DEVELOPMENT COMMITTEE
(Joint Ministerial Committee
of the
Boards of Governors of the Bank and the Fund
On the
Transfer of Real Resources to Developing Countries)

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DC/2000-03

March 24, 2000

RECENT TRENDS IN THE TRANSFER OF RESOURCES TO DEVELOPING COUNTRIES

Attached for the April 17, 2000 meeting of the Development Committee is a background note prepared by World Bank staff on Recent Trends in the Transfer of Resources to Developing Countries. (This note is based on the Global Development Finance 2000, updated to reflect recent events.)

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Recent Trends in the Transfer of Resources to Developing Countries
A Background Note for the Development Committee Meeting of April 17, 2000
Prepared by Staff of the World Bank[1]

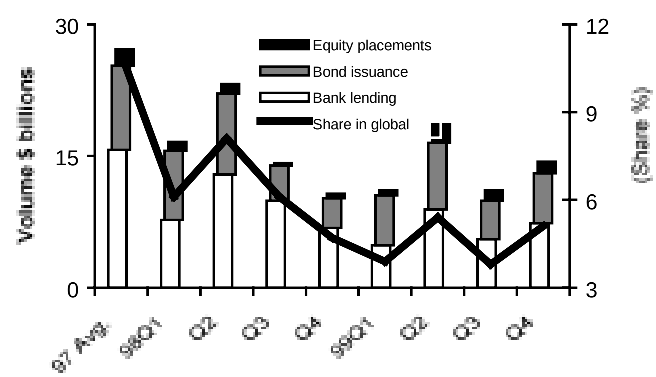
1. The environment for capital flows to developing countries is beginning to recover from the global financial crisis. Growth in developing countries is strengthening, underpinned by stronger and more broadly based growth in industrial country output and in world trade, both of which have in recent months significantly exceeded earlier expectations. The main drivers of the recovery have included stimulative policy measures in the industrial countries (widespread interest rate cuts in late 1998 and, in Japan, fiscal stimulus), the return of confidence in most of East Asia, and a gradual easing of financial conditions throughout virtually the entire developing world.

2. Nevertheless, the decline in net long-term capital flows to developing countries, compared to the high levels reached prior to the East Asian financial crisis, continued in 1999 (annex table). Net long-term flows totaled $291 billion in 1999, down $28 billion from the year before and $53 billion below the peak in 1997. Sharp declines in private debt and portfolio flows from international capital markets in both 1998 and 1999 account for virtually all of this decline, reflecting a sharp retrenchment in lending by international banks, a reduction in bond flows to the private sector in developing countries, and a fall in demand for funds from the East Asian crisis countries. Official flows increased slightly from their 1998 level. In sharp contrast to these developments, net FDI flows have remained high, stabilizing in 1998 and rising by $21 billion in 1999.

Flows from international capital markets

3. The drop in net private flows to developing countries in 1999 was driven by a collapse in gross flows from international capital markets (bond issues, syndicated bank lending and portfolio equity). Gross flows averaged only $11 billion in the first quarter of 1999 (figure 1), the period that witnessed the sharp devaluation in Brazil. This figure is just above the low point reached in the fourth quarter of 1998 following the Russian crisis. Flows recovered slowly over the course of the next three quarters, but for the year as a whole they were 14 percent below 1998 levels and half the peak level reached in 1997.

