7	1.2	2.2
Japanese yen	0.8	0.9	1.9	1.5	1.6
Peruvian nuevo sol	0.0	0.0	0.2	0.0	1.1
Russian ruble	0.0	0.0	0.0	1.1	1.1
Memorandum items					
Advanced-country currencies	99.6	98.9	95.6	94.3	91.2
Developing-country currencies	0.4	1.1	4.4	5.7	8.8

Source: Dealogic DCM Analytics.
Note: The calculations refer only to bonds issued in external (not domestic) markets.

investors (notably pension funds and insurance companies) for long-dated, low-risk assets denominated in local currency. The process of developing local-currency bond markets has been supported by a series of initiatives taken by international financial institutions (box 2.3).

A lack of timely, comprehensive data on domestic debt prevents us from gauging countries' progress over time. The analysis to date has mainly focused on the large emerging-market economies that have more-developed domestic debt markets and higher-quality data available. For example, Hanson (2007) reports that the domestic portion of outstanding public debt in

Box 2.3 The Global Emerging Markets Local Currency Bond (Gemloc) Program

Financial sector development in many emerging markets has been hampered by the absence of liquid, long-term domestic investment instruments. In November 2007 the World Bank announced the Global Emerging Markets Local Currency Bond (Gemloc) Program, an initiative designed to support the development of local-currency bond markets and increase their investability so that more institutional investment from local and global investors can flow into local-currency bond markets in developing countries.

The Gemloc program consists of three components: an emerging-market local-currency bond fund; an index; and technical assistance provided by the World Bank. The bond fund, to be branded by the World Bank Group's International Bank for Reconstruction and Development (IBRD) in partnership with PIMCO, a private investment management company, is expected to raise $5 billion from public and private institutional investors by early 2008 for investment in 15 to 20 emerging markets initially, expanding to 40 countries within five years. The index, the Markit iBoxx Global Emerging Markets Bond Index (GEMX), to be created by the World Bank Group's International Finance Corporation (IFC) in partnership with Markit Group Limited, will establish a benchmark for the asset class and allow a wide range of emerging markets to be targeted by global investors. The index aims to set out clear, transparent criteria so that countries can implement reforms to improve their ranking, attract additional investment, and expand their bond markets. Technical assistance will be available to help countries meet the goals of policy reform and improved market infrastructure, funded by fee income from the fund and the IBRD. The technical assistance component includes a sunset provision of 10 years, during which involvement of the World Bank Group will cease and the private sector is expected to be fully engaged.

Initiatives by international financial institutions to help develop local-currency bond markets date back to 1970, when the World Bank and the Asian Development Bank (ADB) issued yen-denominated bonds in Japan (an emerging-market economy at the time). Regional development banks have been active in helping to develop local-currency bond markets (Wolff-Hamacher 2007). The ADB launched several local-currency bonds in Asia (Hong Kong [China], Republic of Korea, and Taiwan [China]) in the 1990s, followed by China, India, Malaysia, the Philippines, Singapore, and Thailand in 2004. The European Bank for Reconstruction and Development has been active in European transition countries, with local-currency issues in the Czech Republic, Estonia, Hungary, Poland, the Russian Federation, and the Slovak Republic in the mid-1990s. The Inter-American Development Bank launched local-currency issues in Brazil, Chile, Colombia, and Mexico in 2004. In addition, the IFC has borrowed in 31 currencies and was the first nonresident institution to launch local-currency bonds in China, Colombia, Malaysia, Morocco, Peru, and Singapore (with China in partnership with the ADB). In December 2006, the IFC became the first foreign institution to issue a bond denominated in CFA francs, the currency of eight countries in West Africa. The European Investment Bank has issued local-currency bonds in most emerging European economies and has recently extended the program to help develop local-currency debt markets in Africa, with Eurobond issues in Botswana (October 2005), the Arab Republic of Egypt (February 2006), Namibia (March 2006), Mauritius (March 2007), Ghana (October 2007), and Zambia (February 2008).

Table 2.7 Net short-term debt flows to developing countries, by region, 2007
$ billions

Category	2000	2001	2002	2003	2004	2005	2006	2007e
Total	−6.4	−24.9	3.1	53.5	67.5	89.6	94.2	129.7
By region								
East Asia and Pacific	−9.9	1.7	9.9	18.5	32.6	45.2	27.7	31.9
Europe and Central Asia	8.3	−6.0	4.2	30.4	18.3	25.5	55.5	60.0
Latin America and the Caribbean	−0.9	−14.6	−10.3	2.3	7.0	14.5	−3.3	29.4
Middle East and North Africa	−1.9	−3.0	−0.7	2.5	5.4	0.1	0.6	0.9
South Asia	−0.9	−0.9	1.8	0.7	2.6	1.6	3.6	4.0
Sub-Saharan Africa	−1.1	−2.1	−1.8	−1.0	1.6	2.8	10.1	3.6

Sources: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate.

25 large emerging-market economies increased from 38 percent in 1995 to 58 percent in 2004. The World Bank (2007, p. 48) reports that the ratio increased from a little more than half in 1998 to three-quarters in 2006 for a slightly different set of countries. Recent data indicate that the domestic portion of public debt also plays a prominent role in several low-income countries. In 2007, the ratio exceeded 25 percent in almost half of 38 low-income countries where data are available and exceeded 50 percent in five countries—Cameroon, Ethiopia, Guinea-Bissau, Mauritania, and Zambia.

Short-term debt flows—debt instruments with original maturity of less than one year (mostly bank loans and trade credit)—increased by $35.5 billion in 2007; these flows were concentrated in Latin America and the Caribbean, where net flows rebounded from −$3.3 billion to $29.4 billion (table 2.7). Although short-term debt flows to Europe and Central Asia increased by only $4.5 billion, the region still accounted for almost half of total flows.

Large economies receive the vast majority of private debt flows . . .

Bank lending and bond issuance remain highly concentrated in just a few of the largest developing-country economies. In 2007 five countries accounted for over half of syndicated loan commitments and bond issuance; 20 countries accounted for nearly 90 percent (table 2.8). The largest borrower, Russia, accounted for almost one-quarter of the total, well above its share (9 percent) of total developing-country GDP. In contrast, lower-middle-income countries, which accounted for just over half of GDP, received less than 20 percent of syndicated loan commitments and bond issuance.

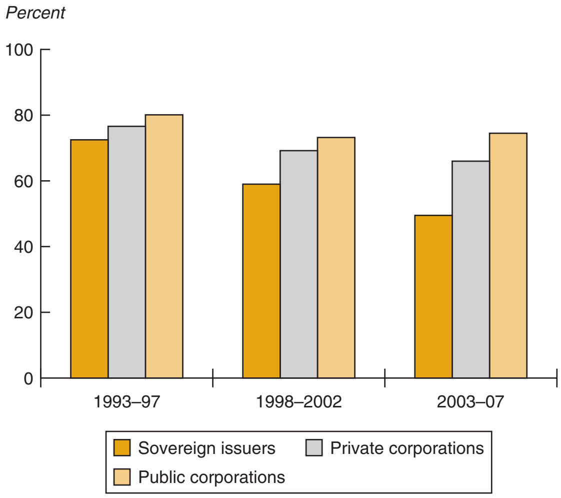
Table 2.8 Share of total syndicated loan commitments to and bond issues by developing countries, 2007
Percentage of total

Borrower	Bank lending	Bond issuance	Bank lending and bond issuance	Nominal GDP
Russian Federation	23.4	23.1	23.3	9.1
India	9.5	5.7	8.5	8.6
Mexico	7.4	8.0	7.5	6.3
Brazil	7.2	8.3	7.5	8.8
Turkey	7.6	4.9	6.8	3.6
China	8.3	1.5	6.4	22.6
Kazakhstan	3.1	6.5	4.1	0.8
South Africa	3.5	4.9	3.9	1.9
Malaysia	3.3	0.2	2.4	1.2
Venezuela, R. B. de	0.8	5.7	2.2	1.8
Top 5	57.6	51.0	53.7	36.3
Top 10	76.7	72.5	72.7	64.7
Top 20	89.7	90.8	87.6	81.2
Upper-middle-income countries	68.5	76.6	70.8	35.2
Lower-middle-income countries	17.9	16.0	17.4	50.7
Low-income countries	13.6	7.3	11.8	14.1
India	9.5	5.7	8.5	8.6
Sub-Saharan Africa	2.5	1.0	2.1	2.8
Others	1.5	0.7	1.3	2.7

Sources: Dealogic Loan Analytics and World Bank staff estimates.

The concentration of bond issuance among the top five developing-country borrowers has declined over the past several years, particularly among sovereign issuers. The top five countries accounted for half of sovereign bond issuance in 2003–07, compared with three-quarters in 1993–97 (figure 2.11). Corporate issuance, though, remains more concentrated than sovereign issuance. In 2003–07, five countries accounted for two-thirds of issuance by private corporations and three-quarters of issuance by public corporations.

Figure 2.11 Share of bond issuance by top five developing countries



Source: Dealogic DCM Analytics.

In sum, bond issuance has become increasingly dominated by corporations located in just a few large emerging-market economies.

. . . but a few low-income countries have recently gained access to private debt markets

Three in five developing countries have never issued a bond in the international market. Until just a few years ago, India was the only low-income country to access the international bond market on a frequent basis.[6] India has been active since the early 1980s, with bond issues in 14 of the past 18 years. Some low-income countries have accessed the international bond market intermittently. For example, Pakistan issued a series of external bonds in the mid-1990s, before its debt crisis in 1998–99, and reestablished access in 2004. In Sri Lanka, the Bank of Ceylon (a public bank) issued a three-year, $12 million bond (private placement) in 1995, followed by a $50 million sovereign issue in 1997. There were no subsequent bond issues until 2005, when Sri Lanka Telecom launched a $100 million issue (private placement), followed by a $500 million sovereign issue in 2007. A few other low-income countries have gained access recently, notably Vietnam in 2005, followed by Mongolia, Ghana, and Nigeria in 2007.

First-time bond issues by low-income countries over the past few years have been well received by the markets. Vietnam issued a $750 million sovereign Eurobond in 2005, followed by a $187 million issue (denominated in domestic currency) in 2007 by a publicly owned corporation (table 2.9). In 2007, the Trade & Development Bank of Mongolia, a public company, issued a $75 million Eurobond; two Nigerian corporations also issued Eurobonds.

Table 2.9 First-time external bond issues by developing countries, 2005–08

Income/date issued	Country	Issuer	Sector	Value (*$millions*)	Currency of issue	Yield (*percent*)	Tenure (*years*)	Credit rating
Low income								
2005-Oct.	Vietnam	Socialist Republic of Vietnam	Sovereign	750	$US	7.25	10	BB-
2007-Mar.	Vietnam	Vietnam Shipbuilding Industry Corp	Public corporate	187	Viet. dong	9.00	10	—
2007-Jan.	Mongolia	Trade & Development Bank of Mongolia	Public corporate	75	$US	8.94	3	BB
2007-Jan.	Nigeria	GTB Finance BV	Public corporate	350	$US	8.81	5	BB-
2007-Mar.	Nigeria	First Bank of Nigeria PLC	Private corporate	175	$US	10.15	10	B
2007-Sep.	Ghana	Republic of Ghana	Sovereign	750	$US	8.68	10	B+
Lower-middle income								
2005-Jun.	Jamaica	Air Jamaica	Public corporate	200	$US	9.60	10	B+
2005-Jun.	Romania	City of Bucharest	Subsovereign	606	Euros	4.28	10	BB+
2005-Dec.	Macedonia	Republic of Macedonia	Sovereign	177	Euros	4.69	10	BB+
2006-Sep.	Fiji	Republic of Fiji Island	Sovereign	150	$US	7.12	5	BB
2007-Feb.	Georgia	Bank of Georgia	Sovereign	200	$US	9.20	5	BB-
2007-May	Belarus	Polesie Trading House	Private corporate	19	Russ. rubles	13.37	3	—
2008-Apr.	Georgia	Republic of Georgia	Sovereign	500	$US	7.64	5	BB-
Upper-middle income								
2006-Sep.	Seychelles	Republic of Seychelles	Sovereign	200	$US	9.47	5	B
2007-Mar.	Serbia	ProCredit Bank AD	Private corporate	165	Euros	6.00	5	BB-
2007-Dec.	Gabon	Republic of Gabon	Sovereign	1,000	$US	7.85	10	BB-

Source: Dealogic Loan Analytics.
Note: — = not available.

Ghana became the first heavily indebted poor country (HIPC) to issue an external bond, offering a $750 million Eurobond issue in September 2007. The bond issue was oversubscribed several times, despite being launched in the midst of the turmoil in international financial markets.

Gabon, an upper-middle-income country, issued its inaugural sovereign bond in December 2007 when it launched a $1 billion, 10-year Eurobond with a yield of 8.25 percent (a 426 basis-point spread over U.S. Treasury yields at the time of issue) that was used to prepay its Paris Club creditors.

There has been a great deal of diversity in first-time bond issues by developing countries over the past few years. The wide range of issue amounts ($19 million to $1 billion), tenures (3 to 10 years), yields (4.28 to 13.37 percent), and credit ratings (B to BB+) indicate that countries do not need to meet specific threshold levels to access the international bond market. Additionally, borrowers with quite different financing needs and risk circumstances have decided to tap the international bond market for the first time.

In 6 of the 13 countries that accessed the international bond market for the first time between 2005 and early 2008, corporate issues preceded sovereign issues. In Nigeria, for instance, a private bank and a public bank issued Eurobonds in 2007, while the country's first sovereign issue is expected to be launched in 2008. This pattern goes against the conventional wisdom that countries must first issue sovereign bonds to set a benchmark to price subsequent corporate issues. There are many examples where corporations based in developing countries have issued bonds before the government has. In fact, corporate issues preceded sovereign issues in almost one-third of the developing countries that gained access to the international bond market since 1990.[7] However, in some of these cases, first-time corporate issues entailed relatively small amounts for project financing, backed by collateral or government guarantees or both.

Table 2.10 Net equity inflows to developing countries, 2000–07
$ billions

Indicator	2000	2001	2002	2003	2004	2005	2006	2007e
Net (FDI and portfolio) equity inflows								
Total	179.0	178.7	166.0	185.9	265.9	357.4	472.3	615.9
By region								
East Asia and Pacific	51.8	50.7	63.2	69.3	89.6	130.3	159.8	166.0
Europe and Central Asia	25.5	26.2	26.2	34.2	68.6	80.1	135.7	182.2
Latin America and the Caribbean	78.9	74.6	54.4	45.6	64.0	82.9	81.9	135.3
Middle East and North Africa	5.0	4.2	4.3	8.4	8.0	17.0	29.5	32.6
South Asia	6.8	8.8	7.7	13.4	16.6	22.4	33.3	64.2
Sub-Saharan Africa	11.0	14.2	10.1	15.1	19.2	24.7	32.2	35.5
Net FDI inflows								
Total	165.5	173.0	160.7	161.9	225.5	288.5	367.5	470.8
By region								
East Asia and Pacific	45.2	48.9	59.4	56.8	70.3	104.2	105.0	117.4
Europe and Central Asia	24.8	26.6	26.1	34.9	63.5	72.2	124.6	161.6
Latin America and the Caribbean	79.5	72.1	53.0	42.3	64.6	70.4	70.5	107.2
Middle East and North Africa	4.8	4.2	4.9	8.2	7.1	14.4	27.5	30.5
South Asia	4.4	6.1	6.7	5.4	7.6	10.0	22.9	28.9
Sub-Saharan Africa	6.8	15.1	10.5	14.4	12.5	17.3	17.1	25.3
Net portfolio equity inflows								
Total	13.5	5.7	5.3	24.0	40.4	68.9	104.8	145.1
By region								
East Asia and Pacific	6.6	1.8	3.8	12.5	19.3	26.1	54.8	48.6
Europe and Central Asia	0.7	−0.4	0.1	−0.7	5.1	7.9	11.1	20.7
Latin America and the Caribbean	−0.6	2.5	1.4	3.3	−0.6	12.5	11.4	28.1
Middle East and North Africa	0.2	0.0	−0.6	0.2	0.9	2.6	2.0	2.1
South Asia	2.4	2.7	1.0	8.0	9.0	12.4	10.4	35.4
Sub-Saharan Africa	4.2	−0.9	−0.4	0.7	6.7	7.4	15.1	10.2

Sources: IMF International Financial Statistics; World Bank Debtor Reporting System and staff estimates.
Note: e = estimate.

Private equity market developments

Equity inflows continue to outpace growth

The expansion of equity inflows to developing countries in 2007 follows three years of strong gains. Net (foreign direct and portfolio) equity inflows reached an estimated $616 billion, an amount equal to 4.5 percent of GDP in developing countries, up just slightly from 4.2 percent in 2006 (table 2.10). Foreign direct investment (FDI) continues to account for the bulk of equity inflows, although less so than in previous years (figure 2.12). Portfolio flows have played a more prominent role over the past few years, accounting for just over 20 percent of equity in 2005–07, up from negligible levels in 2001–02.

The increase in equity flows was led by Latin America and the Caribbean, where the share of equity flows increased from 17 to 22 percent between 2006 and 2007, partially reversing a longer-term trend (figure 2.13). Despite the rebound in 2007, the region's share remains only about half of what it was 10 years ago, while shares going to Europe and Central Asia, South Asia, and Sub-Saharan Africa have doubled.

