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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RECENT TRENDS IN THE TRANSFER OF RESOURCES TO DEVELOPING COUNTRIES

Attached for the September 27, 1999 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 1999, updated to reflect recent events.)

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Recent Trends in the Transfer of Resources to Developing Countries

1. A BACKGROUND NOTE FOR THE DEVELOPMENT COMMITTEE MEETING OF SEPTEMBER 27, 1999

Prepared by Staff of the World Bank[1]

The environment for capital flows to developing countries remains difficult and uncertain. Investor confidence in emerging markets has deteriorated significantly since the onset of the financial crisis. Net long-term flows to developing countries, including both private and official sources, declined from $338 billion in 1997 to $275 billion 1998, as flows from international capital markets fell by almost half.[2] While confidence has improved since the market turmoil which followed the Russian debt moratorium in August 1998, capital flows to developing countries in the first half of this year remained well below the first half of 1998. By contrast, foreign direct investment showed considerable resilience, falling modestly from $163 billion in 1997 to $155 billion in 1998. Net official flows increased from $39 billion to $48 billion due to increased nonconcessional lending in support of countries affected by the crisis.

Preliminary data indicate that net long-term flows may decline further in 1999. Despite increasing signs of a recovery, with stronger than expected growth in Asia and shallower than anticipated recessions in Brazil and Russia, output growth in the developing world in 1999 is expected to remain depressed by historical standards. The prices of developing countries' non-oil primary commodities have fallen further from the very low levels of 1998, and world trade growth remains well below trend. While official flows are likely to remain steady, heightened risk perceptions may further reduce capital market flows. And due in part to a decline in flows to China, FDI flows are expected to remain below the peak reached in 1997, also reflecting the deterioration in growth prospects and increased uncertainty since the onset of the financial crisis.

Flows from international capital markets

The decline in net long-term financial flows to developing countries was largely due to a fall in flows from international capital markets, from $136 billion in 1997 to $72 billion in 1998. Commercial bank loans, bonds, and portfolio equity all saw large declines. In the first half of the year gross capital market flows to East Asia and the Pacific dropped to half the 1997 rate.[3] The decline in long-term flows became generalized following the eruption of crisis in Russia; gross capital market financing to all developing countries dropped to only $11 billion a month in the fourth quarter of 1998, ($17 billion below the fourth quarter of 1997). Developing countries

[1] This note is based in part on Global Development Finance 1999, updated to reflect recent events.

[2] Data on net long-term flows are presented in annex tables 1 (in current prices) and 2 (in constant prices). Estimates for net long-term flows are the same as those presented in *Global Development Finance 1999*.

[3] Capital market developments within the year are best described in terms of gross flows (bond and equity issues and syndicated loan commitments), as data on net flows are only available on an annual basis.

access to short-term finance also was reduced, as the outstanding short-term claims of BIS banks fell from over $450 billion at end-1997 to about $365 billion at end-1998.

Capital market conditions deteriorated further with the devaluation of the Brazilian real in January 1999. Secondary market bond spreads increased for most of the major developing country borrowers. Spreads rose sharply following the devaluation in Latin America, in Europe and Central Asia and in East Asia. And gross capital flows fell further to below $11 billion per month in the first quarter of 1999, lower than the depressed levels in the last quarter 1998. Market access was limited to the most creditworthy borrowers, as the corporate sector accounted for only 20 percent of total emerging market bond issuance in January-July 1999, compared to 38 percent in 1997.

Developing countries' access to capital market financing improved after February 1999 as the situation in Brazil stabilized after the sharp devaluation and some of the East Asian crisis economies showed increasing strength. Secondary market bond spreads fell sharply (the average spread on Brady bonds—an index that is heavily weighted towards Latin America—dropped to 890 basis points in April from over 1300 basis points at end-January), and though extremely high by historical standards, are now lower than the average in 1998. Several of the Latin American economies were able to return to the bond market. Nevertheless, the market has remained volatile, illiquid and thin since the beginning of 1999 and is easily swayed by a few large trades. As a result, pricing new bonds has become difficult and often primary issues have seen their spreads surge in periods following their initial placements.