Figure 1: Gross capital market financing by emerging markets declines from 1997-99 (monthly averages)



Source: Euromoney Bondware and Loanware; World

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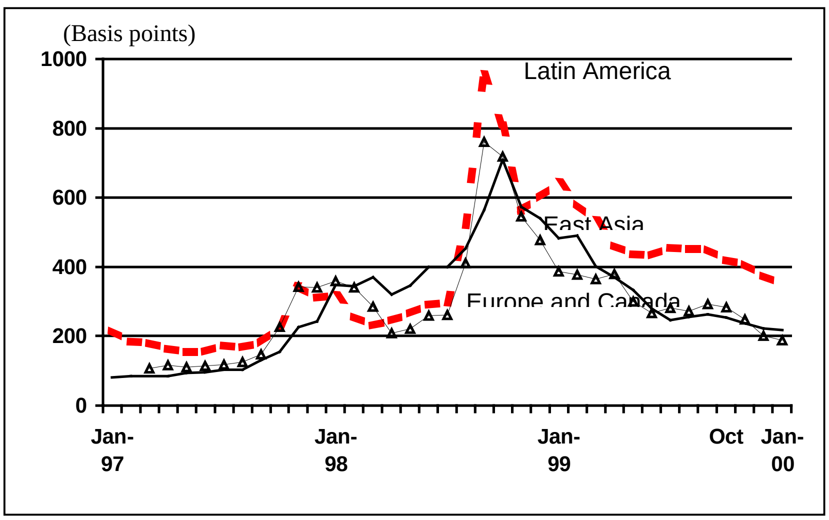
[1] *This note is extracted from Global Development Finance 2000.*

4. However, unlike in 1998, when investors withdrew from emerging markets as a group, the decline in flows in 1999 was sharply differentiated by borrower-country circumstances. Investors continued to retreat from several of the riskier borrowers. These included countries in severe financial crisis and those facing particularly difficult macroeconomic or political challenges. At the same time, several countries have seen an improvement in market access as they have recovered from the financial crisis.

5. A few of the East Asian crisis countries have experienced a return in investor confidence, but the continued low level of investment, reductions in the degree of leverage by several corporations in the wake of the problems experienced during the crisis, and increased reliance on domestic borrowing with the fall in interest rates, have limited countries' external borrowing. Syndicated bank lending to emerging markets had historically been dominated by East Asian borrowers until 1997. The almost 65 percent fall in bank lending to the region in 1998 largely reflected creditors' decisions to cut back on new lending, one of the key causes of the crisis. In 1999, the gross flows to the East Asian crisis countries (Indonesia, Korea, Thailand, and Malaysia) rose only marginally to $29 billion, compared with $71 billion in 1997, largely because of low demand. The fall in gross flows to these four countries from 1997-99 accounted for about one quarter of the total fall in flows to emerging markets.

Figure 2: Secondary market spreads on international bond issues rise during the crisis



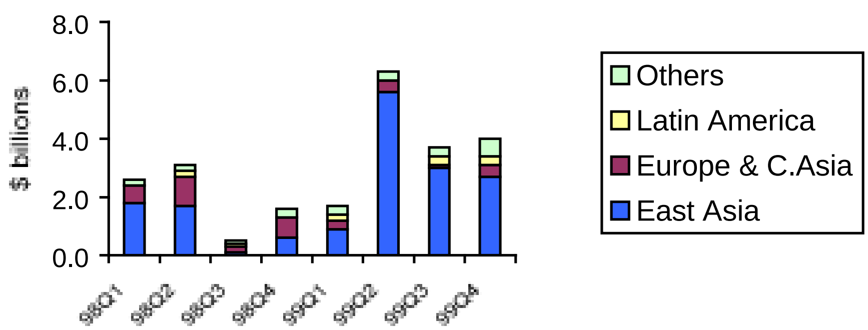
Source: Datastream, Bloomberg and World Bank

6. The differences in access of major developing country borrowers to the capital markets are also seen in the data on secondary market spreads. Investors' heightened risk perceptions as a result of the financial crises were reflected in the rise in secondary market spreads on Brady bonds from 500 basis points at the end of 1997 to over 1100 basis points in late 1998. Almost every major sovereign borrower experienced a rise in secondary market spreads on its outstanding bonds from December 1997 to December 1998. Spreads on Brady bonds rose further in the wake of the Brazilian crisis, to over 1400 basis points, among the highest levels

since the Mexican crisis.[2] Average spreads on benchmark international bonds from Latin America also rose, from 580 basis points in November 1998 to almost 700 basis points in January 1999, although premiums outside of the region rose by less than in Latin America (figure 2).[3]

