

Global Development Finance

Charting a Global Recovery

I: Review, Analysis, and Outlook

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I: REVIEW, ANALYSIS, AND OUTLOOK

2009



THE WORLD BANK

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1 2 3 4 12 11 10 09

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Cover art: Charles Arnoldi, "Jumbo," 2000 (detail).

Cover design: Critical Stages.

ISBN: 978-0-8213-7840-3

eISBN: 978-0-8213-7841-0

DOI: 10.1596/978-0-8213-8213-7840-3

ISSN: 1020-5454

The cutoff date for data used in this report was May 26, 2009. Dollars are current U.S. dollars unless otherwise specified.

Table of Contents

Foreword xi

Acknowledgments xiii

Selected Abbreviations xv

Overview 1

The global recession has deepened 2

Private capital flows are shrinking at an unprecedented rate 3

Financing conditions have deteriorated rapidly 3

Building confidence and strengthening policy coordination are critical to recovery and long-term growth 4

The damage to low-income countries from the crisis must be mitigated 6

Chapter 1 Prospects for the Global Economy 7

Immediate impacts of the crisis 8

Global growth 11

Commodity markets 14

Exchange rates and inflation 17

Policy reactions 19

External balance and vulnerabilities 22

An uncertain medium-term outlook 25

Regional outlooks 27

Risks 31

Policy challenges 33

Notes 34

References 34

Chapter 2 Private Capital Flows in a Time of Global Financial Turmoil 37

The global financial crisis severely reduced private capital flows to developing countries in 2008 39

The downturn began in late 2008, as part of the global financial crisis 41

Remittance flows began to slow down in 2008 54

Prospects: The fall in private capital flows will continue in 2009 56

Annex 2A: Methodology for assessing trends in foreign direct investment 61

Annex 2B: Liquidity problems, bank solvency, and international bank lending to developing countries 62

Annex 2C: Debt Restructuring with Official Creditors	69
Agreements with countries	69
Notes	70
References	71

Chapter 3 Charting a Course Ahead 73

Corporations in developing countries face severe financing difficulties	74
Countries with large financing needs face balance-of-payments crises	80
The potential for expansionary policies varies significantly among developing countries	89
The financial crisis has increased the importance of policy coordination	92
Annex 3A: Modeling the benefits of a coordinated regulatory response to common shocks to confidence	98
Annex 3B: A framework for measuring investor confidence	100
Notes	102
References	102

Appendix: Regional Outlooks 105

East Asia and Pacific	105
Europe and Central Asia	110
Latin America and the Caribbean	118
The Middle East and North Africa	126
South Asia	132
Sub-Saharan Africa	140
Notes	149

Boxes

1.1	Recent initiatives to bolster trade finance	14
1.2	Managing the recovery: Coping with the future impact of recent policies	22
1.3	Potential economic impacts of the A H1N1 flu outbreak	32
2.1	The impact of the current financial crisis has been much deeper and broader than previous crises	44
2.2	The composition of foreign direct investment in times of crisis in the host economies	53
2.3	Bank lending in developing countries and the presence of foreign banks	59
3.1	Foreign bank participation and the financial crisis	79
3.2	Methodology used to estimate external financing gaps	83
3.3	The response of international financial institutions to the trade finance contraction following the crisis	86
3.4	The origins of the financial crisis	94

Figures

1.1	The crisis shook confidence worldwide and resulted in a large decline in global wealth	10
1.2	Stock market wealth declined by 40 to 60 percent in dollar terms	11
1.3	Increased uncertainty caused households and firms to delay purchases of durable and investment goods	12
1.4	Capacity is being underutilized throughout the world	12
1.5	Reflecting increased precautionary saving, industrial production declined sharply	13
1.6	The sharp fall in commodity prices has now stabilized	15
1.7	Oil demand has fallen sharply along with global growth	15
1.8	Falling food and energy prices to bring inflation under control	18