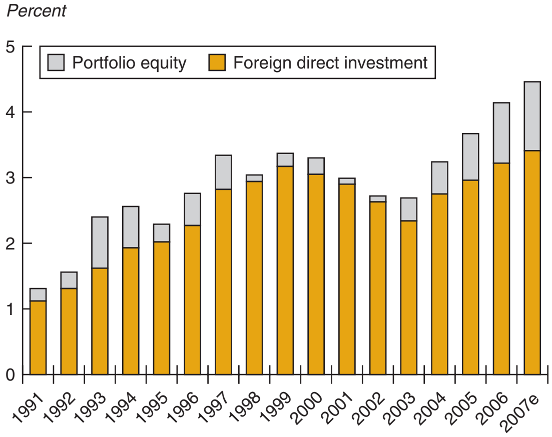
Portfolio equity flows to developing countries increased by $40 billion in 2007, following a $36 billion increase in 2006 (table 2.11). Although the flows increased in dollar terms in 2007, they remained constant as a share of GDP at 0.9 percent. As in past years, most of the flows are concentrated in a few of the largest developing economies—almost three-quarters are expected to go to the BRICs. Strong gains in portfolio inflows to India ($24.5 billion) and Brazil ($18.5 billion) were partially offset by a decline in China ($8 billion).

The largest emerging-market economies play a prominent role in global equity markets, where issuance is on par with that of high-income countries. China, Brazil, and the Russian Federation ranked above all countries except the United States by value of cross-border initial public offerings (IPOs) in 2007, accounting for almost one-third of the IPO total worldwide (table 2.12).[8] Additionally, companies based in each of the BRICs launched at least one IPO valued at over $2 billion—including an $8 billion issue by the Russian bank, VTB Group—demonstrating the depth of the global market for large equity issues by emerging markets (table 2.13).

Emerging and frontier equity markets continue to outperform mature markets

Equity returns in emerging markets continue to outperform those in mature markets, even though emerging equity markets are more volatile. Though the correction in late 2007 and early 2008 was sharper in emerging markets than in mature markets, so were the gains earlier in the year. Equity prices in all markets peaked in October 2007, with

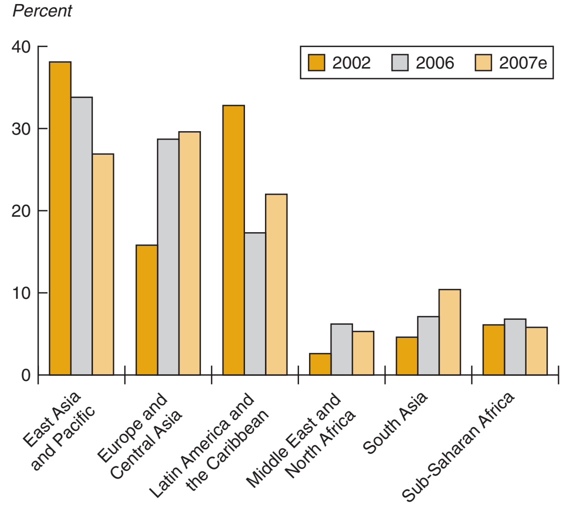
Figure 2.12 Net equity inflows as a share of GDP, 1991–2007



Sources: World Bank Debtor Reporting System and staff estimates.

Note: e = estimate.

Figure 2.13 Share of net equity inflows to developing countries, by region



Sources: IMF International Financial Statistics; World Bank Debtor Reporting System and staff estimates.

Note: e = estimate.

Table 2.11 Top 10 portfolio equity destination developing countries, 2000–07
$ billions

Category	2000	2001	2002	2003	2004	2005	2006	2007e
All developing countries	13.5	5.6	5.5	24.1	40.4	68.9	104.8	145.1
Top 10 countries								
China	6.9	0.8	2.2	7.7	10.9	20.3	42.9	35.0
India	2.3	2.9	1.0	8.2	9.0	12.1	9.5	34.0
Brazil	3.1	2.5	2.0	3.0	2.1	6.5	7.7	26.2
Russian Federation	0.2	0.5	2.6	0.4	0.2	−0.2	6.1	14.8
South Africa	4.2	−1.0	−0.4	0.7	6.7	7.2	15.0	10.0
Turkey	0.5	−0.1	0.0	0.9	1.4	5.7	1.9	5.2
Thailand	0.9	0.4	0.5	1.8	1.3	5.7	5.3	4.4
Philippines	−0.2	0.1	0.2	0.5	0.5	1.5	2.4	3.3
Indonesia	−1.0	0.4	0.9	1.1	2.0	−0.2	1.9	3.1
Malaysia	0.0	0.0	−0.1	1.3	4.5	−1.2	2.4	2.8
Memorandum item								
BRICs	12.5	6.7	7.9	19.3	22.3	38.7	66.3	110.0

Sources: IMF International Financial Statistics; World Bank staff estimates.
Note: BRICs = Brazil, Russia, India, and China; e = estimate.

Table 2.12 Worldwide cross-border IPOs, 2007
$ billions

Category	Value	Share of total *(percent)*	Number of issues	Average issue value *($ millions)*
Total	373.6		2397	16
Top 10 countries	276.2	73.9	1504	18
United States	88.3	23.6	300	29
China	65.5	17.5	249	26
Brazil	32.1	8.6	67	48
Russian Federation	18.4	4.9	18	102
United Kingdom	18.2	4.9	129	14
Spain	15.6	4.2	11	141
Canada	10.4	2.8	333	3
Germany	10.0	2.7	46	22
India	9.4	2.5	112	8
Australia	8.3	2.2	239	3
Memorandum item				
BRICs	125.4	33.6	446	28

Source: Dealogic DCM Analytics.
Note: BRICs = Brazil, Russia, India, and China.

gains for the year of 45 percent in emerging markets, compared with 13 percent in mature markets (figure 2.14). As of mid-May 2008, equity prices in emerging markets were up 32 percent from the beginning of 2007, while mature markets posted gains of only 2 percent. Some of the largest, most actively traded emerging equity markets, however, were also the most volatile. Notably, equity prices in China almost doubled between January and October 2007, only to lose 30 percent of their value over the following six months. Similarly, equity prices in Turkey posted gains of over 70 percent and then lost almost 30 percent of their value over the same period.

Investor confidence in emerging equity markets reflects the countries' strong growth potential over the long term, along with their impressive performance in generating high returns over the

Table 2.13 The 10 largest cross-border IPOs, by developing countries, 2007
$ billions

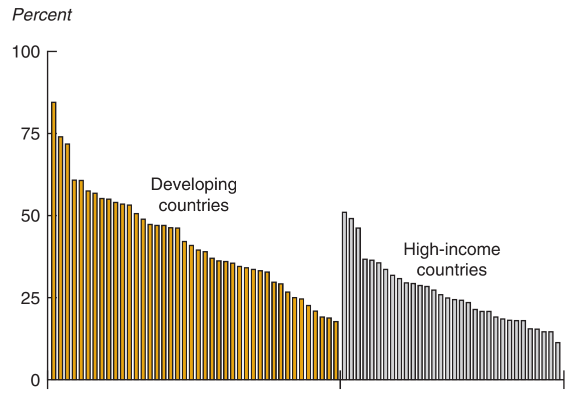
Issuer	Country	Sector	Exchange	Value
VTB Group	Russian Federation	Banking	London and Moscow	8.0
China CITIC Bank Corp Ltd	China	Banking	Hong Kong and Shanghai (China)	4.2
Bovespa Holding SA	Brazil	Finance	São Paulo	3.7
Bolsa de Mercadorias & Futuros	Brazil	Finance (miscellaneous)	São Paulo—Novo Mercado	2.9
Ecopetrol SA	Colombia	Oil and gas	Bogotá	2.8
Redecard SA	Brazil	Finance	São Paulo—Novo Mercado	2.4
DLF Ltd	India	Construction	Bombay	2.3
PIK Group	Russian Federation	Real estate/property	London and Moscow	1.9
SOHO China Ltd	China	Real estate/property	Hong Kong (China)	1.9
Country Garden Holdings Co Ltd	China	Real estate/property	Hong Kong (China)	1.9

Sources: Economist Intelligence Unit Country Reports, *Financial Times,* and other news media.

Figure 2.14 International equity prices, January 2007 – mid-May 2008

Sources: MSCI Barra world and emerging market composite indexes.

Figure 2.15 Average annual return in international equity markets, 2003–07



Sources: MSCI Barra; Standard and Poor's/International Finance Corporation.

past few years. Indeed, composite indexes for emerging and frontier equity markets have strongly outperformed those for mature markets in each of the five past years (table 2.14).

Returns on equity in less-developed countries—so-called frontier markets—have been comparable to those in emerging markets, particularly over the past two years. However, foreign investors would have had difficulty realizing such returns because international access to these markets remains limited. Efforts to increase access to frontier markets are being stepped up (box 2.4), but lack of liquidity remains a major concern in many countries, raising the risk of sharp price declines in the event of a sudden swing in investor confidence.

There has been a great deal of diversity in equity returns across equity markets in developing and advanced countries. Almost 80 percent of developing countries posted average annual returns in excess of 25 percent over the past five years, compared with less than 30 percent of high-income countries (figure 2.15). Moreover, half of developing countries posted average annual returns in excess of 50 percent, compared with only three high-income countries—the Czech Republic, Saudi Arabia, and Slovenia—all of which made the transition to high-income status over the past few years. In general, though, monthly returns in emerging and frontier market have been much more volatile than those in mature markets. The standard deviation of monthly returns over the past five years exceeded 5 percent in three-quarters of emerging and frontier markets, compared to only one-quarter of mature markets.

There has been a great deal of diversity in equity returns across developing countries since equity prices peaked in late October 2007. Between October 2007 and April 2008, equity prices declined in over half of developing countries,

Table 2.14 Returns in international equity markets, 2003–07

Percent

Market type	2003	2004	2005	2006	2007	2003–07	Jan to Oct 2007	Oct 2007 to April 2008	Standard deviation[a]
Mature[b]	30.8	12.1	8.4	17.8	7.1	15.2	11.4	−8.3	2.7
Emerging[c]	51.7	22.4	30.4	29.1	36.5	34.0	45.5	−10.2	5.1
Frontier[d]	35.2	47.8	16.6	33.5	43.3	35.3	38.8	−6.6	3.8

Sources: JPMorgan; Standard and Poor's/International Finance Corporation.
a. Standard deviation of monthly percent changes over the period 2003–07.
b. MSCI world composite index.
c. MSCI emerging markets composite index.
d. Standard & Poor's/International Finance Corporation frontier composite index.

Box 2.4 The development of frontier equity markets

A combination of factors has allowed investor interest in equity markets to spread to a much wider range of developing countries over the past few years. Low interest rates in mature markets have spurred investors' search for yield, while steady improvements in economic fundamentals, along with sustained robust growth, have caused equity returns in many developing countries to exceed those in mature markets by a wide margin. Moreover, institutional investors in mature and emerging-market economies have expanded their holdings of debt and equity securities across a wider range of countries in an effort to exploit potential diversification benefits.

Financial institutions have responded to the growing demand by giving global investors greater access to equity investments in more developing countries. The International Finance Corporations (IFC), in an early effort, began producing standardized equity price indexes for developing countries in 1981. At the time, the IFC covered equity markets in only 10 developing countries. By the late 1990s, coverage had grown to 52 countries, 22 of which are classified as frontier markets because of their low capitalization and lack of liquidity relative to emerging markets (annex 2A). Of the 31 emerging-market countries, 20 are classified as "investable," implying that the market is open to foreign institutional investors based on judgments (by analysts at Standard & Poor's, which acquired the IFC's indexes in 2000) about the extent to which foreign institutions can trade shares on local exchanges and repatriate initial investment capital, capital gains, and dividend income without undue constraint. Countries must have equity markets with a minimum investable market capitalization of $100 million and must meet liquidity requirements (minimum trading volume) to qualify as a frontier market under the S&P/IFC definition. The number of developing countries qualified as frontier markets has expanded from 14 in 1996 to 21 in 2006.

In December 2007 MSCI Barra, a leading provider of international investment analysis, introduced equity price indexes for 19 frontier markets using criteria that appear to be similar to those of S&P/IFC. Yet only 10 of the 19 countries correspond to those covered by S&P/IFC, indicating that there is little agreement on which countries qualify as frontier markets. This is not the case for the emerging-market classification—all 21 countries classified as investable emerging markets by S&P/IFC are also classified as emerging markets by MSCI Barra and are included in the analysis of capital flows to emerging-market economies conducted by the Institute of International Finance. There is, however, little correspondence between the classification of countries' income level (GNI per capita) and equity markets. In particular, equity markets in six high-income countries are classified as frontier markets by MSCI Barra.

In January 2008 Duet Asset Management, a London-based alternative asset manager, started the first Sub-Saharan African index tracking fund, the Duet Victoire Africa Index Fund. The fund is composed of companies listed on the stock exchanges of Botswana, Ghana, Kenya, Malawi, Mauritius, Namibia, Nigeria, Tanzania, Uganda, and Zambia, with capitalization exceeding $250 million.

And in March 2008 the Merrill Lynch Frontier Index was launched. The index is composed of 50 stocks in 17 countries. To be included in the index, stocks must have a minimum market capitalization of $500 million, a minimum three-month average daily turnover of $750,000, and a foreign ownership limit above 15 percent. The index is dominated by companies in the Middle East (50 percent), followed by Asia (23 percent), Europe (14 percent), and Africa (13 percent). Currently the index can be accessed only by institutions such as corporations, mutual funds, and hedge funds.

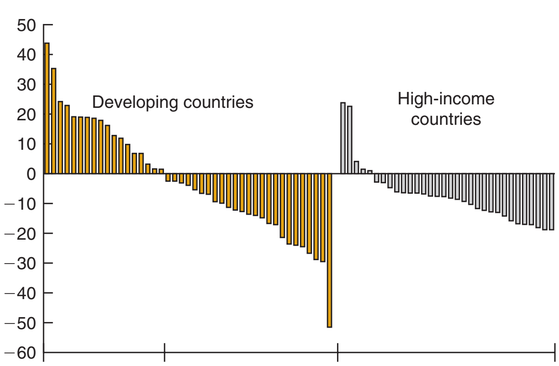
compared with 90 percent of high-income countries (figure 2.16).

FDI inflows continued to expand despite financial headwinds

Net FDI inflows to developing and high-income countries continued to surge in 2007, marking the fourth consecutive year of solid gains (figure 2.17). Global FDI inflows reached an estimated record $1.7 trillion, just over a quarter of which went to developing countries, on par with the previous five years. Net FDI inflows to developing countries as a whole increased to an estimated record $471 billion, an amount equal to 3.4 percent of their GDP, up from 3.25 percent in 2006. The estimated $103 billion increase in 2007 was broadly based across most regions (see table 2.8), led by strong gains in Russia ($22 billion) and Brazil ($16 billion) (table 2.15).

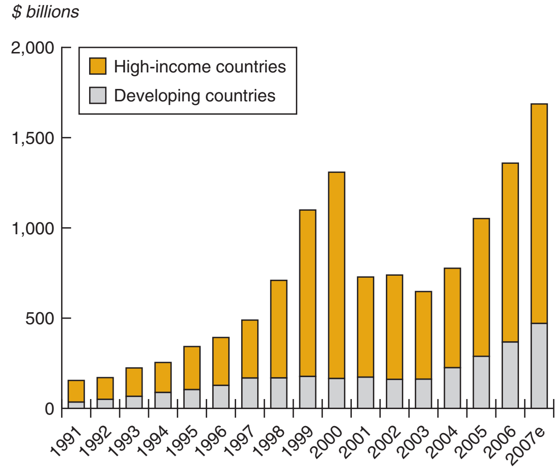
China remained the top destination among developing countries for FDI in 2007, although its share continued to decline relative to other countries. FDI inflows to China have shown little change over the past three years in dollar terms,

Figure 2.16 Return in international equity markets, October 2007 – April 2008



Sources: MSCI Barra; Standard and Poor's/International Finance Corporation.

Figure 2.17 Global FDI inflows, 1991–2007



Source: World Bank staff estimates.
Note: e = estimate.

and China's share of inflows to all developing countries has fallen from 30 percent in 2002–03 to 18 percent in 2007, while the shares of Brazil and Turkey have increased substantially. FDI inflows to China in 2006–07 are equal to 8 percent of domestic investment, down from 15 percent in the late 1990s. Although the overall environment for foreign investment in China remains positive, recent developments have made it more difficult for foreign firms to invest. In particular, the Chinese government is becoming more selective in approving investment projects with foreign involvement, instead giving priority to projects in the interior of the country and those that promise a high degree of technology transfer. This trend has been counterbalanced, however, by China's commitments to the World Trade Organization, which require the gradual opening of sectors including domestic commerce, financial services, insurance, and tourism to foreign investment.

FDI inflows to Russia increased in 2007 despite Russia's lack of progress in improving its investment climate, in particular the unfavorable changes in regulations related to FDI. Foreign investors are drawn by profitable opportunities in extractive industries, along with the potential for continued rapid growth in domestic consumption. The Netherlands and the United Kingdom are main source countries; large flows from Cyprus suggest that "round-tripping" might be playing an important role as well.