7. By contrast, secondary market spreads for most borrowers narrowed over the course of 1999 from the high levels of the early part of the year, but the extent of improvement differed significantly by country, indicating a greater degree of differentiation by investors after the generalized retreat from emerging markets in 1998. Spreads dropped sharply in all major East Asian borrowers through January 2000, further evidence that reduced demand is driving the low level of flows to the region. Nevertheless, spreads on Indonesian debt remained over 500 basis points and spreads in the region remain well above the admittedly low levels of late 1996. In Latin America, spreads on Brazilian Eurobonds have narrowed sharply (to 540 basis points in mid-January 2000 compared with 1220 basis points in January 1999) and spreads on Mexican debt have fallen to about 200 basis points, while spreads on the debt of Argentina, Colombia, and the Republica Bolivariana de Venezuela are 140 to 300 basis points above the levels of late 1996. Eastern European borrowers also have seen a fall in spreads since late 1998. Countries that remain in severe crisis (Ecuador, Pakistan, Russia, and Ukraine) continue to have spreads that vary from one to several thousand basis points.

Figure 3: International equity placements from emerging markets increase in 1999



8. Unlike bank and bond flows, the volume of gross international equity placements from emerging markets recovered strongly in 1999, to more than double the 1998 level (figure 3), but remained at only 70 percent of the 1997 level. This surge in equity flows reflected the sharp recovery of equity markets in emerging market economies in 1999 from the low levels of late 1998. Stock market prices in East Asia rose by 71 percent on average from December 1998 to December 1999, and those in Latin America by 57 percent. Nevertheless, market conditions were less robust later in the year in several countries, and several issues out of Asia were postponed whereas others were offered

[2] *Spread refer to the EMBI+ index of JP Morgan.*

[3] *Average spreads refer to benchmark international bonds of 20 major emerging markets. Spreads for Pakistan, Romania, Russia and Ukraine have not been included in the sample because their extremely high levels distort the overall average.*

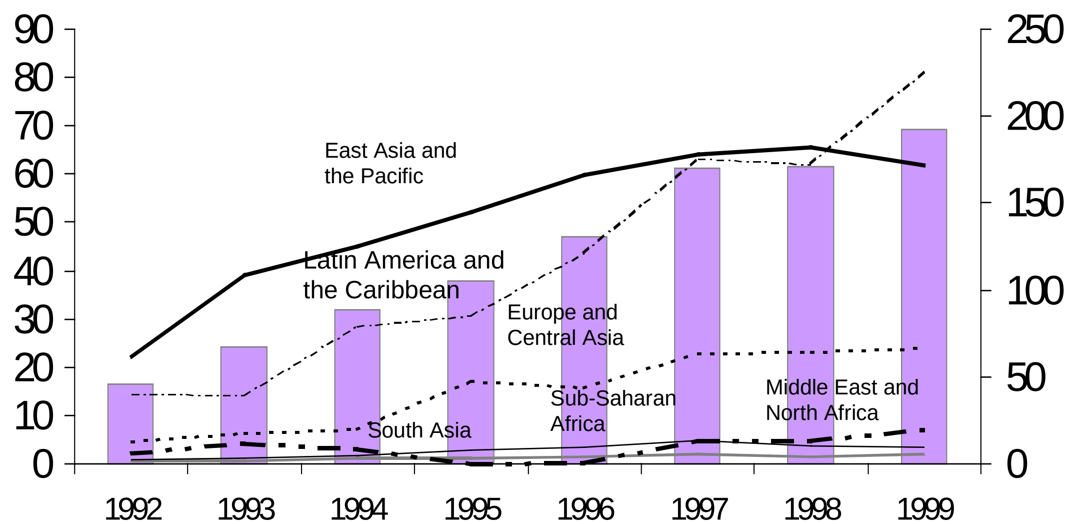
at discounts. Equity flows were primarily supported by large privatization transactions in East Asia, which accounted for 65 percent of total placements in 1999. Apart from privatization, investments for new capitalization showed little increase over 1998. International equity placements in the aggregate continued to account for only 10 percent of gross capital market flows.