1.9	Policy interest rates in both high-income and developing countries have been sharply reduced	20
1.10	The contraction in bank lending has been limited	20
1.11	Much weaker industrial production and exports will cut deeply into government revenues in developing countries	21
1.12	Government balances are expected to deteriorate most sharply in Europe and Central Asia	21
1.13	The crisis has reduced global imbalances	23
1.14	Many developing-country reserves have reached worryingly low levels	25
1.15	Many countries will need to reduce imports sharply due to reduced access to foreign capital	25
1.16	Despite projected stronger growth, considerable excess capacity remains even in 2011	26
1.17	The recovery in East Asia and Pacific will be led by China	27
1.18	High short-term debt-to-reserves ratio in Europe and Central Asia	28
1.19	GDP growth deteriorated markedly in the fourth quarter of 2008 in several major economies in Latin America and the Caribbean	28
1.20	Growth to slow sharply for both oil and diversified exporters in the Middle East and North Africa	29
1.21	Government revenues in South Asia very dependent on trade	30
1.22	Economic growth in Sub-Saharan Africa is projected to decelerate abruptly in 2009 to the lowest level in almost a decade	30
2.1	Net private capital inflows to developing countries, 2000–08	39
2.2	Net private capital inflows to developing regions, 2007–08	40
2.3	MSCI equity index from January 2007–February 2009	42
2.4	Declines in developing-country stock markets in 2008	42
2.5	Gross equity issuance by developing countries, 2006–08	43
2.6	IPO activities in developing countries, 2006–08	43
2.7	Emerging market bond spreads widened sharply at year's end, 2003–09	46
2.8	Bond spreads widened in all asset classes in 2008	47
2.9	Deteriorating credit quality for emerging markets in 2008	47
2.10	Sovereign five-year credit default swap spreads, July 2008–February 2009	47
2.11	Bond issuance by developing-country governments and firms, January–February 2009	48
2.12	Short-term debt flows to developing countries, 2007Q1–2008Q4	49
2.13	Spreads on trade finance credit spiked in 2008	50
2.14	Syndicated bank lending to developing countries, January 2008–April 2009	51
2.15	Quarterly FDI inflows to selected developing countries dipped in 2008	52
2.16	Distribution of income from FDI in selected economies, 2007Q1–2008Q3	52
2.17	Repatriation of assets by financial firms from selected developing countries, 2001–08	54
2.18	Cross-border M&A flows to developing regions, 2007Q1–2009Q1	54
2.19	Net private capital flows as a share of GDP in developing countries, 1970–2010	57
2.20	International banks' claims on emerging markets, 2004–08	58
2.21	Major international banks with cross-border lending exposure to at least 30 developing countries, 1993–2007	60
2B.1	Three-month LIBOR-OIS spread, July 2007–April 2009	62
2B.2	Five-year CDS sector index for banks in the United States and European Union, January 2007–April 2009	62
3.1	Gross external borrowing by developing country corporations, 1998–2008	75
3.2	Spreads on emerging market corporate bonds, February 2007–April 2009	76
3.3	Largest local-currency bond markets, 2007	78