Table 2.15 Top 10 FDI destination developing countries, 2000–07
$ billions

Category	2000	2001	2002	2003	2004	2005	2006	2007e
All developing countries	165.5	173.0	160.7	161.9	225.5	288.5	367.5	470.8
Top 10 countries	114.6	123.5	107.9	101.8	147.5	176.2	226.2	288.9
China	38.4	44.2	49.3	47.1	54.9	79.1	78.1	84.0
Russia	2.7	2.7	3.5	8.0	15.4	12.9	30.8	52.5
Brazil	32.8	22.5	16.6	10.1	18.2	15.2	18.8	34.6
Mexico	17.9	29.4	21.1	15.0	22.5	19.9	19.2	23.2
Turkey	1.0	3.4	1.1	1.8	2.9	9.8	20.1	22.0
India	3.6	5.5	5.6	4.3	5.8	6.7	17.5	21.0
Poland	9.3	5.7	4.1	4.6	13.1	10.4	19.2	17.6
Chile	4.9	4.2	2.5	4.3	7.2	6.7	8.0	14.5
Ukraine	0.6	0.8	0.7	1.4	1.7	7.8	5.6	9.9
Thailand	3.4	5.1	3.3	5.2	5.9	8.0	9.0	9.6
Memorandum item								
BRICs	77.5	74.9	75.0	69.5	94.3	113.9	145.2	192.1

Sources: IMF International Financial Statistics; World Bank staff estimates.
Note: BRICs = Brazil, Russia, India, and China; e = estimate; FDI = foreign direct investment.

Table 2.16 The 10 largest privatizations, mergers, and acquisitions in 2007

Seller	Home country	Buyer		Sector	Value ($ billions)
Standard Bank	South Africa	ICBC	China	Banking	5.5
Oyakbank	Turkey	ING	Netherlands	Banking	2.7
El Mutun	Bolivia	Jindal Steel	India	Iron ore	2.3
Ukrsotsbank	Ukraine	Bank Austria Creditanstalt	Austria	Banking	2.1
Petkim	Turkey	Transcentral Asia	Russia/Kazakhstan	Petrochemical	2.1
Transelec	Chile	Management	United States	Electricity	1.7
BTC	Bulgaria	AIG	United States	Telecom	1.5
Sicartsa	Mexico	Arcelor Mittal	Luxembourg	Steel	1.4
Serasa	Brazil	Experian	Ireland	Financial	1.2
Almacenes Exito	Colombia	Cencosud	Chile	Retail	1.1

Source: World Bank staff estimates.

Net FDI inflows to Latin America and the Caribbean increased by $37 billion in 2007, raising the region's share from 19 percent in 2006 to 23 percent, led by strong gains in Brazil ($16 billion), Chile ($7 billion), and Mexico ($4 billion). Despite the rebound, the region's share is still only about half of what it was in the late 1990s, while the share going to Europe and Central Asia has doubled. The surge in FDI inflows to Europe and Central Asia has been dominated by privatization associated with major reforms, as was the case for the large volume of FDI inflows to Latin America in the late 1990s. The more recent pickup in inflows to Latin America stems from investment in the manufacturing sector and higher overall retained earnings, whereas in the late 1990s, the bulk of FDI inflows entailed privatization in the service sector.

FDI inflows to Sub-Saharan Africa surged from $17 billion in 2006 to $25 billion in 2007, largely because of a single transaction, the $5.5 billion purchase of a 20 percent equity stake in the South African commercial bank Standard Bank by the Industrial and Commercial Bank of China (table 2.16). This is not unusual for South Africa, where large acquisitions over the past few years have resulted in volatile FDI inflows. In 2005, a $5 billion acquisition resulted in net inflow of $6.5 billion, followed by the sale of foreign equity in a mining company in 2006, which resulted in net disinvestment of $0.1 billion. In general, however, FDI inflows to the region have been mainly directed at countries rich in natural resources. In 2006, over 60 percent of FDI inflows to the region went to just three resource-rich countries (Equatorial Guinea, Nigeria, and Sudan).

Equity outflows have also risen dramatically

Rapid growth in equity outflows from developing countries over the past few years has important implications for analyzing capital flows. Net FDI outflows from developing countries increased from $140 billion in 2006 to an estimated $184 billion in 2007, led by Russia ($42 billion), China ($30 billion), and India ($15 billion) (table 2.17). Outflows from Russia increased by $19.5 billion in 2007, fueled mostly by foreign asset acquisitions by Russian firms in the extractive industries of

Table 2.17 Estimated equity outflows from developing countries, 2007
$ billions

Category	FDI and potfolio equity	Category	FDI	Category	Portfolio equity
All developing countries	231.4	All developing countries	183.6	All developing countries	47.8
Top 10 countries	165.1	Top 10 countries	134.0	Top 10 countries	36.3
Russian Federation	44.4	Russian Federation	42.0	Chile	9.9
China	37.0	China	30.0	China	7.0
India	15.0	India	15.0	Poland	5.5
Chile	14.9	Hungary	8.0	Hungary	2.4
Poland	11.5	Kazakhstan	8.0	Russian Federation	2.3
Hungary	10.4	Malaysia	8.0	Kazakhstan	2.1
Kazakhstan	10.1	South Africa	7.0	Peru	2.0
South Africa	8.9	Poland	6.0	South Africa	1.9
Malaysia	8.0	Chile	5.0	Angola	1.7
Venezuela, R. B. de	5.0	Venezuela, R. B. de	5.0	Croatia	1.5

Sources: World Bank staff estimates based on quarterly data from IMF International Financial Statistics.

nearby countries. Outflows from China increased by almost $14 billion and mainly involved major cross-border acquisitions and newly established overseas trade and economic zones. Outflows from Brazil, on the other hand, plummeted to $3 billion in 2007, down from an extraordinarily high level of $28 billion in 2006; the decline was largely the result of a $17 billion acquisition by the Brazilian mining company Compania Vale do Rio Doce of the Canadian mining company Inco.

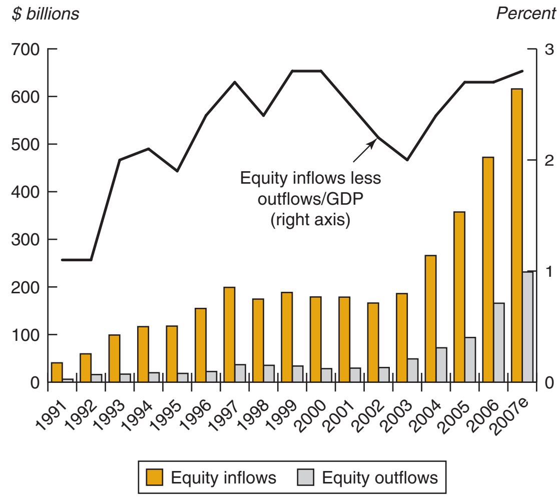
The bulk of FDI outflows from developing countries entails cross-border mergers and acquisitions, valued at $80 billion in 2007, up from $75 billion in 2006. Driven by ample liquidity and the desire to expand their market share abroad and secure raw materials, developing countries are acquiring companies both in developed countries (South-North investment) and in other developing countries (South-South investment). Developing-country corporations are investing abroad in virtually all sectors; the services sector accounts for almost 60 percent of the total.

Net portfolio equity outflows from developing countries increased from $26 billion in 2006 to an estimated $48 billion in 2007, led by Chile ($10 billion), China ($7 billion), and Poland ($5.5 billion).

Net FDI and portfolio equity inflows to developing countries increased by an estimated $404 billion over the past four years (2003–07), while outflows increased by an estimated $182 billion, revealing that developing countries have been receiving more equity capital than they have been investing abroad. However, the difference—equity inflows less outflows—has not increased significantly over the past 10 years relative to the GDP of developing countries (figure 2.18).

The rapid increase in equity outflows over the past few years also has had a major influence on the relationship between developing countries' overall current account balance and capital inflows. This report uses the convention of comparing the overall current account balance of developing countries to capital (debt and equity) inflows and changes in foreign reserves (see table 2.1). This convention has served to focus the discussion on the main elements of capital inflows to developing countries and is not intended to provide a comprehensive analysis of the balance of payments. Omitted elements of the balance of payments—notably capital outflows from developing countries, official transfers, and errors and omissions—are captured by a

Figure 2.18 Equity inflows to and outflows from developing countries, 1991–2007



Sources: IMF International Financial Statistics; World Bank staff estimates.

Note: e = estimate.

balancing item, which has grown (in absolute value) from under $100 billion in 2002–03 to almost $500 billion in 2006 (table 2.18). In 2007 equity outflows accounted for almost two-thirds of the balancing item—including equity outflows in the analysis reduces the balancing item (in absolute value) from $360 billion to $129 billion.

Net capital inflows are also overstated by intercompany loans, which are included in both private debt flows and FDI inflows. In principle, intercompany loans should be subtracted from net capital inflows to avoid double counting. However, in practice, precise estimates of intercompany loans are hampered by poor data quality. Intercompany loans are estimated to have increased from an average level of around $20 billion in 2002–04 to over $70 billion in 2006 before declining to about $60 billion in 2007. Excluding both equity outflows and estimates of intercompany loans from net capital inflows in 2007 reduces the balancing item from −$360 billion to only −$67 billion.

Net official lending returns to more normal levels

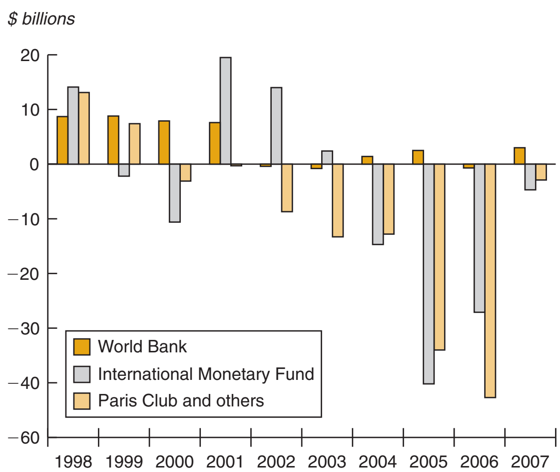
Net official lending continued to decline in 2007, but at a much lower rate than in the past few years. Repayments on loans owed to governments and multilateral institutions exceeded lending by $4 billion in 2007, compared with $70 billion in

Table 2.18 Net capital inflows to and outflows from developing countries, 2000–07
$ billions

Flow type	2000	2001	2002	2003	2004	2005	2006	2007e
Current account balance	36.3	12.8	62.0	116.9	164.3	309.5	431.0	425.9
FDI inflows	165.5	173.0	160.7	161.9	225.5	288.5	367.5	470.8
FDI outflows	21.0	18.0	23.7	39.1	63.5	80.0	140.1	183.6
FDI inflows–outflows	144.5	155.0	137.0	122.8	162.0	208.5	227.4	287.2
Portfolio equity inflows	13.5	5.6	5.5	24.1	40.4	68.9	104.8	145.1
Portfolio equity outflows	7.4	11.4	7.0	9.9	8.7	13.8	25.8	47.8
Portfolio equity inflows–outflows	6.1	−5.8	−1.5	14.2	31.7	55.1	79.0	97.3
Equity inflows	179.0	178.6	166.2	186.0	265.9	357.4	472.3	615.9
Equity outflows	28.4	29.5	30.7	48.9	72.2	93.8	165.8	231.4
Equity inflows–outflows	150.6	149.1	135.5	137.1	193.8	263.6	306.5	384.5
Debt inflows	−0.4	4.5	8.9	72.8	128.8	152.4	217.5	413.0
Debt and equity inflows	178.6	183.1	175.1	258.8	394.7	509.8	689.8	1028.9
Debt inflows and equity inflows–outflows	150.2	153.6	144.4	209.9	322.6	416.0	524.0	797.5
Change in reserves (− = increase)	−42.6	−80.4	−166.5	−292.4	−402.4	−390.8	−634.2	−1090.7
Intercompany loans	20.9	19.6	18.0	21.8	19.6	41.1	73.4	62.2
Balancing item[a]	−172.3	−115.5	−70.6	−83.2	−156.6	−428.5	−486.7	−360.2
excluding equity outflows	−143.9	−86.0	−39.8	−34.3	−84.4	−334.7	−320.8	−128.8
and intercompany loans	−123.0	−66.5	−21.8	−12.5	−64.8	−293.6	−247.5	−66.6

Sources: IFS, World Bank Debtor Reporting System and staff estimates.
Note: e = estimate.
[a]Combination of errors and omissions and transfers to and capital outflows from developing-countries.

Figure 2.19 Net official debt flows to developing countries, 1998–2007



Sources: World Bank Debtor Reporting System and staff estimates.

2005–06 (figure 2.19). Net official lending has declined by a cumulative total of $185 billion over the past five years, as middle-income countries made voluntary prepayments to the Paris Club and multilateral institutions.

High oil prices, in particular, have enabled several major oil-exporting countries to prepay official debt over the past few years. Notably, Russia paid off its Soviet-era debts with a total of $37 billion prepayments to Paris Club creditors in 2005–06, while Nigeria made $14 billion in prepayments to its Paris Club and London Club creditors.[9] In May 2007 the Paris Club agreed to accept prepayments from Peru for outstanding debt valued at $2.5 billion. The prepayment was partly financed by a $1.5 billion sovereign bond, which enabled Peru to improve the maturity structure of its debt. The Paris Club also agreed to accept buybacks at market value on debt owed by Jordan and Gabon valued at $2.3 billion and $2.5 billion, respectively.[10]

Lending by the IMF (purchases) has continued to decline, reaching $2.5 billion in 2007, down from $4 billion in 2005–06 and dramatically down from levels exceeding $30 billion at the beginning of the decade, when Argentina, Brazil, and Turkey all experienced major financial crises. Favorable global economic and financial conditions have virtually eliminated IMF lending to countries in need of emergency financing, permitting countries such as Argentina, Brazil, and Turkey to repay their outstanding debt. IMF credit outstanding declined to under $15.5 billion at end-December 2007, down from a high of just under $100 billion in 2003.

Net lending by the World Bank averaged only $0.8 billion over the past six years (2002–07). This reflects a number of factors. The favorable economic and financial conditions during this period enabled debtor countries to repay structural adjustment loans to the International Bank for Reconstruction and Development (IBRD) made during the financial crises of the late 1990s. Principal repayments to the IBRD exceeded disbursements by $4.4 billion on average over the period 2002–07, offset by $5.2 billion in net lending by the International Development Association (IDA). The change in the composition of net lending by the World Bank implies a shift away from IBRD lending to middle-income countries toward IDA lending to low-income countries, with a much higher average grant element. Moreover, IDA has provided a growing proportion of financial resources in the form of grants rather than loans, which are not included in the debt flow calculations.

In general, most of the large repayments made to official creditors over the past few years involved nonconcessional loans to middle-income countries. Concessional loans and grants to low-income countries are a better measure of development assistance.

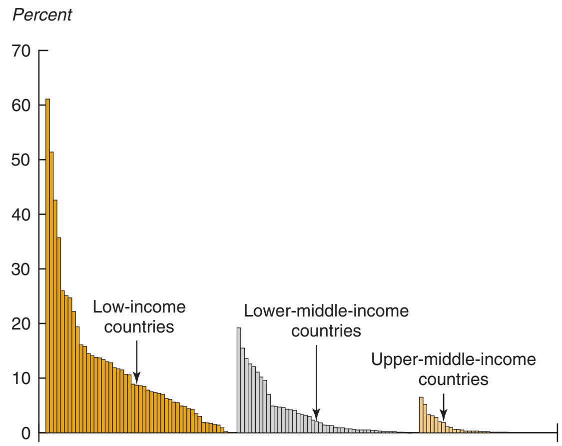
Official development assistance

Some developing countries have recently gained access to the international bond market. However, many countries still need to make significant progress on improving the fundamentals that will enable them to access private debt markets on favorable terms, without endangering debt sustainability over the long term. Many developing countries will continue to depend heavily on concessionary loans and grants from official sources to meet their financing needs for some time. In 2006, official development assistance exceeded 10 percent of GDP in 30 countries (figure 2.20).

Little progress on official aid commitments, aside from debt relief

Net ODA disbursements by the 22 member countries of the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD) totaled $103.7 billion in 2007, down from $104.4 billion in 2006 and a record $107.1 billion in 2005. The decrease in ODA over the past two years largely reflects the return of debt relief to more normal levels following two extraordinary Paris Club agreements in 2005, under which Iraq and Nigeria received a total of $19.5 billion in debt relief from their Paris Club creditors, followed by another $13 billion in

Figure 2.20 Net ODA disbursements as a share of GDP in developing countries, 2006



Source: OECD Development Assistance Committee (DAC).

2006. Debt relief continues to play a critical role in the development agenda, especially for many of the poorest countries burdened by heavy debt service payments. At the United Nations' Conference on Financing for Development in Monterrey in 2002, donors pledged that debt relief would not displace other components of ODA. In 2007, however, ODA net of debt relief increased by only 2.4 percent in real terms (adjusted for inflation and exchange rate movements) (table 2.19).

There has been a shift in the share of ODA disbursements (excluding debt relief) provided by DAC member countries since the Monterrey Consensus in 2002. Notably Japan's share has declined from 14.5 percent in 2002 to only 8 percent in 2007, while the U.S. share has risen from 20 percent to 23.5 percent. Existing commitments imply a substantial shift from the United States to the 15 DAC EU countries. The share provided by these countries is projected to increase from 55.6 percent in 2007 to 64 percent in 2010, while that provided by the United States is projected to decline from 23.5 to below 19 percent (OECD 2007, table 3).