Foreign direct investment

9. FDI flows have remained resilient over the past 2 years, despite the series of financial crises, although their rate of increase has slowed considerably from that of the mid-1990s. FDI flows to developing countries are estimated at $192 billion in 1999, equal to 2.8 percent of GDP, up from $171 billion in 1998 (figure 4). About half of the increase in 1999 is accounted for by one-time payments under Argentina's privatization program. This rough stability in FDI flows is in sharp contrast to the experience of the mid-1990s, when net FDI inflows jumped from 0.8 percent of developing country GDP in 1991 to 1.8 percent between 1994, and then rose to 2.7 percent by 1997. Slower growth prospects in developing countries and increased uncertainty in the global economy have discouraged foreign investors from continuing this rapid increase in new long-term commitments. FDI remains relatively concentrated, with the top 10 developing country recipients accounting for 77 percent of total FDI flows to developing countries.

Figure 4: FDI flows to developing countries continue to rise (billion US dollars)

regional totals (lines) *grand total (bars)*



10. The greater resilience in FDI flows than of capital market flows in the face of the financial crises is partly due to the fact that FDI is more responsive to long-term growth trends than to short-term changes in financial returns. FDI flows are also determined in part by access to natural resources and human capital, which were not immediately affected by the crises. Moreover, currency depreciations in the crisis countries reduced their production costs and asset

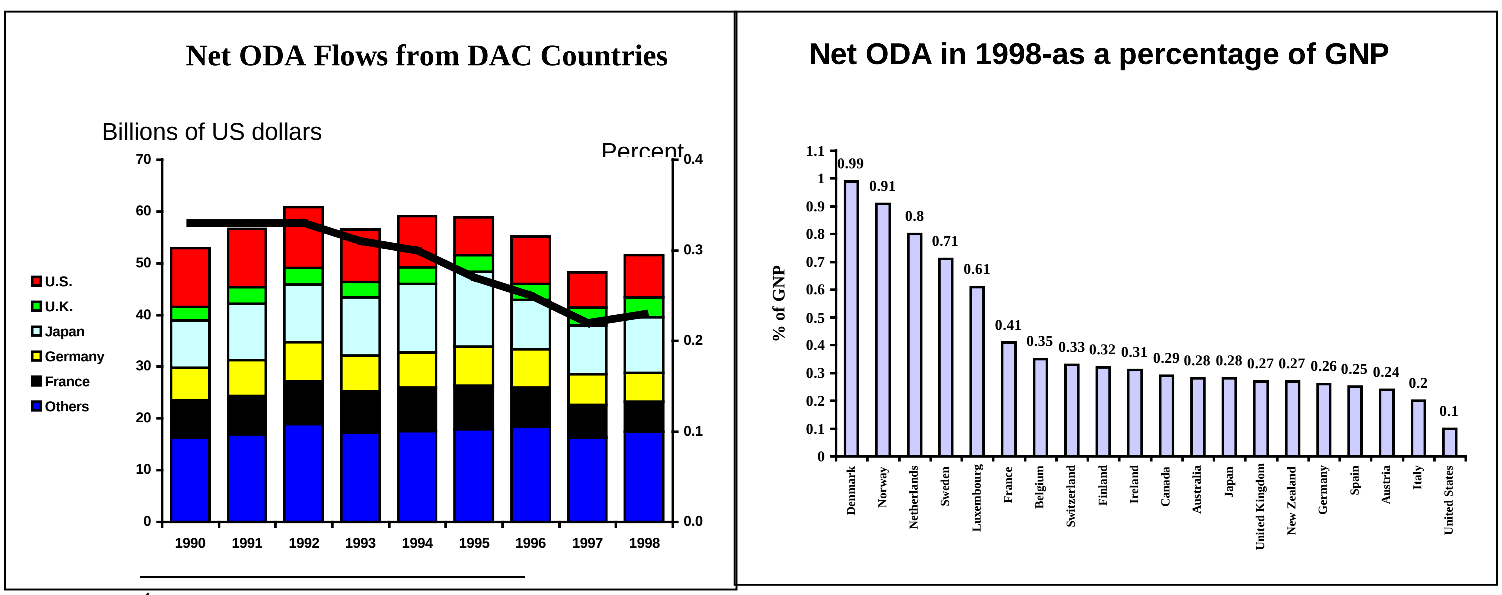
values in foreign currency terms.[4] This, together with opportunities for profitable corporate restructuring through mergers and acquisitions in crisis-affected countries, provided additional incentives to foreign investors.[5] Nevertheless, FDI flows are also subject to slowdown or reversal in the event of economic difficulties. For example, increased uncertainty with economic crises may cause investors to reduce new commitments, accelerate affiliates' repayments of debt to home offices, or take offsetting positions through derivatives. In the latter case, the decline in investors' exposure to the country is not even recorded in the data on FDI flows. In a limited number of countries, investment financed by joint ventures' external borrowing may be incorrectly classified as FDI, and thus may tend to behave similarly to capital market flows. But such cases make up only a very small fraction of total FDI flows to developing countries.