3.4	Pension assets in selected countries as a share of GDP, 2007	78
3.5	Corporate bond issuance in domestic markets, 2004Q1–2009Q1	78
3.6	Foreign holdings of domestic bonds, 2007	80
3.7	External financing needs of developing countries, 1990–2009	80
3.8	Estimated external financing needs of 102 developing countries in 2009	80
3.9	Equity price changes versus external financing needs of developing countries, August 2008–February 2009	81
3.10	Exchange-rate changes and external financing needs in developing countries, August 2008–February 2009	81
3.11	Change in sovereign bond spreads and external financing needs of developing countries, August 2008–February 2009	81
3.12	External financing needs in 2009, by region	84
3.13	External financing gaps in 2009, by region and under alternative scenarios	84
3.14	Real GDP growth in five Asian countries, 1996–98	88
3.15	Net ODA disbursements by DAC donors, 1991–2008	88
3.16	Policy interest rates in developing countries, January 2007–March 2009	89
3.17	Growth of foreign reserves in developing countries, 1996–98 and 2006–08	91
3.18	Fiscal stimulus measures by G-20 developing countries	91
3.19	Developing countries with fiscal deficits exceeding 3 percent of GDP at the onset of the financial crisis	92
3A.1	Record volatility in the global equity, credit, commodity, and foreign exchange markets, May 2007–April 2009	100
3A.2	Correlation of authors' composite global index of consumer confidence with State Street index of investor confidence	101
A.1	East Asia and Pacific production dropped sharply but shows signs of bottoming out	105
A.2	China is key to East Asian prospects	109
A.3	Output declined rapidly in the fourth quarter of 2008	111
A.4	Financial crisis increased the price of risk	112
A.5	High short-term debt to total reserves ratios in Europe and Central Asia	115
A.6	Lower commodity prices should see inflation decline	116
A.7	Improved initial conditions are helping Latin America and the Caribbean weather the crisis	119
A.8	EMBI sovereign spreads surged as the crisis shook investors' confidence	120
A.9	Economic conditions in Latin America and the Caribbean have deteriorated sharply	121
A.10	Sharply weaker investment growth has contributed to GDP slowdown	121
A.11	Output and current account balances will deteriorate in 2009, improving only modestly in 2010	123
A.12	Middle East and North Africa oil revenues hit hard by global recession in 2009	126
A.13	Middle East and North Africa bourses hit hard at the worst of financial crisis	127
A.14	Remittances, FDI and tourism revenues decline as a share of GDP	129
A.15	JP Morgan Emerging Market Bond Index (EMBI), stripped spreads	133
A.16	South Asian exports, values	134
A.17	Industrial production in South Asia	135
A.18	Government revenue in South Asia is very dependent on trade	140
A.19	Bond spreads in Sub-Saharan Africa widened sharply in the wake of the global financial crisis	141
A.20	Terms of trade losses since July have been significant in some countries as commodity prices plunged	142

A.21	External trade and private consumption deteriorated markedly in the fourth quarter of 2008 in South Africa	142
A.22	Economic growth decelerated abruptly in 2009 to the lowest level in almost a decade in Sub-Saharan Africa	144
A.23	Large terms of trade losses expected in countries exporting minerals and oil	145
A.24	Terms of trade gains expected among oil-importing countries in 2009	145

Tables

1.1	The global outlook in summary	9
1.2	Investment demand fell sharply worldwide	11
1.3	Export volumes and production plummet into early 2009	13
1.4	Metal demand plummeted with industrial production	16
1.5	Most developing-country currencies depreciated sharply against the majors	17
1.6	Increase in the number of poor due to changes in food prices since December 2005	18
1.7	Policy interest rates have dropped across most of the world	19
1.8	Lower commodity prices have reduced imbalances	23
1.9	Lower commodity prices should improve terms of trade for oil importers	24
1.10	A protracted recession	33
2.1	Net capital inflows to developing countries	40
2.2	Net capital inflows to developing regions, 2005–08	40
2.3	Emerging market bond issuance in 2009	48
2.4	Major book-runners for emerging market bonds, 2007Q1–2009Q1	49
2.5	Short-term debt stock in developing countries by sector, 2008Q3	49
2.6	Major bilateral bank loans in February 2009	51
2.7	Remittance flows to developing countries, 2002–08	55
2.8	Outlook for remittance flows to developing countries, 2009–10	56
2A.1	Regression results of FDI forecasting model, fixed-effects panel regression	61
2B.1	Lending standards, interbank liquidity, and credit to emerging economies	64
2B.2	U.S. bank performance and credit to emerging economies	65
2B.3	U.S. bank capitalization and credit to emerging economies	67
3.1	Foreign debt contracted by developing-country corporations, 1998–2008	75
3.2	Estimates of developing countries' external financing needs in 2009	82
3.3	Estimated external financing gap in developing countries, 2009	82
3.4	Net official flows, 2002–08	84
3.5	Multilateral development bank's planned 2009–11 financial response to the crisis, as of April 2009	85
3.6	Total assets and equity of the major MDBs, 2007	87
3A.1	Evidence that investors' confidence is shaped by a combination of factors	102
A.1	Net capital flows to East Asia and Pacific	107
A.2	East Asia and Pacific forecast summary	108
A.3	East Asia and Pacific country forecasts	110
A.4	Net capital flows to Europe and Central Asia	113
A.5	Europe and Central Asia forecast summary	114
A.6	Europe and Central Asia country forecasts	117
A.7	Net capital flows to Latin America and the Caribbean	120
A.8	Latin America and the Caribbean forecast summary	122