Relative to GNI in DAC donor countries, ODA net of debt relief was unchanged at 0.25 percent in 2007, just slightly above the 0.23 percent level recorded in 2002, the year of the Monterrey Consensus, and well below the 0.33 percent level attained in the early 1990s (figure 2.21). ODA by DAC member countries is projected to increase to 0.35 percent of GNI based on commitments made in 2005 (OECD 2008a). This would require an average annual growth rate of over 14 percent in

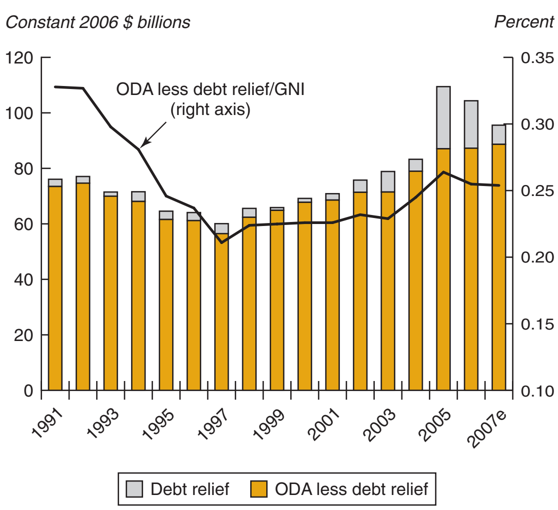
Table 2.19 Net disbursements of official development assistance excluding debt relief, 1990–2007

Constant 2005 $ billions

Donor	1990	1995	2000	2002	2003	2004	2005	2006	2007e
All donors	69.9	61.7	68.1	73.9	73.7	80.8	89.0	90.4	
DAC donors	69.8	60.6	66.6	69.8	69.8	77.0	85.1	85.4	87.4
United States	14.1	8.9	11.2	13.9	15.9	20.2	23.9	21.3	20.6
United Kingdom	4.1	4.8	6.2	5.7	7.3	7.2	7.3	9.6	9.4
Germany	7.9	7.3	6.9	6.5	6.3	7.1	6.7	7.6	8.4
France	9.1	8.1	6.1	7.6	6.0	7.0	7.0	7.0	7.4
Japan	11.2	11.2	12.3	10.1	9.1	8.6	10.0	9.2	7.0
Netherlands	3.7	3.7	4.8	4.2	4.2	4.1	4.8	5.1	5.2
Sweden	2.2	1.9	2.4	2.7	2.7	2.7	3.4	3.9	4.0
Canada	3.2	2.7	2.4	2.9	2.5	2.9	3.8	3.4	3.5
Spain	1.3	1.8	2.0	2.5	2.3	2.3	2.5	3.2	4.7
Norway	1.9	1.9	2.0	2.5	2.6	2.5	2.8	2.7	3.1
Australia	1.3	1.6	1.5	1.5	1.5	1.6	1.7	2.1	3.0
Italy	4.4	2.2	2.1	3.3	2.8	2.5	3.4	2.2	2.5
Switzerland	1.0	1.1	1.3	1.2	1.4	1.5	1.8	1.6	2.4
Belgium	1.2	1.0	1.2	1.3	1.3	1.3	1.5	1.5	1.5
Ireland	0.1	0.2	0.4	0.6	0.6	0.6	0.7	1.0	1.3
Finland	0.9	0.4	0.5	0.6	0.6	0.7	0.9	0.8	0.9
Austria	0.2	0.6	0.6	0.5	0.5	0.6	0.7	0.7	0.7
Korea	0.1	0.1	0.3	0.4	0.4	0.5	0.8	0.4	0.4
Greece	..	0.2	0.4	0.4	0.4	0.3	0.4	0.4	0.4
Portugal	0.3	0.3	0.4	0.5	0.4	1.1	0.4	0.4	0.4
Luxembourg	0.0	0.1	0.2	0.2	0.2	0.2	0.3	0.3	0.3
New Zealand	0.1	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3
Non-DAC donors	0.1	1.1	1.5	4.1	3.9	3.8	3.9	5.0	
Arab Countries	..	0.7	0.8	3.4	3.0	2.1	1.4	2.4	
Turkey	..	0.2	0.1	0.1	0.1	0.3	0.6	0.7	
Korea	0.1	0.1	0.3	0.4	0.4	0.5	0.8	0.4	
Memorandum items									
G-7 countries	53.9	44.2	46.3	48.8	49.2	55.2	61.5	60.1	59.4
DAC EU countries	37.0	33.6	36.0	37.9	36.7	39.6	41.6	45.4	49.4

Source: OECD Development Assistance Committee (DAC).
Note: e = estimate; EU = European Union; G-7 = group of seven countries (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States).

Figure 2.21 Net ODA disbursements by DAC donors, 1991–2007

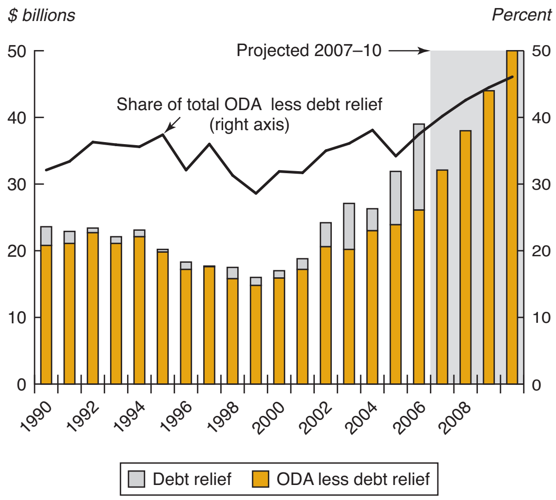


Source: OECD Development Assistance Committee (DAC).
Note: e = estimate; ODA = official development assistance.

real terms over the balance of the decade, three times the observed rate of 4.6 percent since the Monterrey Consensus in 2002.

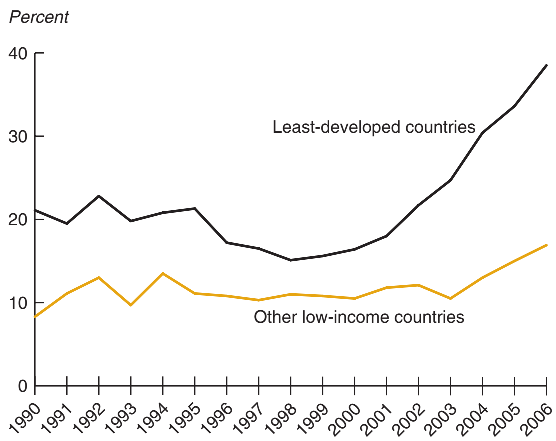
The amount of ODA allocated to Sub-Saharan Africa has increased significantly since the early part of the decade, rising from $11.5 billion in 2000 to $39 billion in 2006 in real terms (figure 2.22). However, much of the increase has come in the form of debt relief. Excluding debt relief, the region received 37.5 percent of total ODA in 2006, up from 34 percent in 2006 but slightly below its 38 percent share in 2004. To meet their pledged increase to Sub-Saharan Africa of $50 billion (in real terms) by 2010, ODA donors would have to increase the flow of aid to the region by an average annual rate of 18 percent over the balance of the decade (in real terms), well above the 9 percent rate observed in 2002–06. This would also require that donors allocate 46 percent of their projected ODA commitments to countries in Sub-Saharan Africa.

Figure 2.22 Net ODA disbursements to Sub-Saharan Africa, 1990–2010



Source: OECD Development Assistance Committee.

Figure 2.23 Share of ODA disbursements excluding debt relief to low-income countries, 1990–2006



Source: OECD Development Assistance Committee.

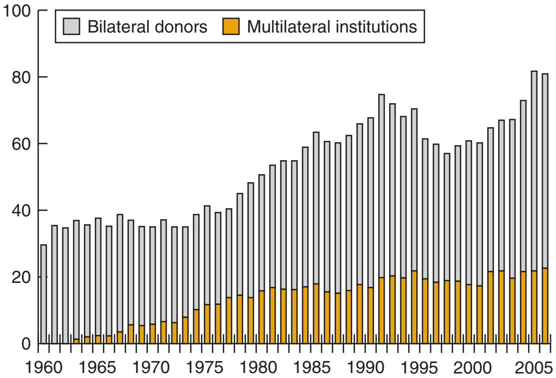
The amount of aid going to the 49 low-income countries designated by the United Nations to be least developed (LDCs) has increased significantly since the late 1990s. The share of ODA disbursements excluding debt relief allocated to the LDCs rose from a low of 15 percent in 1998 to 38.5 percent in 2006. ODA allocated to other low-income countries over the same period increased more modestly, from 11 to 17 percent (figure 2.23).

Several empirical studies have examined whether donors have become more selective in allocating aid across countries on the basis of equity and performance criteria.[11] A central issue in this line of research is whether donors have allocated a higher portion of aid to countries in most need (typically measured using income levels) and with better economic policies and institutions. The existing empirical evidence on this issue is mixed. Dollar and Levin (2004) and Claessens, Cassimon, and Van Campenhout (2007) find that donors have become more selective in allocating ODA to countries on the basis of GDP per capita and measures of policy performance and institutional quality, but Easterly (2007) and Easterly and Pfutze (2008) report conflicting results. Following this line of research, regression analysis was used to examine how equity and performance criteria have influenced donors' allocation of ODA over the past few years. The results (reported in annex 2B) indicate that the allocation of ODA in 2006 was influenced by cross-country differences in GDP per capita, and by the World Bank Worldwide Governance Indicators. Moreover, we find that donors have allocated a higher portion of aid to countries in Sub-Saharan Africa, controlling for their income and performance levels. The estimates imply that countries in Sub-Saharan Africa with a GDP per capita of $480 (the median level for low-income countries in 2006) received ODA disbursements equal to about 19.5 percent of their GDP, on average, while countries outside of Sub-Saharan Africa with a GDP per capita of $760 (one standard deviation higher) received only about 12.5 percent. Estimates obtained in each year over the period 2002–06 suggest that the influence of all three explanatory variables has declined since 2004, implying that donors have become less selective.

Developing countries have become important sources of aid for other developing countries. Unfortunately, there is little comprehensive, up-to-date data on the activities of "emerging donors," making it difficult to gauge their impact. Non-DAC donors' share of ODA disbursements (excluding debt relief) has been relatively stable, averaging around 5 percent in 2002–06.[12] China is estimated to have provided between $2 billion and $3 billion in concessional loans in 2005; India, an additional $1 billion (Kharas 2007, p. 12). Concessional loan commitments made by China, Brazil, and India to other developing countries increased from $2.5 billion in 2005 to $3.5 billion in 2006.[13] The average grant element of all loan commitments made by China, Brazil, and India was about

Figure 2.24 Net ODA disbursements excluding debt relief, 1960–2006

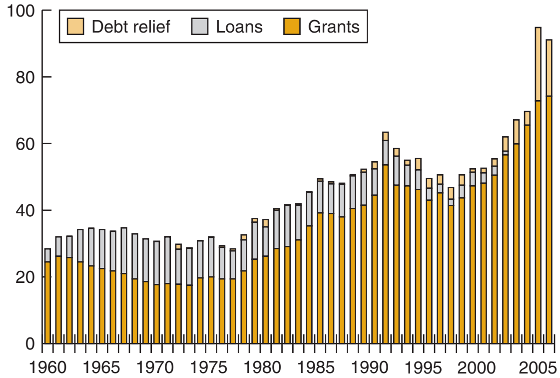
Constant 2005 $ billions



Source: OECD Development Assistance Committee.

Figure 2.25 Net ODA disbursements by bilateral donors, 1960–2006

Constant 2005 $ billions



Source: OECD Development Assistance Committee.

one-third in 2005–06, equal to the average for other countries.

The volume of ODA disbursed by multilateral institutions has been stable at around $20 billion in real terms (constant 2005 dollars) since the early 1990s, while that disbursed by bilateral donors has fluctuated widely (figure 2.24). However, there has been a significant shift in the composition of disbursements across multilateral institutions. In 1990 UN agencies accounted for almost 30 percent of multilateral disbursements, while the European Commission (EC) accounted for just over 20 percent. By 2006, the share disbursed by UN agencies had fallen to less than 15 percent, while the EC share had doubled to just over 40 percent.

The International Development Association (IDA) has accounted for around 30 percent of net ODA disbursements by multilateral institutions on average since 1990. IDA's share is expected to increase somewhat over the balance of the decade as a consequence of the 15th replenishment of IDA (IDA15) completed in December 2007. The IDA15 replenishment of $41.6 billion represents an increase of $9.5 billion over the previous replenishment (IDA14), the largest expansion in donor funding in IDA's history. Forty-five countries, the highest number of donors in IDA's history, made pledges to the IDA15 replenishment, with six countries—China, Cyprus, the Arab Republic of Egypt, Estonia, Latvia, and Lithuania—joining the list of donors for the first time. IDA15 will support low-income countries by increasing its activities in combating climate change, facilitating regional integration and cooperation, boosting infrastructure investment, and providing greater support to postconflict countries, notably in Sub-Saharan Africa.

Net ODA disbursements by bilateral donors have become dominated by grants. In 2002–06, repayments on ODA loans to bilateral creditors exceeded disbursements by almost $2 billion, on average. This is in sharp contrast to the late 1960s, when net lending accounted for about one-third of net ODA disbursements (figure 2.25).

Debt burdens continue to decline

Along with the major debt relief initiatives, the shift from bilateral ODA loans to grants, ongoing over the past 40 years, has significantly reduced the debt burdens of many low-income countries, particularly for those that have reached the HIPC completion point and received additional debt relief from the Multilateral Debt Relief Initiative. In 2007, 14 of the 21 HIPCs that had reached completion point by the end of 2006 had external debt-to-GDP ratios below 37.5 percent, the median for other developing countries (figure 2.26).[14] In 2000 the median external debt-to-GDP ratio for those same 22 countries was 109 percent, twice the median level for other developing countries (53 percent).

The external debt burden of all developing countries continues to decline, especially the portion owed to public creditors (or that is publicly guaranteed). The nominal value of public and publicly guaranteed external debt declined from 25 percent of GDP in 1999 to 10 percent in 2007, while private nonguaranteed debt remained stable at 9 percent of GDP (figure 2.27).

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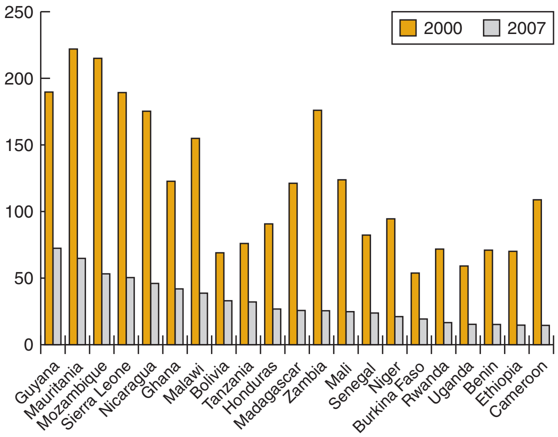
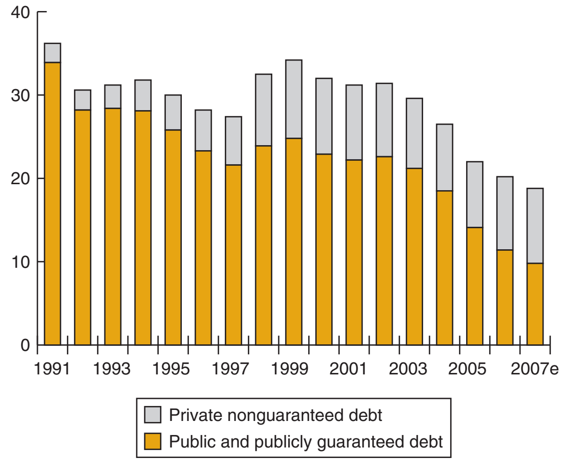
Figure 2.26 External debt as a share of GDP in 21 HIPCs



Source: World Bank Debtor Reporting System.
Note: HIPCs = heavily indebted poor countries.

Figure 2.27 External debt as a share of GDP in developing countries, 1991–2007



Source: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate.

Recent trends in remittances

Officially recorded remittance transfers to developing countries are estimated to have increased to $240 billion in 2007, an amount equal to 1.8 percent of GDP, down from an average level of 2.0 percent of GDP over the previous five years (table 2.20).[15] The actual size of migrant remittance flows, including unrecorded flows through formal and informal channels, is arguably much larger (World Bank 2006b). In particular, remittance flows to Sub-Saharan Africa are grossly underestimated, with wide deficiencies in data reporting for several countries and a predominance of informal channels for the transmission of remittances.

Latin America and the Caribbean continued to receive the largest amount of remittance flows among developing regions. However, the rate of growth of remittances to the region (particularly to Mexico) slowed markedly, a result of slower growth in output (which has reduced demand for labor in the construction sector in particular) and increased anti-immigration sentiment in the United States.[16] Apprehensions along the U.S.-Mexico border have declined by nearly 50 percent from the level in 2000, indicating a reduction in the number of undocumented migrants trying to enter the United States. Recent enforcement efforts appear to have reduced the number of seasonal migrants and their ability to send remittances, especially through formal channels (Ratha and others 2007).