Official flows

11. Official development assistance (ODA) flows from donors rose in 1998. Between 1992 and 1997, total ODA from DAC member countries to developing countries and multilateral institutions fell steadily from 0.33 percent of their combined GNP to a record low of 0.22 percent. Data from the OECD shows a reversal of this trend in 1998 as aid flows rose by $3.2 billion (8.9 percent in real terms) to $51.5 billion. This represented 0.23 percent of DAC members combined GNP (figure 5).

12. The 1998 data seem to mark an end to a 5-year fall in ODA (usually explained in terms of "donors' fatigue"). Fourteen of the 21 DAC member countries reported a rise in ODA in real terms in 1998; the most significant increases came from Italy, Japan, and the United States. Nevertheless, much of this increase is expected to be transitory, due in part to the timing of

Figure 5: Net ODA from donor countries rises slightly in 1998



Source: OECD

[4] *In addition to reduced prices of imported materials, real manufacturing wages and property prices and rents fell significantly as discussed in* Global Economic Prospects 1999 *and World Bank country reports.*

[5] *Short-term determinants of FDI were discussed in detail in* Global Development Finance 1999. Global Economic Prospects 1999 *provides further discussions of corporate restructuring in East Asia.*

contributions to multilateral agencies and to other factors such as the Asian crisis. Japan reported a $1.3 billion rise in aid outflows, reflecting a surge of loans to countries affected by the Asian crisis. The United States likewise increased its aid budget by $1.3 billion, reflecting increased deposits of promissory notes with multilateral development banks and rises in food and emergency aid, especially to Africa. Italy reported a recovery of its aid outflows to $2.4 billion, partly reflecting increased flows to multilateral agencies. Some part of the rise in ODA, on the other hand, reflects the commitment by some countries to increase their aid flows. The firmest commitment is that of the United Kingdom, which has pledged to raise its aid budget by 25 percent by 2001; its aid in 1998 rose by 7.8 percent in real terms.

13. It remains to be seen, however, whether this year's increase in development assistance will be maintained, since several other countries are still in the process of tightening their budgets. Canada, France, and Germany, for example, reported a decline in aid outflows in real terms of 11.4 percent, 6.2 percent and 4.1 percent, respectively. The reduction in Canada's aid was due to the prepayment in 1997 of some scheduled 1998 contributions to multilateral agencies.