A.9	Latin America and the Caribbean country forecasts	124
A.10	Net capital flows to the Middle East and North Africa	128
A.11	Middle East and North Africa forecast summary	130
A.12	Middle East and North Africa country forecasts	131
A.13	Net capital flows to South Asia	134
A.14	South Asia forecast summary	137
A.15	South Asia country forecasts	139
A.16	Net capital flows to Sub-Saharan Africa	141
A.17	Sub-Saharan Africa forecast summary	144
A.18	Sub-Saharan Africa country forecasts	146

Foreword

THE CRISIS OF THE PAST TWO YEARS is having dramatic effects on capital flows to developing countries, and the world appears to be entering an era of lower growth. This edition of *Global Development Finance* revisits the genesis of the turmoil—which began in a relatively small segment of the U.S. credit markets and mutated into a major worldwide financial and economic crisis—and explores the broad approach needed to chart a global recovery.

This year, global output is projected to fall by 2.9 percent; global trade by 10 percent. Growth in the developing world is expected to slow to 1.2 percent. Excluding China and India, GDP in other developing countries will fall at a rate of 1.6 percent. Meanwhile, private investment flows to developing countries plummeted by more than 40 percent in 2008 as access to international debt markets dried up and portfolio equity inflows all but ceased.

Unprecedented situations call for unprecedented policy responses. Through ambitious unilateral and multilateral actions, both conventional and unconventional, governments have drawn on monetary policy, fiscal stimulus, and guarantee programs to shore up the banking industry, which lay at the epicenter of the crisis. Those actions are beginning to have a positive impact on financial markets, where liquidity conditions in global interbank markets have begun to ease, credit risk premiums have narrowed, and equity markets have staged a tentative revival. However, the policy agenda for stabilizing financial markets and fostering global economic recovery is broad and complex. Major challenges remain.

Greater integration of the global economy and the increasing importance of private actors in international finance over the past three decades have brought enormous benefits to developing countries, but they also have widened the scope for economic turmoil. Consider trade and flows of private capital. The share of international trade in developing countries' output grew from 35 percent in 1980 to 57 percent in 2007. New markets

opened for producers in the developing world, and prices lowered for consumers. But rising trade also widened channels through which a slowdown in economic activity in one group of countries could spread to other countries. Capital flows have grown with trade, and developing countries today are much more dependent on flows of private capital than they were at the peak of the boom of the 1970s. Once dominated by bank lending to sovereign governments, most capital now flows through a variety of transactions between private entities—and those flows respond rapidly to financial disruptions. Thus, even though most developing countries maintain better policies and have stronger institutions than they did at the onset of previous crises, more of them are nevertheless vulnerable to external disruptions. Emerging-market equities and investments have always been sensitive to the global economic cycle, but the current downturn has hit developing countries especially hard. Emerging-market borrowers, both private and public, will encounter increased competition from developed countries as the latter dramatically expand government deficit debt financing as well as government-guaranteed bank debt issuance.

The crisis has affected the external financing position of all developing countries—but not equally. Those that have high levels of external debt, large current-account deficits, and shallow foreign reserves are more likely to encounter difficulties in obtaining the finance they will need to avoid a more severe contraction in growth. Many private firms in the developing world will be hard pressed to service their foreign-currency liabilities with revenues earned in depreciating domestic currencies while confronting declining global export demand. The likelihood of balance-of-payments crises and restructurings of corporate debt in these countries warrant special attention. Countries that pursued prudent macroeconomic policies in the years preceding the crisis have more flexibility than others to respond to short falls with expansionary fiscal and monetary policies and so keep their domestic industries afloat.