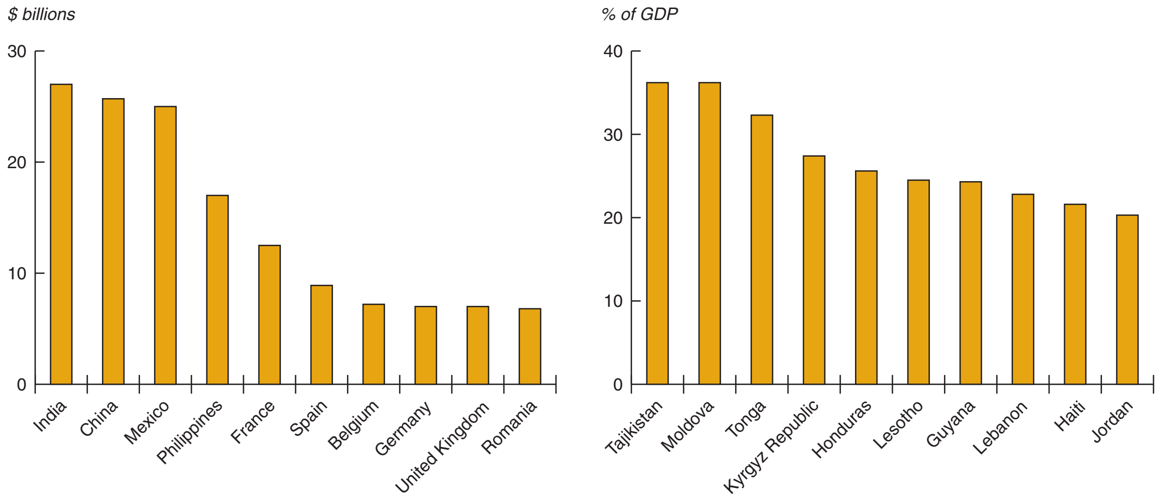
By contrast, remittance receipts in developing countries in Europe and Central Asia increased significantly. Strong demand for labor in oil-exporting

Table 2.20 Remittance flows to developing countries, 2000–07
$ billions

Category	2000	2001	2002	2003	2004	2005	2006	2007e
Total	84.5	95.6	115.9	143.6	161.3	191.2	221.3	239.7
By region								
East Asia and Pacific	16.7	20.1	29.5	35.4	39.1	46.6	52.8	58.0
Europe and Central Asia	13.1	12.7	14.0	16.7	21.1	29.5	35.1	38.6
Latin America and the Caribbean	20.0	24.2	27.9	34.8	41.3	48.6	56.5	59.9
Middle East and North Africa	12.9	14.7	15.3	20.4	23.1	24.2	26.7	28.5
South Asia	17.2	19.2	24.1	30.4	28.7	33.1	39.8	43.8
Sub-Saharan Africa	4.6	4.7	5.0	6.0	8.0	9.3	10.3	10.8

Source: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate.

Figure 2.28 Top remittance-receiving countries, by dollars and percentage of GDP



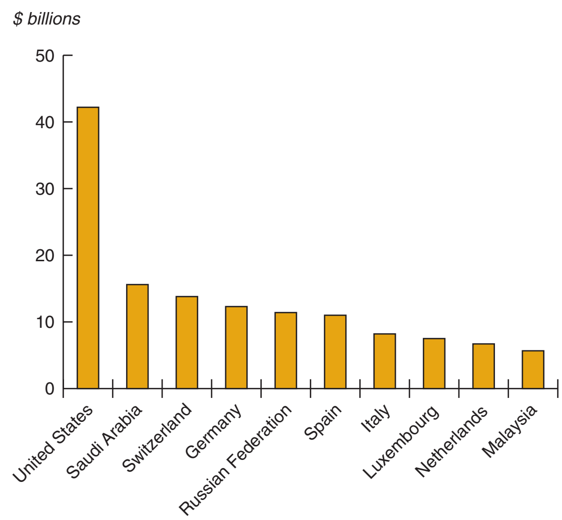
Source: World Bank staff estimates.
Note: e = estimate.

Middle Eastern countries boosted remittances to Bangladesh by 19 percent and to Pakistan by 17 percent in 2007 and contributed to South Asia and the Middle East and North Africa having the highest share of remittance receipts relative to their GDP. In the Philippines, remittances rose by 14 percent year over year during the first 11 months of 2007. Remittances to India rose by 30 percent in the first half of the year.

India, China, and Mexico were the top three recipients of remittances in 2007 and accounted for nearly one-third of remittances received by developing countries (figure 2.28). The countries receiving the most remittances as a share of GDP were small, poor economies such as Tajikistan, Moldova, Tonga, Kyrgyz Republic, and Honduras, where these flows exceeded 25 percent of GDP (see figure 2.28). In general, remittance receipts represent a significantly larger share of output in low-income countries (3.6 percent) than in middle-income countries (1.7 percent).

High-income countries are the dominant source of global remittance flows, led by the United States ($42 billion) and followed by Saudi Arabia ($15.6 billion) (figure 2.29). Developing countries receive somewhere between 10 and 29 percent of their remittance flows from other developing countries (South-South flows) equivalent to $18 billion to $55 billion (Ratha and Shaw 2007). Russia and Malaysia, both middle-income countries, are important sources of remittance flows to other developing countries.

Figure 2.29 Top remittance-sending countries



Source: World Bank staff estimates.

Prospects for capital flows

The impact of the financial turmoil on development finance

The turmoil that gripped financial markets worldwide began with a credit shock in the U.S. subprime mortgage market in mid-2007, amplified by highly leveraged financial institutions holding related securities. This led to a surge in demand for short-term financing, resulting in a liquidity crisis.

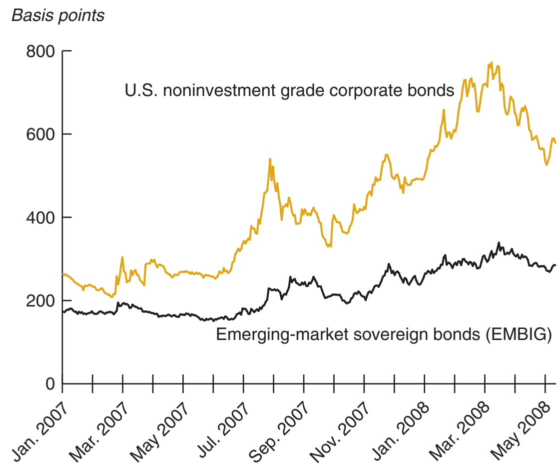
The origin of the crisis in the U.S. subprime mortgage market can be traced back to 2002–06, a period characterized by very favorable financial and economic conditions. An extended period of abundant liquidity and low interest rates worldwide sparked a search for yield that induced some investors to take on additional risk with little in the way of extra compensation. These factors were supported by robust global growth, fueling a four-year expansion in the global credit cycle.

At the same time, rapid growth in the market for asset-backed securities and structured financial products (such as collateralized debt obligations) in major financial centers facilitated both lending (by reducing the costs entailed in assessing and managing the risks) and borrowing (by effectively increasing liquidity and the availability of credit). These financial innovations boosted the level of exuberance that tends to set in during a prolonged expansion in the credit cycle. Spreads on corporate and emerging-market bonds declined to record lows; equity prices rallied in many countries. The degree of risk was especially underestimated in the low-quality segment of the U.S. mortgage market (subprime loans), where lending standards had loosened significantly.

By midyear 2007 it became apparent that the default rate on U.S. subprime mortgages would be substantially higher than initially projected by credit rating agencies, implying that the credit quality of assets backed by those mortgages would be downgraded substantially. However, little was known about the size of exposures held by the various financial institutions involved in the mortgage intermediation process. Moreover, the complex nature of structured financial instruments made it very difficult to price the underlying assets. The lack of transparency and the difficulty of pricing complex securities undermined the secondary market for asset-backed securities. The cost of issuing such securities increased sharply in August, as financial markets recognized that the magnitude of loan losses was more severe than originally envisaged.

The resulting sell-off in risky assets caused emerging-market sovereign bond spreads (measured using the JP Morgan Emerging Markets Bond Index [EMBI] Global composite index) to widen to over 300 basis points in March 2008, up from a record low of 150 basis points in early June 2007 (figure 2.30). Volatility in global financial markets soared amid high uncertainty surrounding the rapid turnaround in financial conditions. Investors' appetite for risk waned, leading to a sell-off in risky assets in mature and emerging markets alike, which was

Figure 2.30 Bond spreads, January 2007 – mid-May 2008



Source: JPMorgan.

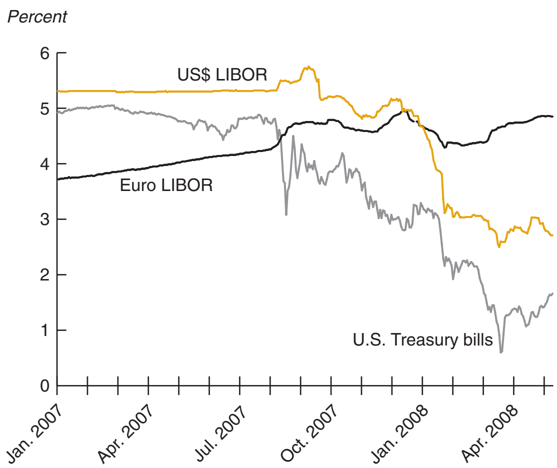
Note: EMBIG = JPMorgan Emerging Markets Bond Index Global.

intensified by forced selling resulting from margin calls and redemption orders by hedge fund investors.

Uncertainty about counterparty risk spread throughout the financial system, causing a surge in demand for short-term financing (IMF 2008a). This had a marked impact on the interbank market, where spreads between interbank borrowing rates and yields on government securites rose dramatically (see chapter 3). Notably, the spread between the three-month London Interbank Offered Rate in U.S. dollars ($US/LIBOR) and the yield on three-month U.S. Treasury bills exceeded 200 basis points in late 2007 and again in March 2008, compared with an average level of less than 50 basis points in the 12 months before the subprime crisis (figure 2.31).

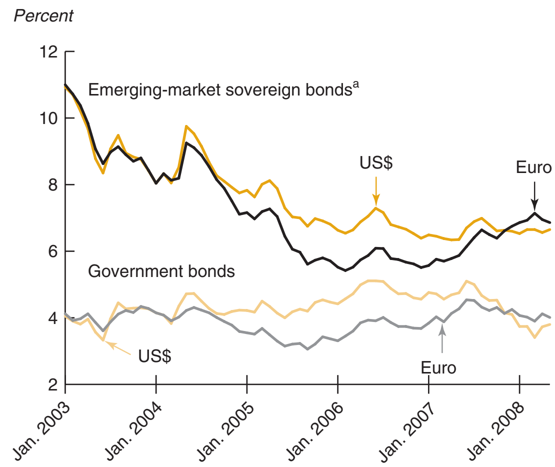
Central banks in mature markets introduced unprecedented measures in an effort to provide the liquidity needed to keep markets functioning in an orderly manner. In the United States, the Federal Reserve began easing monetary policy in August 2007 out of concern that the disruption in the financial system could lead to an abrupt economic slowdown. A series of interest-rate cuts reduced the federal funds rate from 5.25 percent in mid-August 2007 to 2.00 percent in mid-April 2008. The dramatic decline in U.S. short-term interest rates reduced the $US/LIBOR by over 200 basis points between August 2007 and early 2008. In contrast, LIBOR lending denominated in euros increased during this period, reaching 485 basis points in mid-May 2008, up by over 100 basis points since early 2007.

Figure 2.31 Three-month LIBOR and yield on three-month U.S. Treasury bills, January 2007 – mid-May 2008



Source: U.S. Board of Governors of the Federal Reserve System.
Note: LIBOR = London Interbank Offered Rate.

Figure 2.32 Yields on 10-year government bonds and emerging-market sovereign bond spreads, January 2003 – mid-May 2008



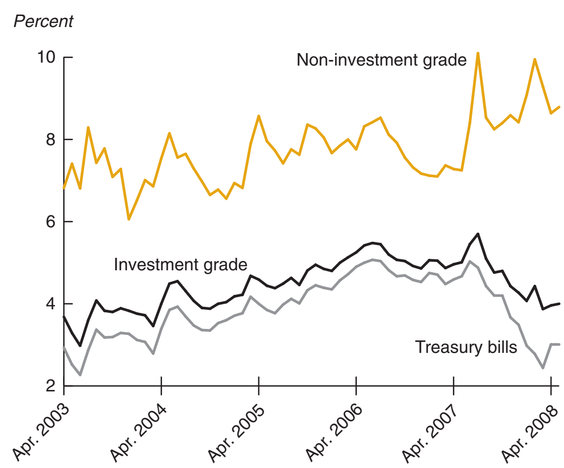
Source: JPMorgan.
a. Government bond yields plus emerging-market sovereign bond spread (EMBI Global) composite index.

Yields on U.S. government securities declined in response to the reductions in the U.S. federal funds rate and the sharp increase in the demand for liquid, safe assets by financial institutions. The yield on one-month U.S. Treasury bills fell from 5 percent in early August 2007 to under 1 percent in March 2008, the lowest rate since mid-2004. During the same time period, the yield on 10-year U.S. Treasury bonds fell from 4.75 percent to below 3.5 percent, the lowest level since mid-2003 (figure 2.32). The decline in the benchmark yields on dollar-denominated emerging-market sovereign bonds offset the rise in bond spreads, keeping the yield relatively stable. Yields on euro-denominated emerging-market sovereign bonds, however, increased by over 125 basis points between January 2007 and mid-May 2008.

The turmoil had a much larger impact on the cost of credit provided to the corporate sector, particularly for less-creditworthy borrowers. In the United States, spreads on non-investment-grade corporate bonds increased by over 500 basis points between early 2007 and March 2008, while spreads on U.S. investment-grade corporate bonds increased by only 160 basis points over the same period, indicating that the adverse economic and financial developments were expected to have a greater impact on less-creditworthy corporations. A similar pattern was observed in emerging markets, indicating that financial markets were discriminating mainly on the basis of risk characteristics of corporations, irrespective of location. In other words, credit conditions tightened significantly for less-creditworthy corporate borrowers domiciled in mature- or emerging-market economies alike.

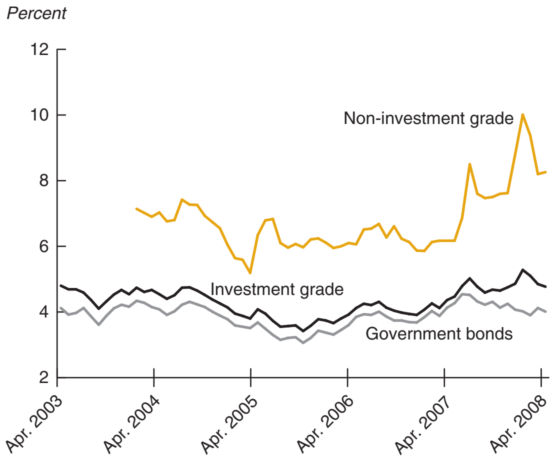
The implicit yield on five-year investment-grade corporate bonds in the United States declined by over 1 percentage point between early 2007 and early 2008, while yields on non-investment-grade corporate bonds have increased by over 1.5 percentage points (figure 2.33). Yields on non-investment-grade bonds issued by corporations in the Euro

Figure 2.33 Yields on 5-year U.S. corporate bonds, April 2003 – mid-May 2008



Source: Market CDX indexes for 5-year U.S. corporate bonds.

Figure 2.34 Yields on 5-year Euro Area corporate bonds, April 2003 – mid-May 2008



Source: Market iTraxx index for 5-year Euro Area corporate bonds.

Area increased by around 2 percentage points during the same period, exceeding levels observed over the past five years (figure 2.34).

Although corporations issuing non-investment-grade bonds face higher financing costs, a growing proportion of bonds issued by emerging-market economies carries investment-grade ratings. In the mid-1990s only about one-quarter of emerging-market bonds were rated investment grade, compared with one-half in 2007. On the whole, improved credit ratings have reduced the cost of bond issuance by governments and corporations in developing countries.

The discussion above examines the cost of external financing faced by developing countries in foreign currency (U.S. dollars and euros), reflecting the need to measure financing costs across several countries on a common basis. Measuring financing costs in domestic currency is more relevant for governments and corporations whose revenues and expenditures are largely denominated in domestic currency. Exchange-rate movements over the past few years have had a major influence on the cost of debt service and the value of outstanding debt in many developing countries. For instance, in 2007 the Turkish lira appreciated by 17.5 percent against the U.S. dollar and 7 percent against the euro, which significantly reduced debt service payments on its debt denominated in U.S. dollars and euros (as measured in lira). Moreover, developing countries have significantly increased their external borrowing denominated in domestic currency (see tables 2.5 and 2.6).

In sum, the turbulence in financial markets has had little impact on the cost of sovereign borrowing from abroad, but it has significantly raised the cost of non-investment-grade corporate issues.