14. Aid flows received by poor countries, as measured by their receipts of concessional finance, are estimated to have risen in 1999 (see annex table). An increase in multilateral concessional lending was partially offset by a decline in bilateral aid flows Thus, net concessional finance totaled US$39.4 billion (in current terms) in 1999, above the US$37.3 billion in 1998, but some US$6 billion below the 1995 level. One positive development in 1998-99 was renewed attention and effort at raising resource flows to those very poor countries in Sub-Saharan Africa and elsewhere that are implementing better poverty reduction programs through the HIPC initiative. The HIPC Initiative is discussed in a separate paper.

Long-Term Aggregate Net Resource Flows to Developing Countries

(US$ billions, current)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Official Development Finance	36.0	41.0	41.1	40.0	41.5	55.9	62.4	54.1	53.4	45.9	53.9	31.0	39.8	50.4	52.0
Concessional Flows															
Official Grants [1]	13.6	15.9	16.8	18.2	19.2	28.2	35.1	30.5	28.4	32.7	32.7	28.0	26.0	27.1	26.4
Official Concessional Loans	12.1	13.2	16.4	15.7	15.0	15.5	15.7	13.6	13.2	13.5	12.5	11.5	7.5	10.2	13.0
Official Non-concessional Loans	10.3	11.9	7.9	6.1	7.3	12.2	11.6	10.0	11.8	-0.3	8.7	-8.5	6.3	13.1	12.6
Private Flows	31.6	23.5	24.8	39.1	38.4	43.5	61.7	99.7	165.8	174.4	203.3	282.1	303.9	267.7	238.8
Private Loans	20.6	13.5	10.7	18.7	11.9	15.7	18.8	38.1	48.8	50.4	62.2	102.1	103.4	81.2	19.2
Foreign Direct Investment [2]	10.9	9.4	13.4	19.3	23.1	24.1	35.3	47.5	66.0	88.8	105.0	130.8	170.3	170.9	192.0
Portfolio Equity Investment	0.1	0.6	0.7	1.1	3.4	3.7	7.6	14.1	51.0	35.2	36.1	49.2	30.2	15.6	27.6
AGGREGATE NET FLOWS	67.6	64.5	65.9	79.1	79.9	99.4	124.1	153.8	219.2	220.3	257.2	313.1	343.7	318.3	290.7
Memorandum Items:															
Interest payments	72.4	67.4	66.6	75.4	72.3	70.5	72.3	68.5	68.7	78.2	100.9	106.5	112.8	120.1	135.3
Profits on Foreign Direct Investment	11.9	11.4	12.4	13.3	17.1	17.6	18.3	20.9	22.9	24.9	26.5	29.9	31.8	35.2	41.6
Private Grants	2.9	3.3	4.0	4.3	4.0	5.1	5.4	5.9	6.3	7.0	6.6	6.3	6.9	2.0	0.0
Related Data:															
Net Use of IMF Credit [3]	0.1	-2.8	-6.4	-5.0	-2.5	-1.9	4.8	1.5	1.9	1.6	16.9	0.6	14.2	20.0	-12.7
Technical Coop. Grants	7.6	9.0	10.8	12.2	12.1	14.2	15.5	17.6	18.2	16.8	20.1	18.5	15.5	16.1	15.9
World Bank Net Flows	5.2	5.6	4.8	2.9	3.1	5.1	2.6	0.1	2.8	-0.3	1.1	1.4	6.7	6.6	4.5
IDA-Net Flows	2.8	3.1	3.8	3.7	3.4	4.1	4.3	4.8	4.5	5.6	4.9	5.7	5.3	4.8	4.7

Sources: DRS and OECD.
Note: 1999 numbers are estimates.
1/ Excludes Technical Cooperation.
2/ Source: IMF.
3/ Includes IMF Trust Fund and EASF.

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Deflator (Import price/US$ based)	78.4	81.5	88.7	93.5	95.4	101.9	100.5	104.3	101.1	102.0	111.2	111.2	107.2	100.6	100.0