Low-income developing countries, initially cushioned from the direct impact of the financial crisis, are now feeling effects that have spread through other channels. Net private capital flows will be insufficient to meet the external financing needs of many of these countries, and in view of the intense fiscal pressures triggered by the crisis, the prospects for large increases in aid flows are dim. The bulk of new commitments by international financial institutions will go to middle-income countries in 2009, and workers' remittances to low-income countries are projected to decline by 5 percent. Such sobering facts reinforce the importance of broad international agreement to mobilize the necessary resources to achieve the MDGs.

The financial crisis in today's integrated global economy has underlined the importance of coordinating policy so that measures taken in one country complement, rather than defeat, those taken in another. The economic channels through which nations trade goods and services also serve to propagate crisis when countries resort to protectionism. For that reason, it is imperative that countries coordinate policies to provide adequate financing for trade and resist the politically tempting tactic of protectionism—either in the trade or financial arena.

Recent actions by the world's central banks illustrate the utility of concerted action. With international banks operating in a multiple-currency world, central banks need ready access to several major currencies to fulfill their role of providing liquidity to their banks. Thus, the swap facilities that were created by the U.S. Federal Reserve and the People's Bank of China in response to the crisis are likely to be reinforced by other central banks acting in concert. Central banks in many countries, including some developing countries, also have acted together to reduce interest rates, expand their lending, provide guarantees to encourage more private lending, and take other action to jump-start credit markets stalled by the crisis.

Today's crisis constitutes a triad of tight credit, diminished confidence, and global recession, set in the context of an interconnected world

economy. The world is transitioning from an extended credit boom and economic overheating to an era of slower growth. Looking to medium-term developments, participants in the international financial system—consumers, investors, traders, and firms—must adapt their behavior to the new realities of tightened credit conditions, a prominent role of the state in financial affairs, large excess capacity in many industrial sectors, and more closely coordinated regulatory policy. Governments, for their part, must support emerging signs of recovery in financial markets with persistent, robust policy efforts to transform the adverse feedback loop between the financial sector and the real economy into a positive one. In a world of global financial institutions, effective oversight of the financial system can be achieved *only* through coordinated efforts, because lax regulation in one jurisdiction makes it more difficult to enforce adequate standards elsewhere. Greater international cooperation in sharing information and establishing broad standards for regulation is important to making national regulators more effective and thus the global financial system more stable.

Global Development Finance is the World Bank's annual review of global financial conditions facing developing countries. The current volume provides analysis of key trends and prospects, including coverage of the role of international banking in developing countries. A separate volume contains detailed standardized external debt statistics for 128 countries, as well as summary data for regions and income groups. Additional material and sources, background papers, and a platform for interactive dialogue on the key issues can be found at <http://www.worldbank.org/prospects>. A companion online publication, "Prospects for the Global Economy," is available in English, French, and Spanish at <http://www.worldbank.org/globaloutlook>.

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Acknowledgments

THIS REPORT WAS PREPARED BY THE International Finance Team of the World Bank's Development Prospects Group (DECPG). Substantial support was also provided by staff from other parts of the Development Economics Vice Presidency, World Bank operational regions and networks, the International Finance Corporation, and the Multilateral Investment Guarantee Agency.

The principal author was Mansoor Dailami, with direction from Hans Timmer. The report was prepared under the general guidance of Yifu Justin Lin, World Bank Senior Vice President and Chief Economist. The principal authors of each chapter were:

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Preparation of the appendixes on official debt restructuring was managed by Eung Ju Kim. Augusto Clavijo provided support for formatting figures and tables for the final version of the report, and Eugen Tereanu provided research assistance for chapter 3.