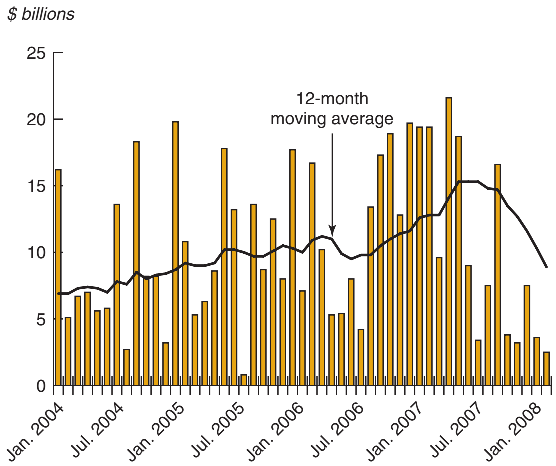
Early indications suggest that capital flows have declined

The turmoil in global financial markets appears to have had a marked impact on bond issuance worldwide. Global bond issuance surged to a record \$4 trillion in the first half of 2007 but then fell sharply to \$2 trillion in the second half of the year, the lowest second-half volume since 2002. Bond issuance by developing countries declined from \$108 billion to only \$40 billion from the first to the second half of 2007. The decline was concentrated in the corporate sector; corporate issues fell sharply from a record \$85 billion in the first half of 2007 to only \$25 billion in the second half, while sovereign issuance has declined gradually since early 2006 and was evenly shared between investment-grade and non-investment-grade securities.

Global bond issuance continued to decline into the first quarter of 2008, with a total volume of \$1 trillion, down almost 50 percent from the first quarter of 2007. Much of the decline has been concentrated in structured financial instruments, particularly asset-backed securities and collateralized debt obligations. The pace of bond issuance by developing countries dropped off sharply in mid-2007, with monthly volumes averaging only \$6 billion from July 2007 to March 2008, down from an average of \$15 billion during the same period in 2006 (figure 2.35).

The sharp decline in bond issuance since mid-2007 reflects both supply and demand factors. On the demand side, the reassessment of credit risks and increase in risk aversion on the part of international investors has led to wider bond spreads, particularly for less-creditworthy corporations. And for their part, borrowers are reluctant to launch major bond issues in an environment characterized by high volatility and uncertainty surrounding the demand for new issues. Many governments and corporations that have been active in the past do not have pressing financing needs and hence prefer to postpone their issuance programs until the market settles. In some countries, governments and corporations have been able to meet more of their financing needs by borrowing in the domestic bond market. The decline in corporate bond issuance has

Figure 2.35 Bond issuance by developing countries, January 2004 – March 2008



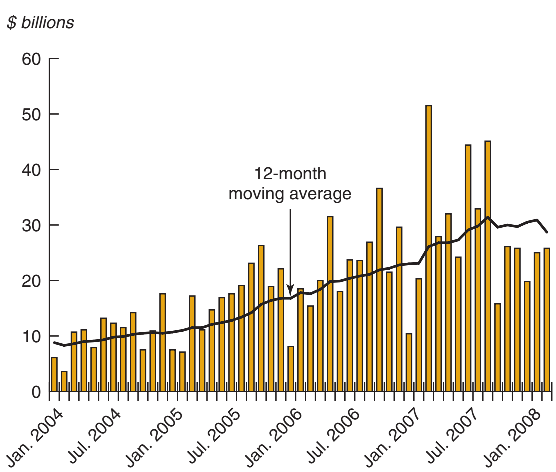
Source: Dealogic DCM Analytics.

been more prominent among non-investment-grade issues, which comprised only 18 percent of corporate issues between October 2007 and March 2008, compared with 55 percent over the same period the previous year.

The turmoil has also curtailed cross-border bank lending and equity issuance by developing countries, but less so than for bond issuance. The volume of syndicated loan commitments to developing countries posted strong gains until October 2007 (figure 2.36). However, some of the increase reported in the third quarter of the year represented transactions agreed to in the preceding few months. Monthly loan commitments averaged $23 billion from October 2007 to March 2008, down from an average of $28 billion over the same period in the previous year. Equity issuance by all countries totaled $118.5 in the first quarter of 2008, the lowest level in five years. Equity issuance by developing countries increased throughout most of 2007, reaching a record $26 billion in October, which coincided with the peak in equity prices, and then fell sharply in early 2008 as equity prices declined. Equity issuance by developing countries averaging only $5 billion in January and March 2008, the lowest level in five years (figure 2.37). A total of 91 IPOs were withdrawn or postponed during this period, the highest on record since 2001 following the sharp correction in equity prices.

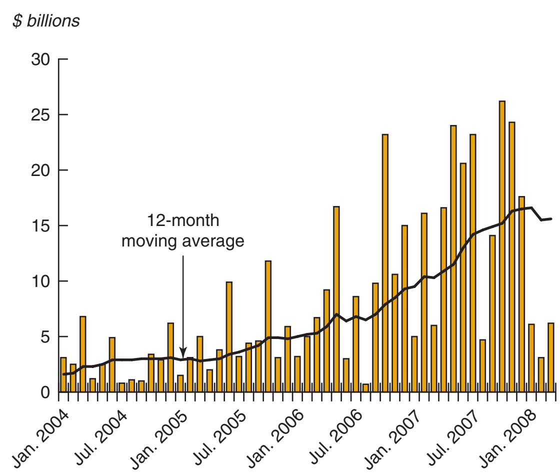
The turmoil also seems to have significantly dampened merger and acquisition (M&A) activity. The value of M&A deals worldwide announced in the first quarter of 2008 totaled $652 billion, down 40 percent year over year and the lowest level in four years. Difficulty in arranging financing for leveraged buyouts is believed to be a major factor. That has been most evident for private equity firms; their participation in M&A deals fell to $52 billion in the first quarter of 2008, down 70 percent year over year. The decline in M&A activity by private equity firms has been partially offset, however, by the growing role of sovereign wealth funds, which invested $25 billion in M&A deals in the first quarter of 2008, compared with $60 billion

Figure 2.36 Cross-border syndicated loan commitments to developing countries, January 2004 – March 2008



Source: Dealogic Loan Analytics.

Figure 2.37 Equity issuance by developing countries, January 2004 – March 2008



Source: Dealogic Loan Analytics.

over the entire year 2007, accounting for 35 percent of world M & A activity (Global Insight 2008, p. 3).

In sum, early indications are that the turmoil has curtailed private debt and equity flows to developing countries. However, it is unclear whether this constitutes a turning point in the credit cycle or a temporary interruption in borrowing activity.

Private capital flows to developing countries are expected to decline moderately

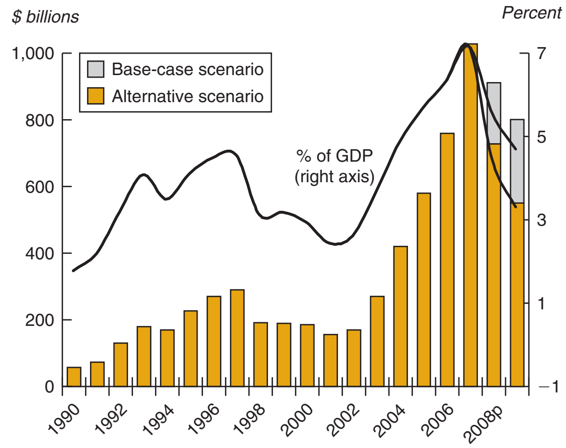
Tighter credit conditions, together with more moderate global growth, are expected to curb the expansion of private capital flows over the balance of 2008 and into 2009. Corporations in developing countries will find it more difficult to obtain credit; those that do will face higher financing costs, particularly the less creditworthy. It is important to recognize, however, that financing conditions have been very favorable over the past few years. Ample liquidity and investors' search for yield reduced bond spreads to record lows, while private capital flows to developing countries surged to record levels. An orderly adjustment in the credit cycle at the current juncture is desirable to the extent that capital flows fall to levels that can be sustained over the longer term.

As in past episodes, investor sentiment will have a major influence on whether the adjustment will be gradual or abrupt. Despite high volatility, investor confidence in emerging market assets has remained high. However, that could change quickly given the high degree of uncertainty surrounding current market conditions. This uncertainty makes projecting capital flows much more difficult, even over the short term. With this in mind, we prefer to characterize the realm of possibilities with reference to two alternative scenarios.

Under our base-case ("soft-landing") scenario, private capital flows are projected to decline moderately over the balance of 2008 and into 2009, falling from 7.5 percent of GDP ($1.03 trillion) in 2007 to 5.0 percent ($850 billion) in 2009, which is still above the previous peak reached in 1996 (4.4 percent) just before the East Asian financial crisis (figure 2.38). Under our "hard-landing" scenario, private capital flows are projected to decline more abruptly, falling to 3.5 percent of GDP ($550 billion) in 2009, just slightly below the average level over the period 1993–2002 (3.7 percent).

In addition to the moderation in global growth projected for 2008–09 (see chapter 1),

Figure 2.38 Net private capital flows to developing countries, 1990–2009



Sources: World Bank Debtor Reporting System and staff estimates.
Note: Estimate was made for 2007; p = projections for 2008–09.

tighter financing conditions are also expected to curb private capital flows. The intermediation process underlying the provision of credit has been impaired by the fallout from the U.S. subprime crisis, and some time is likely to be needed before normal financial operations are restored. In the few years leading up to the turmoil, ample liquidity supported a surge in M&A activity by providing easy financing for leveraged buyouts. Investment banks had little difficulty arranging financing for syndicated bank loans, which also expanded rapidly. These forces swiftly reversed in late 2007 when major financial institutions in mature markets (mainly the United States and Europe) began announcing large write-downs resulting from sharp declines in the market value of their holdings of asset-backed securities, along with major trading losses in some cases. Losses on unsecured U.S. loans are estimated at $225 billion as of March 2008, along with an additional $720 billion in mark-to-market losses on related securities (IMF 2008a, table 1.1).[17] Major international banks are expected to bear roughly half of these loses, with the balance spread among a wide range of institutional investors (such as insurance companies, pension funds, money market funds, and hedge funds) (IMF 2008a, p. 12). Estimates of additional write-downs suggest that the process will continue over the course of 2008. In mid-March one major financial institution—Bear Stearns—required financial support from the U.S. Federal Reserve when it failed to meet margin calls by creditors concerned about the declining market value of collateral (notably asset-backed securities) put up by Bear Stearns to secure its short-term financing needs. Other major financial institutions have been able to restore their capital-to-asset ratios by curtailing dividend payments, terminating share buybacks, and raising equity capital (from sovereign wealth funds in many cases).

Although capital adequacy has not been a major problem so far (other than in the case of Bear Stearns), hoarding of liquidity and concerns about counterparty risk have continued to strain interbank and other short-term lending markets (see chapter 3). This has impaired the intermediation process, causing assets to accumulate on bank balance sheets. Investment banks are reported to have a substantial inventory of loans that they have been unable to syndicate. Leveraged loans held by investment banks have lost around 15 percent of their market value in the United States and Europe between mid-2007 and early 2008, before recovering partially in the spring.[18] Banks have also come under pressure to expand credit to off-balance-sheet entities (conduits and structured investment vehicles) and borrowers that normally fund their operations in the segments of the financial market that have ceased to function. In particular, companies that have been unable to access short-term financing from the asset-backed commercial paper market have drawn on lines of bank credit. Moreover, hedge funds under pressure to finance margin calls and redemptions have also accessed bank credit lines. Faced with the financial pressures outlined above, many of the major banks, securities firms, and financial guarantors have curtailed their lending activity in an effort to restore their balance sheets.[19] There is also the possibility that global banks may significantly curtail lending activities by their subsidiaries operating abroad in an effort to restore balance sheets in the parent bank (see chapter 3). Moreover, heightened uncertainty surrounding the availability of interbank liquidity may also curtail cross-border lending to developing countries (see chapter 3).

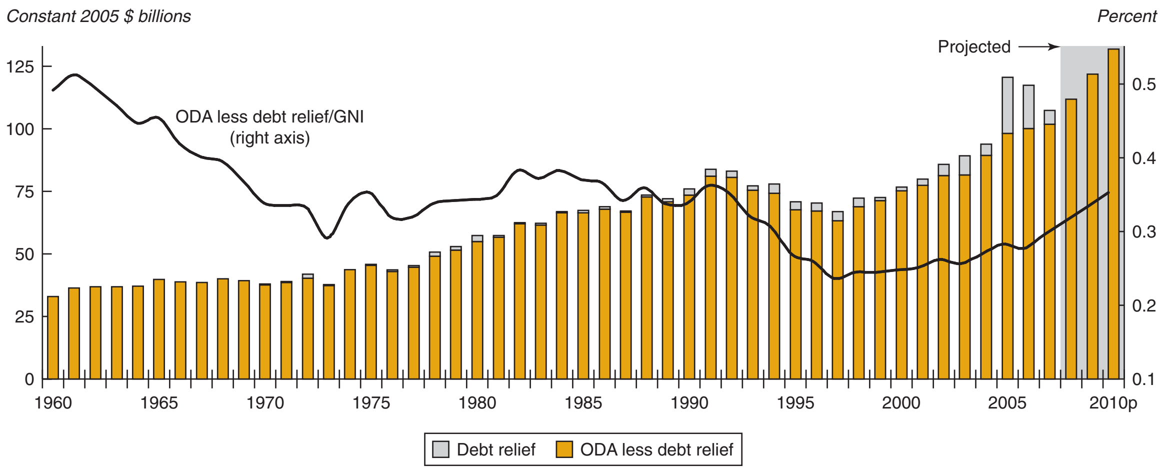
The deleveraging process is being complicated by the lack of transparency and valuation difficulties for some credit instruments and is likely to continue over the balance of 2008 and into 2009. The adjustment will curtail the ability of investment banks to arrange leveraged financing for large M&A transactions and syndicated bank loans. This will provide investment opportunities for those private equity firms that have capital to be deployed, particularly those with expertise in emerging markets, along with sovereign wealth funds and state-owned enterprises looking to expand their operations abroad. Moreover, institutional investors' holdings of emerging-market assets are well below levels implied by their capitalization value and hence are expected to rise significantly over the medium term. Assets under management worldwide by pension, insurance, and mutual funds are estimated to be in the $55 trillion to $60 trillion range at end 2006, which greatly exceeds the value of assets managed by sovereign wealth funds ($2.5 trillion to $3.5 trillion), hedge funds ($1.5 trillion), and private equity funds ($0.7 trillion to $1.0 trillion) (Farrell and others 2007, Exhibit 2; Global Insight 2008, p 16). Expectations of continued rapid growth in emerging-market economies and the potential diversification benefits make investments in emerging markets very attractive to institutional investors in advanced and developing countries alike. However, given concerns about overvaluation in some emerging equity markets along with the risk of an abrupt slowdown in global growth, fund managers may prefer to postpone taking on more exposure to emerging-market assets until global economic and financial conditions have improved.

Given the nature of the adjustment process outlined above, we expect private debt flows to decline by more than equity flows. This assessment partly reflects the observation that private debt flows tend to have a larger cyclical element than FDI inflows, the East Asian crisis being a prime example. Although this has also been the case for portfolio equity flows as well, we believe that equity flows more generally will be supported by the growing demand for equity investments by institutional investors, sovereign wealth funds, and state-owned enterprises over the medium term.

Donors need to enhance aid significantly to meet their commitments

For the many developing countries that depend heavily on capital flows from official sources to meet their financing needs, their short-term prospects will be largely determined by the extent to which donors meet their commitments to augment ODA. Under existing commitments, DAC member countries have pledged to raise ODA to

Figure 2.39 Net ODA disbursements by DAC donors, 1960–2010



Source: OECD Development Assistance Committee (DAC).
Note: ODA = official development assistance; p = projected 2008–10.

0.35 percent of their GNI by 2010, which would be well short of the UN target of 0.7 percent but would represent more rapid progress than that achieved over the past four years since the Monterrey conference in 2002 (figure 2.39).

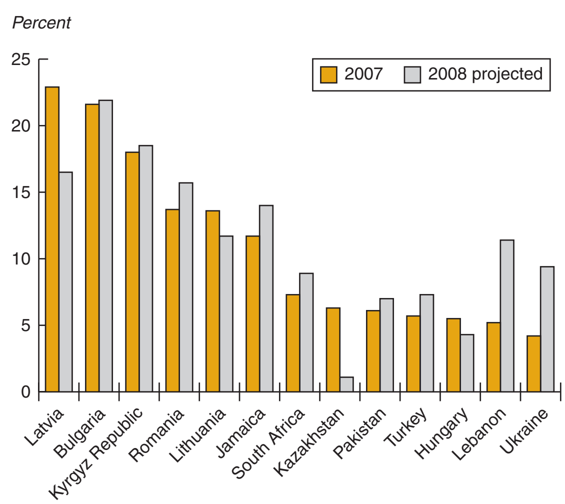
The moderation in growth in high-income countries projected for 2008–09 will make it more difficult for donors to honor their ODA commitments, particularly in donor countries with sizable fiscal deficits. However, the ODA commitments are small relative to countries' other fiscal expenditures and hence will not prevent them from attaining their overall fiscal objectives. Moreover, honoring ODA commitments over the balance of the decade would raise ODA as a share of GNI to levels observed throughout much of the 1970s and 1980s.

Key financial risks

If financial conditions in mature markets were to deteriorate significantly over the balance of 2008, developing countries would likely experience a pronounced decline in private capital flows. A state of heightened uncertainty would make it more difficult for the major investment banks to attract equity capital, which would accentuate their need to curtail lending activities in an effort to restore their balance sheets. The deleveraging process coupled with a further decline in investors' appetite for risk could reduce the supply of global capital significantly, raising its cost, particularly for less-creditworthy corporations.

