Overview

THE WORLD ECONOMY HAS ENdured a period of financial turmoil and slowing growth since mid-2007. As these events have unfolded, financing conditions facing developing countries have shifted from the benign environment of 2002–06 to the current state of heightened market volatility and tight credit conditions. With these tensions setting the stage, 2008 is shaping up to be a challenging year for development finance.

Strong fundamentals underpinned most developing countries' initial resilience to deteriorating economic and financial conditions. As of mid-2007, total developing-country foreign exchange reserves amounted to $3.2 trillion (23.6 percent of their combined GDP, with the top five countries accounting for 68 percent of the total figure), many countries were posting strong economic growth, emerging equity markets were rallying (outperforming mature markets by a wide margin for the fourth consecutive year), and spreads on emerging-market sovereign bonds had reached record low levels. The balance of risks, however, has now plainly tilted to the downside. Various indicators signal that economic growth in the United States and Europe is slowing more than previously expected. Across the developing world, inflationary pressures, stemming from dramatic increases in energy and food prices in many cases, complicate the role that monetary and fiscal policy can play in maintaining macroeconomic stability over the medium term. Meanwhile, as financial services have become increasingly globalized, the reconciliation of national autonomy with the demands of international banking has become more difficult.

The international financial community has a complex burden to shoulder in ensuring that the turmoil does not undermine long-term global growth and stability. In mature markets, governments have responded with a series of unprecedented policy measures aimed at preserving orderly conditions in certain financial market segments and instilling confidence in the financial system as a whole. Yet developing and high-income countries alike face the challenge of balancing short-term and long-term policy goals. Striking the appropriate balance will vary from country to country, but in general policy makers need to recognize the limitations of activist measures. Countries that undertake prudent fiscal planning and use monetary policy instruments to effectively maintain price stability will be better placed to sustain growth over the long term.

Global growth is slowing

The slowdown in high-income countries has become more apparent since the end of 2007. GDP growth in the United States is expected to decline from 2.2 percent in 2007 to 1.1 percent in 2008, significantly weaker than the World Bank's December 2007 projection of 1.9 percent. Although to a lesser extent, growth projections for Japan and the Euro Area for 2008 have also been revised downward, to 1.4 percent and 1.7 percent, respectively. The incipient downshift in high-income countries is expected to be relatively short lived, however—growth rates are expected to pick up in 2009 and to fully recover by 2010.

Growth in developing countries will also decline in 2008. Working together, factors including the slowdown in high-income countries, financial market turmoil, and overheating in several developing countries are expected to curtail growth in developing countries as a whole from 7.8 percent in 2007 to 6.5 percent in 2008, considerably below the projection of 7.1 percent made in December 2007. The deceleration is expected to be broadly based across most developing regions, with the largest declines in East Asia and the Pacific (1.9 percentage points) and Latin America and the Caribbean (1.2 percentage points). The decline in the East Asia and Pacific region will be concentrated in China, where growth is expected to fall by 2.5 percentage points. Growth in Sub-Saharan Africa, in contrast, is expected to pick up moderately in 2008, reaching 6.3 percent, the highest rate in 38 years, but then decline to 5.9 percent by 2010, a rate slightly above the average over the past five years. In general, the slowdown in developing countries is expected to be more moderate but longer lasting than that in developed countries, reflecting an adjustment to a more sustainable growth rate. Despite the adjustment, the projected developing-country growth rate of 6.4 percent in 2009–10 is above the average over the first half of this decade (5.6 percent) and well above the average of the 1980s and 1990s (3.4 percent), illustrating the acceleration of the underlying growth potential.

The striking rise in goods and services trade between developing and high-income countries and among developing countries (South-South trade) over the past few years and the increase in flows of labor and capital across borders imply that economic and financial links are now stronger than ever. These tighter links will tend to accentuate the transmission of cyclical fluctuations across countries, in contradistinction to the notion that the business cycle in developing countries has become decoupled from that in high-income countries. Although developing and developed countries have become more closely integrated, trend growth rates in developing countries will continue to be significantly higher, indicating that underlying structural factors are playing an important role in overall economic performance. While the current slowdown in high-income countries is expected to curb the cyclical element of growth in developing countries, it is unlikely to affect the underlying trend component, implying that improved policies, higher investments, and technological progress in developing countries will support robust growth over the longer term.

Tighter financing conditions are curbing private capital flows

Net private capital flows to developing countries increased by $269 billion in 2007, reaching a record $1 trillion. This marks five consecutive years of strong gains in both private debt and equity components. Net bank lending and bond flows have increased from virtually zero in 2002 to 3 percent of developing countries' GDP in 2007, while net foreign direct and portfolio equity flows have increased from 2.7 percent of GDP to 4.5 percent. The regional composition of private debt and equity flows became more broadly based in 2007, as shares shifted away from the East Asia and Pacific and Europe and Central Asia regions toward Latin America and the Caribbean and South Asia. Gains were especially strong in Latin America and the Caribbean, where the share of total private debt and equity doubled from 10 to 20 percent, while the share going to Europe and Central Asia declined from 48 to 40 percent.