The estimates of financial flows and debt were developed in a collaborative effort between DECPG and the Financial Data Team of the Development Data Group (DECDG), led by Ibrahim Levent. DECPG's Global Trends Team, under the leadership of Hans Timmer, was responsible for the projections. The projections and regional appendix were produced by Oana Luca, Annette de Kleine Feige, Elliot Riordan, Cristina Savescu, and Ivailo Izvorski, in coordination with country teams, the offices of the chief economists of the Bank's regions, and the offices of directors of the Bank's Poverty Reduction and Economic Management network. Among those who contributed were Luca Barbone, Marcello Guigale, August Kouame, Ernesto May, Vikram Nehru, Ritva Reinikka, Sudir

Shetty, and Augusto de la Torre. The short-term commodity price forecasts were produced by John Baffes, Betty Dow, and Shane Streifel.

Two background notes and papers were prepared by experts outside the Bank: Paul Masson (University of Toronto, international policy coordination) and Robert Hauswald (American University, the impact of crises on international bank lending). From within the Bank, notes and papers were received from Constantino Hevia (foreign bank responses in Latin America), Oliver Fratzscher (corporate risk management), Sanket Mohapatra (workers' remittances), Ismail Dalla (consultant, local capital market development and trade finance), and Dana Vorisek (monitoring of media coverage of the crisis). The online companion publication of GDF, "Prospects for the Global Economy," was prepared for the Web by Sarah Crow, Cristina Savescu, Yan Bai, and Maria Hazel Macadangdang, with the assistance of the global trends team. Technical help in the production of the Web site was provided by Reza Farivari, Shahin Outadi, Malarvizhi Veerappan, Cherin Verghese, and Kavita Watsa.

The report also benefited from the comments of the Bank's Executive Directors, made at an informal meeting of the Board of Directors on May 26, 2009.

Many others provided inputs, comments, guidance, and support at various stages of the report's preparation. Merli Margaret Baroudi, Marilou Jane Uy, Jeffrey Lewis, Robert Kahn, M. Willem van Eeghen, and Charles Blitzer (International Monetary Fund) served as peer reviewers during the Bankwide review of the manuscript. Within the Bank, additional comments were provided by Luis Pereira Da Silva, Alan Gelb, Celestin Monga, Maria Soledad Martínez Peria, Augusto de la Torre, Sergio Schmukler, and Norman V. Loayza.

Steven Kennedy and Marty Gottron edited the report. Rosalie Marie Lourdes Singson provided assistance to the team and to Merrell Tuck-Primdahl, who managed production and dissemination activities. Book design, editing, and production were coordinated by Aziz Gökdemir, Stephen McGroarty, and Denise Bergeron of the Office of the Publisher at the World Bank.

Selected Abbreviations

ADB	Asian Development Bank	IMF	International Monetary Fund
AfDB	African Development Bank	IPO	initial public offering
BIS	Bank for International Settlements	LIBOR	London interbank offered rate
CDSs	credit default swaps	M&A	mergers and acquisitions
CIS	Commonwealth of Independent States	mb/d	million barrels per day
DAC	Development Assistance Committee	MDB	multilateral development banks
DRS	Debtor Reporting System	MDGs	Millennium Development Goals
EBRD	European Bank for Reconstruction and Development	MIGA	Multilateral Investment Guarantee Agency
EU	European Union	NIE	newly industrialized economy
FDI	foreign direct investment	ODA	official development assistance
G-7	Group of Seven	OECD	Organisation for Economic Co-operation and Development
G-20	Group of 20	OPEC	Organization of the Petroleum Exporting Countries
GDP	gross domestic product	PRGF	Poverty Reduction and Growth Facility
GTFP	Global Trade Finance Program	REER	real effective exchange rate
GTLF	Global Trade Liquidity Program	saar	seasonally adjusted annual rate
HIPC	heavily indebted poor country	SADC	Southern African Development Community
IADB	Inter-American Development Bank	SDR	special drawing rights
IBRD	International Bank for Reconstruction and Development	WTO	World Trade Organization
IDA	International Development Association		
IFC	International Finance Corporation		
IFI	international financial institutions		