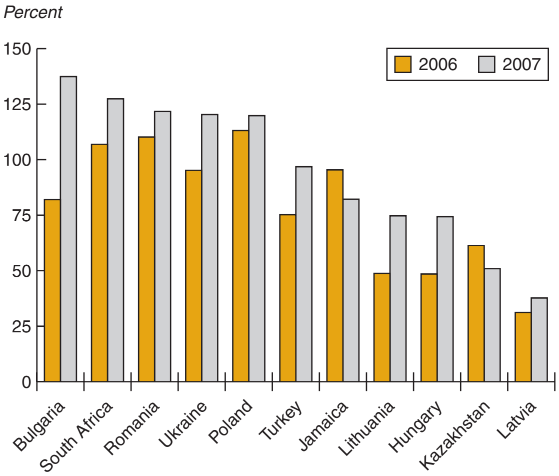
Most developing countries are well placed to withstand a sharp downturn in the credit cycle, but some may be vulnerable, particularly those with large external imbalances and heavy financing needs. In 2007, current account deficits exceeded 15 percent of GDP in Bulgaria, the Kyrgyz Republic, Latvia, and Lebanon and are projected to improve only marginally in 2008 (figure 2.40). Moreover, current account deficits in Lebanon, Pakistan, Romania, South Africa, and Ukraine are expected to widen in 2008. Many of these countries are already saddled with high debt burdens, especially

Figure 2.40 Current account deficits as a share of GDP in 13 countries, 2007–08



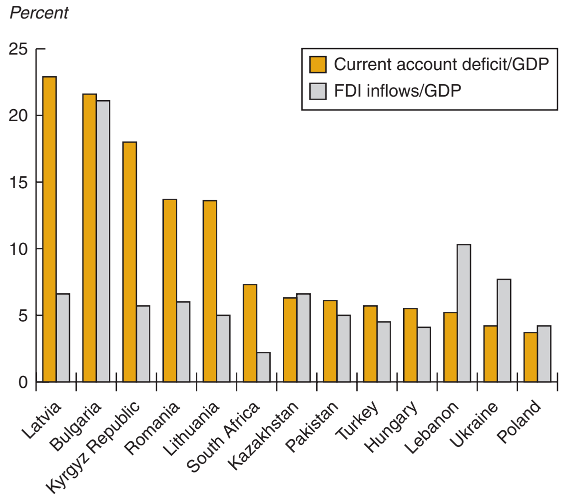
Sources: IMF International Financial Statistics; World Bank staff.

Figure 2.41 Foreign reserves as a share of short-term debt in 11 countries, 2006–07



Sources: World Bank Debtor Reporting System; IMF International Financial Statistics.

Figure 2.42 FDI inflows and current account deficits as a share of GDP in 13 countries, 2007



Sources: IMF International Financial Statistics; World Bank staff.
Note: FDI inflows are estimates based on quarterly data.

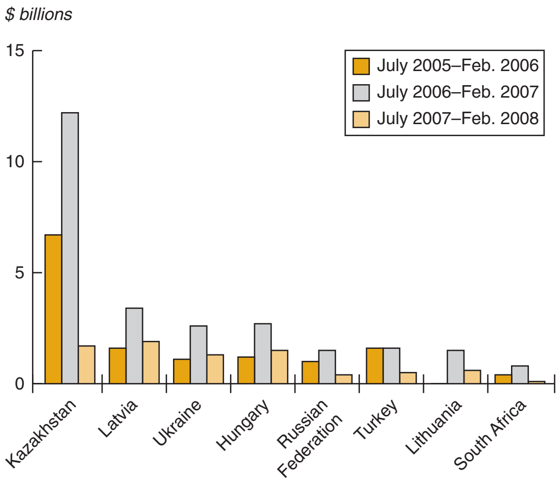
Hungary, Latvia, and Lebanon, where external debt obligations exceed 90 percent of GDP, compared with 25 percent for developing countries as a group.

Many developing countries have ample foreign reserves to provide a buffer should they encounter external financing problems. At the end of 2007, foreign reserve holdings in three-quarters of developing countries exceeded the amount of principal and interest payments due in 2008. However, this is not the case in countries such as Hungary, Jamaica, Kazakhstan, Latvia, and Lithuania, all of which have current account deficits in excess of 5 percent of GDP (figure 2.41). In Latvia, reserve holdings at end 2007 cover only 38 percent of principal and interest payments due in 2008.

Countries where the current account deficit is financed largely by FDI inflows (rather than debt-creating capital flows) are less vulnerable to external financing difficulties. By and large, FDI inflows have tended to provide a more stable source of external financing than private debt and portfolio equity flows, especially in times of turbulence (World Bank 2003, box 2.4; World Bank 2004, pp. 86–87). This is of particular importance in Bulgaria, Kazakhstan, Lebanon, Pakistan, Poland, Turkey, and Ukraine, where the value of FDI inflows is estimated to have covered their entire current account deficit in 2007 (figure 2.42). However, FDI outflows have risen significantly in some of these countries (namely, Hungary, Poland, and South Africa), reducing the amount of external financing provided by FDI when inflows are netted against outflows. In the case of South Africa, FDI outflows are estimated to be roughly equivalent to FDI inflows in 2007, providing no net external financing.

A surge in private debt inflows to the banking sector in some countries has fueled rapid credit growth and intensified inflationary pressures over the past few years (World Bank 2007, p. 115). The pace of borrowing has declined in most countries since the turmoil began in mid-2007, but remains high relative to previous years. In particular, Kazakh banks borrowed $2 billion (1.7 percent of GDP) between October 2007 and April 2008, down from $13 billion (12.2 percent of GDP) during the same period the previous year and below the $5.5 billion (6.7 percent of GDP) borrowed the year before that (figure 2.42). Russian banks borrowed $10.6 billion between July 2007 and February 2008, down from $19 billion during the same period the previous year but just slightly below the $11 billion borrowed the year before that (figure 2.43). Banks in Russia, Kazakhstan, and Ukraine did very little borrowing in January and February 2008, giving the impression of a credit squeeze. However, banks in other countries have continued to access syndicated bank loans and issue bonds in the international market. Banks in Latvia, for example, received syndicated bank loan commitments totaling $0.5 billion in January and February 2008,

Figure 2.43 Cross-border bank loan commitments to and bond issuance by the banking sector as a share of GDP in 8 countries, July 2005 – February 2008



Sources: Dealogic DCM Analytics and Loan Analytics.

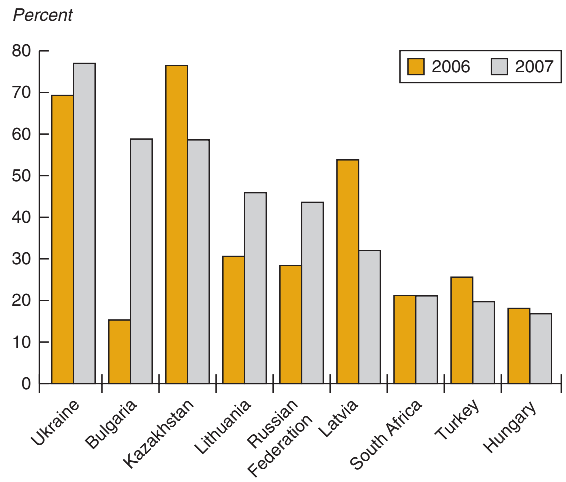
following $2 billion in borrowing over the entire year 2007 (an amount equal to over 60 percent of the country's GDP). Banks in Hungary borrowed a total of $1.7 billion in January and February 2008, following $2.7 billion in total borrowing in 2007.

It is important to recognize that monthly data on syndicated bank loan commitments do not include lending by parent banks to subsidiaries operating abroad; such lending has played a prominent role in the surge in bank lending to the countries discussed above.[20] Moreover, monthly fluctuations in syndicated loan commitments and bond issuance are quite volatile, making it difficult to ascertain whether recent events mark the beginning of a protracted downturn in the credit cycle or whether borrowers and lenders are waiting for financial conditions to settle.

The pace of domestic credit growth has declined somewhat in some countries (Kazakhstan, Latvia, and Turkey) but has picked up in others (Bulgaria, Lithuania, Russia, and Ukraine) (figure 2.44). Inflation has increased significantly in most developing countries, mainly because of a sharp rise in commodity and food prices (see chapter 1). Inflation has risen above 10 percent in most of the countries experiencing rapid credit growth, namely, Bulgaria, Kazakhstan, Latvia, Lithuania, Russia, and Ukraine (figure 2.45).

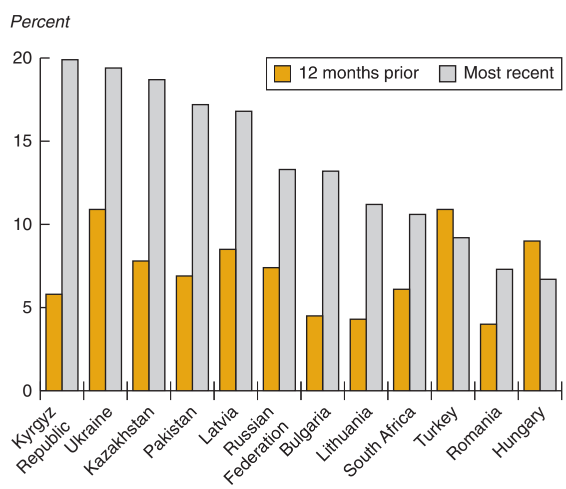
The rally in emerging-market equity prices since 2002 raised concerns that asset prices were overvalued in some countries, raising the risk of a sharp correction. Equity prices have declined significantly from their peak in October 2007, notably in China and Turkey (a drop of almost 30 percent as of early May 2008). However, in most cases the recent correction brings equity prices back to levels attained in mid-2007 before the turmoil. Despite the correction, equity prices in 40 of 43 developing countries recorded overall gains between January 2007 and April 2008, compared with just 15 of

Figure 2.44 Domestic credit growth in 9 countries, 2006–07



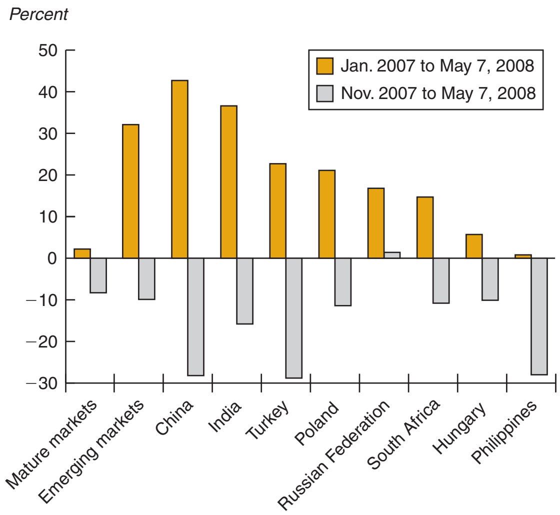
Source: IMF International Financial Statistics.

Figure 2.45 Inflation in 12 countries



Sources: IMF International Financial Statistics; World Bank staff.
Note: 12-month change in the consumer price index

Figure 2.46 Equity market returns in 8 countries, January 2007 – early May 2008



Sources: Morgan Stanley; Standard & Poor's.

23 high-income countries (figure 2.46). Equity prices have increased more than threefold in 17 developing countries over the past five years. This increase reflects several factors, including improved fundamentals in many cases, but concerns remain that some countries need a further correction.

So far the impact of the turmoil in financial markets on the more vulnerable countries has been mixed. Sovereign bond spreads widened by more than 200 basis points in Lebanon, South Africa, and Ukraine between early June 2007 and the end of March 2008, compared with 165 basis points for the EMBI Global composite index, but spreads have been less affected for other vulnerable countries, notably Poland (60 basis points) and Hungary (55 basis points). Few currencies have come under pressure, with the exception of the South African rand, which depreciated by 14 percent against the U.S. dollar (and almost 30 percent against the euro) between January and March 2008. Equity prices have declined sharply in countries with large current account deficits (notably South Africa and Turkey), but also in countries with sizable surpluses (China and the Philippines).

Vulnerable countries can help alleviate the risk of a hard landing by implementing close surveillance of potential exposures in their banking systems and by managing demand pressures using monetary and fiscal policy measures with a strong focus on medium-term objectives.

Annex 2A

Table 2A.1 List of countries in emerging- and frontier-market indexes

$ dollars

Income/country	GNI per capita in 2006	Emerging markets				Frontier markets	
		IIF	MSCI	S&P/IFC Investable	S&P/IFC Noninvestable	MSCI	S&P/IFC
High income (> $11,116)							
Kuwait	..	0	0	0	1	1	0
United Arab Emirates	..	0	0	0	1	1	0
Israel	..	0	1	1	0	0	0
Qatar	..	0	0	0	1	1	0
Slovenia	18,890	0	0	0	0	1	1
Bahrain	..	0	0	0	1	1	0
Korea, Rep. of	17,690	1	1	1	0	0	0
Taiwan, China	17,230	0	1	1	0	0	0
Saudi Arabia	..	0	0	0	1	0	0
Trinidad and Tobago	13,340	0	0	0	0	0	1
Czech Republic	12,680	1	1	1	0	0	0
Estonia	11,410	0	0	0	0	1	1
Number of countries in index		**2**	**3**	**3**	**3**	**4**	**3**
Upper-middle income ($3,956 < $11,115)							
Oman	..	0	0	0	1	1	0
Hungary	10,950	1	1	1	0	0	0
Slovak Republic	9,870	1	0	0	0	0	1
Croatia	9,330	0	0	0	0	1	1
Poland	8,190	1	1	1	0	0	0
Latvia	8,100	0	0	0	0	0	1
Mexico	7,870	1	1	1	0	0	0
Lithuania	7,870	0	0	0	0	0	1
Chile	6,980	1	1	1	0	0	0
Venezuela, R. B. de	6,070	1	0	0	1	0	0
Botswana	5,900	0	0	0	0	0	1
Russian Federation	5,780	1	1	1	0	0	0
Malaysia	5,490	1	1	1	0	0	0
Lebanon	5,490	0	0	0	0	1	1
Mauritius	5,450	0	0	0	0	1	1
Turkey	5,400	1	1	1	0	0	0
South Africa	5,390	1	1	1	0	0	0
Uruguay	5,310	1	0	0	0	0	0
Argentina	5,150	1	1	1	0	0	0
Romania	4,850	1	0	0	0	1	1
Brazil	4,730	1	1	1	0	0	0
Bulgaria	3,990	1	0	0	0	1	1
Number of countries in index		**15**	**10**	**10**	**1**	**5**	**9**

(continued)

Table 2A.1 List of countries in emerging- and frontier-market indexes *(continued)*

$ dollars

Income/country	GNI per capita in 2006	Emerging markets				Frontier markets	
		IIF	MSCI	S&P/IFC Investable	S&P/IFC Noninvestable	MSCI	S&P/IFC
Lower-middle income ($906 < $3,955)							
Kazakhstan	3,790	0	0	0	0	1	0
Jamaica	3,480	0	0	0	0	0	1
Namibia	3,230	0	0	0	0	0	1
Algeria	3,030	1	0	0	0	0	0
Thailand	2,990	1	1	1	0	0	0
Tunisia	2,970	1	0	0	0	1	1
Peru	2,920	1	1	1	0	0	0
Ecuador	2,840	1	0	0	0	0	1
Colombia	2,740	1	1	0	1	0	0
Jordan	2,660	0	1	0	1	0	0
China	2,010	1	1	1	0	0	0
Ukraine	1,950	1	0	0	0	1	1
Morocco	1,900	1	1	0	1	0	0
Indonesia	1,420	1	1	1	0	0	0
Philippines	1,420	1	1	1	0	0	0
Egypt, Arab Rep. of	1,350	1	1	1	0	0	0
Sri Lanka	1,300	0	0	0	1	1	0
Number of countries in index		**12**	**9**	**6**	**4**	**4**	**5**
Low income (< $906)							
Côte d'Ivoire	870	0	0	0	0	0	1
India	820	1	1	1	0	0	0
Pakistan	770	0	1	0	1	0	0
Vietnam	690	0	0	0	0	1	1
Nigeria	640	0	0	0	1	1	0
Kenya	580	0	0	0	0	1	1
Ghana	520	0	0	0	0	0	1
Bangladesh	480	0	0	0	0	0	1
Number of countries in index		**1**	**2**	**1**	**3**	**3**	**4**

Source: World Development Indicators.
Note: .. = ; IIF = International Institute of Finance; MSCI = Morgan Stanley Capital Internation—Barra; S&P/IFC = Standard & Poor's/International Finance Corporation.

Annex 2B: Econometric analysis of aid selectivity

Regression analysis was used to gauge the extent to which donors allocated aid to countries on the basis of equity and performance criteria. This entailed estimating equations of the form:

$$\text{aid}_i = \beta_0 + \beta_1\text{equity}_i + \beta_2\text{SSA} + \beta_3\text{performance}_i + \varepsilon_i,$$

where aid = net ODA disbursements as a percent of GDP; equity = GDP per capita (in log form); SSA = dummy variable (1 for countries in Sub-Saharan Africa, 0 otherwise); performance = average value of six World Bank Worldwide Governance Indicators (WGI); and ε_i = random error term.

The estimates reported below indicate that equity (GDP per capita) played a significant role in donors' allocation of aid in 2006 (β_1 is statistically significant in regressions 1 to 4). Regression 1 indicates that donors allocated aid to countries in Sub-Saharan Africa much the same as they did to other countries (β_2 is statistically insignificant). However, the SSA dummy variable becomes significant when two outliers are excluded from the analysis (regression 2).