Although financial institutions in developing countries are believed to have little direct exposure to U.S. subprime mortgage securities or related assets, large write-downs on mortgages and other assets incurred by major banks and securities firms that operate worldwide have forced these institutions to reduce lending activity in order to restore their balance sheets. The manner in which such credit retrenchment will affect the financing of corporate borrowers in developing countries depends on the nature of international credit intermediation—cross-border versus locally funded credit, foreign banks' internal capital market operations, and the maturity structure of credit extended. Both experience and research indicate that home-country conditions matter for foreign banks' credit supply behavior and reaction to financial shocks.

The practical impacts of ongoing credit turmoil in mature markets have been particularly visible in markets for emerging-market corporate borrowers, who have seen their access to syndicated bank lending affected in terms of cost and volume of deals transacted. Currently available evidence indicates that both the number of loans signed and the total deal value declined in the fourth quarter of 2007 and the first quarter of 2008.

Developing countries have become more vulnerable to external shocks

Most developing countries were on a strong footing when economic and financial conditions began to deteriorate in mid-2007, although the external financial position of many countries has weakened in the interim. Current account balances, for example, have worsened in two-thirds of developing countries. (China and major oil exporters such as Algeria, the Islamic Republic of Iran, Nigeria, República Bolivariana de Venezuela, and the Russian Federation are exceptions; their current account balances improved significantly in 2007.) Half of developing countries ran current account deficits in excess of 5 percent of GDP in 2007. But alongside this trend, developing countries have continued to cumulate foreign exchange reserves, providing a substantial buffer should they encounter trouble meeting their external financing needs. Foreign exchange reserve holdings by developing countries increased from 100 percent of the value of their short-term debt in 2000 to almost 320 percent in 2007. Three-quarters of the increase, however, was held by the BRICs (Brazil, Russia, India, and China).

Separately, the dramatic rise in global food and other commodity prices has worsened the external position of some developing countries over the past few years. For example, in Lesotho, an extreme case, commodity price increases worsened the trade balance by an estimated $550 million over 2003–07 as the country's current account deficit widened from 12.6 to 27.4 percent of GDP. Lesotho received only $315 million in foreign aid over 2002–06, enough to cover slightly more than half of the external financing gap caused by the rise in commodity prices. However, most other developing countries have seen higher food import costs offset by increased export earnings from other commodities, such as metals or oil.

The deterioration in external positions over the past year has left many developing countries more vulnerable to external shocks. Countries with heavy external financing needs are most vulnerable, particularly in cases where private debt inflows into the banking sector have fueled rapid expansion in domestic credit and raised inflationary pressures. The surge in energy and food prices has intensified such pressures, making a timely monetary policy response all the more important for maintaining macroeconomic stability and protecting the hard-fought-for gains in credibility achieved over the past several years. Moreover, the sharp rise in oil prices over the past six months may threaten growth in a way that the increases between 2003 and 2006 did not. These earlier increases occurred in a context of strong growth, low and stable inflation, and healthy current account positions that facilitated developing countries' absorption of the oil price rise. With inflation intensifying, growth slowing, and current account deficits worsening in many developing countries, the recent hikes may adversely affect growth and domestic demand more strongly than currently projected.

Soaring food and energy prices pose daunting challenges

Prices of food staples have soared more than 100 percent since 2005 in nominal dollar terms, though the rise is much less when domestic inflation and exchange rates in developing countries are considered. Nevertheless, the increase in food prices is a cause for great concern. The real price of rice hit a 19-year high in March 2008; almost simultaneously, the real price of wheat reached a 28-year high that was almost twice the average price over the past 25 years. In some countries, escalating food and energy prices have more than offset the benefits of robust economic growth, reducing the purchasing power of the poorest people, many of whom have no margin for survival. These increases have serious implications for developing countries' abilities to reduce poverty and make progress on the other Millennium Development Goals. Countries hardest hit are in dire need of foreign aid. Donors, however, have made slow progress in scaling up development assistance in recent years.

Even though more low-income countries have accessed the international bond market in recent years (Ghana, Mongolia, Nigeria, and Vietnam have all issued first-time external bonds since 2005), most private capital flows to developing countries go to just a few large economies. Low-income developing countries still depend heavily on grants and concessionary loans 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. Although these countries are less vulnerable than other developing countries to an abrupt downturn in the credit cycle, many of them are battling a much more fundamental challenge: the dramatic rise in food and energy prices.