Three alternative measures were used as indictors of performance: the average value of the six Worldwide Governance Indicators, the IDA Resource Allocation Index (IRAI) and International Country Risk Guide (ICRG) composite index. Only the WGI average was found to be statistically significant (regressions 3 and 4). The main component indexes of the WGI, IRAI, and ICRG were not significant either. These inferences partly reflect the fact that the IRAI and ICRG have more limited country coverage than the WGI (the IRAI and ICRG are available only for 72 and 92 countries respectively, compared with 124 for the WGI). None of the explanatory variables were found to have a significant influence on donors' allocation of ODA on a per capita basis (not reported). The year-over-year change in the WGI was found to be positively correlated with ODA allocations but was insignificant as well.

Regression 3 was estimated for each of the years 2002–06 separately and pooled (with fixed effects). The results (reported below) indicate that the influence of GDP per capita on donors' aid allocations (β_1) has steadily declined since 2003, as has donors' preference for allocating a higher portion of aid to countries in Sub-Saharan Africa (β_2) and to countries with higher performance ratings (β_3).

Table 2B.1 Estimates obtained for 2006

Regression	Dependent variable	β_1	β_2	β_3	R^2	Nobs
1	ODA / GDP	−4.78	1.49		0.423	127
		(0.76)	(2.00)			
		[0.00]	[0.46]			
2	ODA / GDP	−3.45	3.43		0.575	125
		(0.48)	(1.26)			
		[0.00]	[0.007]			
3	ODA / GDP	−4.56	2.95	2.98	0.633	124
		(0.54)	(1.20)	(0.72)		
		[0.00]	[0.016]	[0.00]		
4	ODA ex. debt relief / GDP	−4.44	2.00	3.00	0.613	124
		(0.51)	(1.12)	(0.68)		
		[0.00]	[0.077]	[0.00]		

Source: World Bank staff.
Note: Nobs = number of observations; ODA = official development assistance. Standard error of estimate is reported in parentheses; p-value, in square brackets. Regressions 2 to 4 exclude two outliers—Burundi and Solomon Islands, where ODA exceeds 50 percent of their GDP.

Table 2B.2 Estimates of regression 3, 2002–06

Regression 3	2002	2003	2004	2005	2006	2002–06
β_1	−5.56	−6.96	−6.21	−4.77	−4.56	−5.56
(SE)	(0.83)	(1.35)	(0.74)	(0.714)	(0.54)	(0.39)
[P-value]	[0.00]	[0.00]	[0.00]	[0.00]	[0.00]	[0.00]
β_2	4.71	4.51	3.74	3.53	2.95	3.93
(SE)	(1.73)	(2.81)	(1.57)	(1.53)	(1.20)	(0.83)
[P-value]	[0.008]	[0.11]	[0.02]	[0.02]	[0.016]	[0.00]
β_3	4.25	3.43	5.04	2.69	2.98	3.60
(SE)	(1.18)	(1.91)	(1.05)	(0.95)	(0.72)	(0.54)
[P-value]	[0.00]	[0.075]	[0.00]	[0.005]	[0.00]	[0.00]
R^2	0.52	0.40	0.61	0.54	0.63	0.49

Source: World Bank staff.

Annex 2C: Commercial Debt Restructuring

Developments between April 2007 and April 2008

Developing countries continued their proactive liability management exercises during the past year. Between April 2007 and April 2008, seven countries carried out buyback operations to retire about $4 billion of its outstanding external debt. Of these, Peru and the Philippines bought back about $964 million of Brady bonds by exercising the embedded call option to eliminate nearly all of their outstanding Brady debt, joining Brazil, Colombia, Mexico, and República Bolivariana de Venezuela as countries that have retired all of their Brady bonds. Other bond markets also saw major buyback activities as part of the developing countries' general liability management strategy to clean up external debt and rebalance debt profile. It is also notable that Mexico and the Philippines issued debt-exchange warrants, which have been used successfully to replace external debt with domestic debt. Finally, although it is not discussed in this review, Brazil has reportedly redeemed about $480 million of global bonds during the year. (Detailed information on Brazil's transactions is currently not available.)

Debt buyback operations in developing countries

Colombia. In June 2007, the Colombian government agreed to buy back around $850 million, at face value, of its dollar-denominated global bonds due 2008, 2009, 2010, and 2011. The transaction reflects the country's long-term liability management strategy to reduce its dollar-denominated debt and its currency. The buyback operation was financed by the issue of a new $1 billion peso-denominated global bond due in 2027. The new issue priced at par to yield 9.85 percent, which was rated Ba2 by Moody's Investor Service and BB+ by Standard & Poor's. The government also agreed to retire 50 percent of the global peso-denominated TES bonds due 2010 and 25 percent of the floating-rate notes due 2013.

Mexico. In March 2008, Mexico carried out a debt-management operation to retire about $714 million of its dollar-denominated global bonds (with 10 different maturities) between 2009 and 2034 through an open-market purchase. According to the finance ministry, the buyback was to be financed by local bond issues and loans from international institutions. This transaction reflects the Mexican government's strategy to improve the terms and conditions of its external debt and to strengthen its benchmark global bonds. In April 2008, the government announced the issuance of a debt-exchange warrant, Mexico's fourth offering since launching the first one in November 2005. This warrant entitles holders to exchange about $1.25 billion of various foreign currency bonds for a combination of peso-denominated and inflation-linked bonds.

Nicaragua. In December 2007, the government of Nicaragua reached an agreement with creditors to a cash buyback of more than $1.3 billion of the country's commercial external debt, out of total eligible claims of $1.4 billion. The agreement was reached with the support of a grant of up to $62 million from the World Bank's Debt Reduction Facility (DRF) and with contributions from various northern European countries, Russia, and the United Kingdom. The first closing of the operation was scheduled to take place in mid-December, and the second closing was expected in the first quarter of 2008. The Ministry of Finance and Public Credit said in a statement that the $1.3 billion accepted for buyback was tendered by Nicaragua at a price of 4.5 percent of the debt's current face value, with the participation of more than 99 percent of creditors (including investors who had won judgments in foreign courts). As a result, the government said in the statement that the country's external debt is expected to fall to 57 percent of GDP in 2007 from 130 percent in 2003.

Peru. The Peruvian government bought back about $838 million of Brady bonds (FLIRB, PDI, and discounts) at the redemption price of 70 percent of the par amount in March 2008, retiring nearly all of Peru's remaining Brady debt. According to the government, the buyback will be financed with cash from the Treasury and a future sale of local currency bonds. In December 2007, the government had already approved a local issue of bonds for the equivalent of $485.8 million in one or more tranches. This debt management operation is in line with the government strategy to restructure its foreign debt by extending maturities and replacing it with sol-denominated debt. In February 2007, the government carried out a liability management operation that swapped and bought back about $2.5 billion of outstanding Brady bonds (FLIRB, PDI, Pars, and discounts) and Global 12s for new securities and cash.

The Philippines. In May 2007, the Philippine government exercised a call option to buy back $126 million of Principal Collateralized Interest Reduction Bonds due in 2018, fully redeeming its Brady bonds issued in 1992 as part of a debt restructuring program. The buyback operation will enable the government to realize about $12.6 million in debt-service savings and to free up $82.3 million in collateral. This transaction marked the third time that the government used an early redemption provision provided under the Brady bonds. In 2006, the sovereign undertook two buyback operations to redeem about $701 million of Brady bonds ($410 million in June and $165 million in December). In February 2008, the Philippines announced it would issue as many as $2 billion of debt-exchange warrants to holders of its foreign currency bonds. The warrants will allow investors to exchange the dollar- and euro-denominated bonds due 2017 with 10-year treasury bonds (with a yield of 5.875 percent) due 2018, in the event of a default.

Poland. In March 2008, the Polish government undertook a buyback operation to retire $125.5 million of its Brady bonds through the secondary market at below par value. This operation redeemed $104.1 million of RSTA bonds and $21.4 million of par bonds. After the buyback, the country's remaining Brady debt stands at $420 million, down from the original $8 billion in 1994. The transaction reflects the commitment of the Polish government to repay old obligations created by the conversion of debt to the London Club.

Uruguay. In December 2007, the government of Uruguay successfully completed its latest debt management exercise, retiring a total of $240 million in global and local bonds maturing in or before 2012. Through the transaction, Uruguay bought back $116 million in global bonds, including $91 million from seven sets of dollar bonds due between 2008 and 2012, and $25 million from two sets of euro-denominated bonds maturing in 2011 and 2012. The government also repurchased $124 million from 17 sets of local bonds denominated in dollars and others in pesos, which are linked to the Uruguayan inflation rate. The transaction was part of Uruguay's strategy to reduce its foreign currency debt and to improve its debt profile by rebalancing from dollars to local currency.

Annex 2D: Debt Restructuring with Official Creditors

This annex lists official debt restructuring agreements concluded in 2007. Restructuring of intergovernmental loans and officially guaranteed private export credits takes place under the aegis of the Paris Club. These agreements are concluded between the debtor government and representatives of creditor countries. Paris Club treatments are defined individually with the consensus of all creditor countries. Most treatments fall under predefined categories, listed below by increased degree of concessionality: "Classic terms," the standard treatment; "Houston terms" for highly indebted lower-middle-income countries; "Naples terms" for highly indebted poor countries; and "Cologne terms" for countries eligible for the HIPC Initiative. To make the terms effective, debtor countries must sign a bilateral implementing agreement with each creditor.

Agreements with countries

Sierra Leone. In January 2007, the Paris Club creditors agreed on a 91 percent debt reduction for Sierra Leone, who had reached the completion point under the enhanced HIPC Initiative on December 15, 2006. Of the $240 million due to the Paris Club creditors as of December 2006, roughly $218 million was cancelled because of the Paris Club's share in the enhanced HIPC Initiative effort, and additional debt relief of $22 million was granted on a bilateral basis. As a result of the agreement and the additional bilateral assistance, Sierra Leone's debt to the Paris Club will be completely cancelled.

FYR Macedonia. On January 24, 2007, the Paris Club creditors agreed to FYR Macedonia's offer to prepay up to $104 million of it debt at par. The buyout operations are to be carried out, on a voluntary basis, between January 31, 2007, and April 30, 2007, we don't after conclusions of bilateral agreement by participating Paris Club members. This prepayment offer translates into interest savings for FYR Macedonia, and it improves the credit quality of the country.

Central African Republic. In April 2007, the government of the Central African Republic reached an agreement with the Paris Club creditors to restructure $36 million of its external public debt. This decision followed the IMF's approval (on December 22, 2006) of the country's contract under the Poverty Reduction and Growth Facility (PRGF) and the examination by the IMF and the World Bank (IDA) of the preliminary document under the enhanced HIPC Initiative in March 2007. The agreement with the Paris Club reschedules roughly $28.4 million in arrears and maturities falling due during the consolidation period (between December 1, 2006 and November 30, 2009) under the "Naples terms." Loans made as official development assistance (ODA) before the cutoff date are to be repaid progressively over 40 years, with 16 years of grace, at an interest rate equal to or greater than the rate of the original loans. For non-ODA commercial credits, the pre-cutoff debts are cancelled by 67 percent, and the remaining payments will be rescheduled over 23 years, with a 6-year grace period.

Peru. In May 2007, the Paris Club creditors agreed on Peru's offer to prepay up to $2.5 billion of its non-ODA debt falling due between 2007 and 2015. Under the agreement, the principal of a prepayment would be made at par and offered to all creditors. For the participating Paris Club members, the prepayment will be made on October 1, 2007, after the bilateral implementation agreements are concluded. The Peruvian government is expected to finance the Paris Club payment with the issuance of debt in the domestic market.

São Tomé and Principe. On May 24, 2007, the Paris Club creditors agreed to a significant debt reduction for *São Tomé and Principe*, who reached the completion point under the enhanced HIPC Initiative in March 2007. To restore the country's debt sustainability, the Paris Club decided to cancel the debt valued at $23.9 million in nominal terms. As a result, the debt owed to Paris Club creditors would be reduced to $0.6 million in nominal terms. Creditors also committed on a bilateral basis to grant additional debt relief so that the country's debt will be fully cancelled.

Gabon. In July 2007, The Paris Club creditors agreed in principle to accept Gabon's buyback of its non-ODA debt at market value. According to the Paris Club, the face value of eligible debt for early repayment amounts to roughly $2.33 billion (as of July 1, 2007), which was previously rescheduled in 1994, 1995, 2000, and 2004, and falls due up to 2019. Several of Gabon's Paris Club creditors will likely participate in the early repayment operation, although it will be up to each country to decide. This debt buyback operation is in line with the Gabon government's reform policy to reduce its exposure to potential external shocks. This policy also led to a 3-year IMF Stand-By Arrangement that was approved in May 2007.

Jordan. In October 2007, the Paris Club creditors agreed to Jordan's offer to prepay up to $2.5 billion of its non-ODA debt, which had been previously rescheduled by the Paris Club in 1994, 1997, 1999, and 2002. For the participating Paris Club members, this early repayment operation is scheduled to take place between January 1 and March 31, 2008, after conclusion of bilateral implementation agreements. It is expected that around $2.1 billion in debt will be retired at a discount averaging 11 percent, for a total of $1.9 billion. The prepayment is to be largely financed by privatization proceeds, which stood at $1.1 billion as of August 2007.

Notes

1. This report uses the convention of analyzing net equity inflows from the perspective of equity claims by foreigners on the country receiving the investment (the net change in domestic liabilities in the balance of payments). This definition does not include net equity *outflows* associated with the net change in equity claims by domestic residents on other countries (the net change in domestic assets in the balance of payments), which is the convention used by other organizations such as the Institute of International Finance (2008) and the IMF (2008c).

2. Private debt refers to bonds and loans intermediated through private financial markets. Creditors include both private and public institutions (notably public pension funds, government sponsored agencies, and sovereign wealth funds). In contrast, official debt refers to loans from multilateral organizations (such as the World Bank, regional development banks, and other multilateral and intergovernmental agencies), and bilateral loans from governments.

3. The data, however, cover only about half of reserves held by developing countries and newly industrializing economies, down from 60 percent in the mid-1990s.

4. Based on estimates reported by Farrell and others (2007), Hildebrand (2007), Truman (2007), Griffith-Jones and Ocampo (2008), Global Insight (2008), and IMF (2008b).

5. In the case of Brazil, a syndicated bank loan to the telecom company Tele Norte Leste Participacoes accounted for $6.5 billion of the $6.9 billion total. In the case of Mexico, a syndicated bank loan for an infrastructure project (highway development) accounted for $3.4 billion of the $3.9 billion total.

6. Exceptions include the following. Papua New Guinea issued a seven-year, $20 million sovereign bond (private placement) in 1984. The Republic of Congo issued a five-year, $600 million sovereign Eurobond in 1994.

7. This calculation is based on the Dealogic Loan Analytics database. "First-time" bond issuance is defined as a situation in which a government or corporation issues a bond in the international market after 1989 in a country that had no external bond issues during the 1980s.

8. "Cross-border" IPOs refer to issues that can be purchased by nonresidents. The values reported in table 2.10, however, refer to the total value of the IPOs, not just the portion purchased by nonresidents. Moreover, nonresident purchases that exceed 10 percent of the issuing company's capitalization are classified as an FDI inflow.

9. The London Club of creditors, an informal group of commercial banks that join together to negotiate their claims against sovereign debtors, received $1.5 billion of this amount.

10. The buyback transactions between Gabon and its Paris Club creditors took place in December 2007 and January 2008, while Jordan's buyback transactions took place between January and March 2008.

11. See the literature survey in Claessens, Cassimon, and Van Campenhout (2007) and the references therein.

12. Non-DAC donors are 15 countries that are not members of the DAC but that nevertheless report their aid activities to the DAC. They have not yet reported their ODA disbursements for 2007.

13. Based on public and publicly guaranteed loan commitments using the same concessionality criteria as that used by the OECD DAC to define ODA (loans a grant element of at least 25 percent calculated with a 10 percent discount factor).

14. São Tomé and Principe reached its completion point under the enhanced HIPC Initiative in May 2007, followed by The Gambia in December 2007, bringing the number of HIPCs that have reached their completion points to 23.

15. Remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers; for definitions and to access the entire data set, see www.worldbank.org/prospects/migrationandremittances.

16. Remittances to Mexico grew only by 1 percent from January to December 2007, compared with an annual growth of over 20 percent from 2002 through 2006.

17. Recent mark-to-market losses of around $700 billion greatly exceed estimates of default loses ($422 billion) calculated by the OECD (2008), suggesting that the size of

the actual write-downs could turn out to be much lower than implied by current asset prices.

18. Based on the Leveraged Loan Index reported by Standard & Poor's and the Loan Syndications and Trading Association (S&P/LSTA).

19. Greenlaw and others (2008) estimate that mortgage losses could prompt banks and other lenders to reduce their total assets by $2 trillion.

20. In 2006, bank loan disbursements to the Europe and Central Asia region totaled $260 billion (according to the World Bank Debtor Reporting System), while syndicated loan commitments totaled only $97 billion (according to Dealogic Loan Analytics). The $163 billion difference results largely from lending by parent banks and from subsidiaries operating abroad, categories that are included in the data collected by the DRS but not in that collected by Dealogic Loan Analytics.

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