At the United Nations Conference on Financing for Development in Monterrey in 2002, participants agreed to take steps to correct dramatic shortfalls in the resources required to achieve internationally agreed-upon development goals. The United Nations urged donor countries to make concrete efforts to increase ODA toward its target of 0.7 percent of their gross national income (GNI). Although debt relief continues to play an important role in the development agenda, especially for the poorest countries burdened by heavy debt service payments, donors pledged that debt relief would not displace other components of ODA. Five years on, little progress has been made. Net ODA disbursements by the 22 member countries of the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development totaled $103.7 billion in 2007, down from 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 2006. Excluding debt relief, ODA increased from 0.23 percent of the GNI of donor countries to 0.25 percent between 2002 and 2007, still well below the 0.33 percent attained in the early 1990s. Donors would have to increase ODA by an annual rate of more than 14 percent, three times that observed in the years since the Monterrey Consensus, over the balance of the decade just to meet existing commitments. Even with that rate of growth, ODA net of debt relief would be only 0.35 percent of GNI in DAC countries by 2010, half the U.N. target. This year will be a critical one for development finance as donors meet to address progress made and to reaffirm goals and commitments at the United Nations' Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus.

Internationalization of banking offers distinct economic benefits

While the current weakness in international banks' balance sheets will adversely affect some borrowers in developing countries, the positive implications of changes in the nature and character of international credit intermediation are likely to be more enduring. Foreign bank presence today constitutes an important structural feature of the banking industry in many developing countries, particularly countries in Europe and Central Asia, Latin America and the Caribbean, and Sub-Saharan Africa. Driven by technological advances, easing regulatory constraints, and global economic integration, foreign banks have dramatically increased their cross-border lending to, and investment in, developing countries. As a result, developing countries have reaped substantial gains through the increased availability of finance to credit-constrained firms and households, the provision of sophisticated financial services, and incentives for improved efficiency as domestic banks compete with foreign entrants. Such benefits, which can make critical contributions to growth and development, deserve to be protected.

The process, however, needs to be carefully managed because the presence of international banks also presents some potential risks. First, as has been seen recently, international banks can transmit adverse financial shocks around the globe: pressure on major banks' capital positions, deteriorating liquidity positions in interbank markets, and tightening of credit standards can lead international banks to sharply reduce credit to developing countries. Second, the ability of foreign-owned banks to raise funding from their parent banks abroad can fuel a domestic credit boom, potentially offsetting efforts by central banks to contain domestic inflationary pressures or restrict capital inflows. Efforts to reap the benefits of foreign bank presence while controlling risks could focus on vetting the soundness of entering banks, in part by soliciting information from home-country financial authorities and by ensuring effective coordination between host- and home-country supervisors.

Current challenges require an enlightened international policy response

Rarely has the international community been called upon to respond to so many complex policy challenges at once—from immediate actions to address soaring global food and energy prices and the taming of volatility in private global finance to the needs for mitigating the effects of high-income-country slowdown and sustaining economic momentum without jeopardizing long-term growth and stability. Tackling such challenges requires collective resolve and clear thinking. It is crucial that developing-country policy makers renew their commitment to the sound policies of the recent past while recognizing the implications of changes in the financial climate currently under way. Priorities should include sustaining the structural changes and institution-building efforts that have allowed developing countries' continued integration into global capital markets, strengthening regulation and supervision aimed at limiting currency and maturity mismatches, and in countries that hold a large share of their foreign debt in short-term instruments, intensifying efforts to monitor foreign borrowing by banks and risk management strategies by corporations with access to external debt markets.

Recent events in financial markets have illustrated once again that policy coordination among the world's major central banks is necessary at times of stress to prevent global instability. To date, coordination has mainly taken the form of joint liquidity provision, and that has been critically successful in preventing a liquidity squeeze in global interbank markets developing into broader systemic risk. Given the extent of cross-border exposures, coordination of financial regulation is also necessary in the current environment, as inadequate regulation in one country can have major repercussions in others. In this context, recent recommendations by the Financial Stability Forum to raise capital requirements for certain structured credit products, to increase oversight of banks' risk management practices, and to improve credit rating agencies' safeguards against conflicts of interest are welcome. As for interest-rate policy, synchronized moves among central banks are limited because of the nature of the current global payment imbalances, which dictate differentiated policy responses and approaches.

Helping developing countries adjust to soaring food prices represents a major policy challenge and the most critical in terms of its impact on the poor. In the short term, donors are urged to augment financing to the United Nations World Food Programme to help address this emergency in a timely manner. In addition, providing more aid in the form of budgetary support would enable developing countries to extend safety net programs, such as targeted cash transfers, to the most vulnerable groups and to expand risk management instruments to protect the poor. Over the longer term, assistance aimed at developing domestic agricultural sectors would help alleviate the impact of high food prices on the poor and would promote sustainable employment and growth.

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