Gross private flows in January-July 1999 increased relative to the low point reached in the second half of 1998, but still totaled a third lower than the comparable period last year. *Bond issuance* at $45 billion was 30 percent lower during January-July 1999 compared to the same period a year ago, as issues from Europe and Central Asia and Latin America plunged 60 percent and 20 percent respectively. Russia, which accounted for the bulk of bond issuance from the region in 1998, has been completely shut out from the markets this year. *Bank lending commitments* dropped 45 percent during the same period. All regions recorded declines, but again, Europe and Central Asia and Latin America registered particularly severe drops of more than 50 per cent. However, *international equity placements* (which account for only 11 percent of total gross flows) jumped over 80 percent during this period on the back of large privatization issues out of East Asia, particularly South Korea and Thailand. Equity markets in Asia have been the star performers, the main drivers being the promise of corporate restructuring, falling domestic interest rates and appreciating exchange rates.

Table 1: Gross capital flows to developing countries, monthly averages

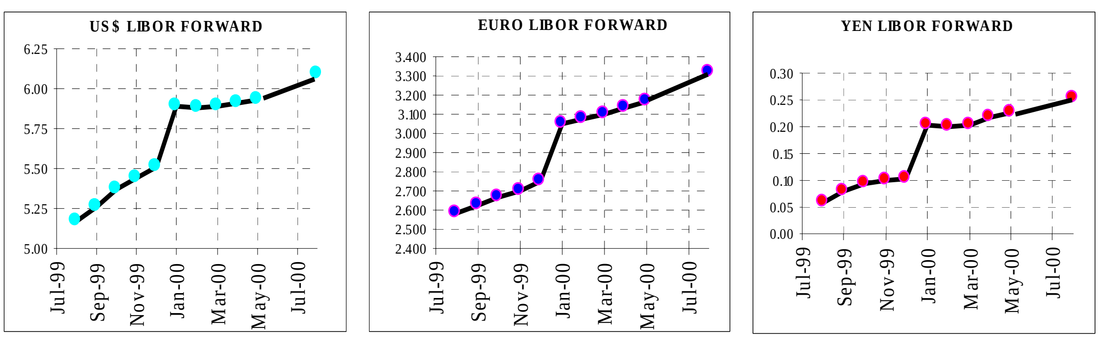
(US$ billions)	1997	1998	98 1st half	98 2nd Half	99 1st Half
All developing countries	24.2	16.2	19.9	12.5	13.9
Sub-Saharan Africa	0.9	0.5	0.7	0.4	0.7
East-Asia & Pacific	6.2	3.0	3.2	2.7	3.6
South Asia	1.0	0.4	0.7	0.1	0.4
Europe & Central Asia	4.3	3.9	4.4	3.3	2.0
Latin America & Caribbean	10.1	7.4	9.8	5.0	6.5
Middle East & North. Africa	1.7	1.0	1.0	1.1	0.7

Source: Euromoney and World Bank

Note: Gross capital market flows include bond issues, syndicated loan commitments, and equity issues, based on reports from the international capital markets. Although Korea was classified as a high-income country in Global Development Finance 1999, it is included in the developing country aggregate since it is a borrower from the World Bank.

Private capital flows to emerging markets are expected to remain weak, and may decline further during the rest of 1999. Recent movements in spreads, particularly in Latin America, indicate that investors in emerging markets remain edgy and prone to overreaction. This is also evident in the case of bank lending, where major banks are experiencing difficulties in selling securitized emerging market assets to regional banks in the United States. There also is some concern that market liquidity may decline in December due to fears of market disruptions related to Y2K,[4] which may further reduce flows to emerging markets in the last quarter of the year. The financial markets are already pricing in a liquidity shortage in January 2000. The LIBOR forward curves for three currency majors (shown below for August 10, 1999) indicate a 25 basis points jump in the US dollar and Euro LIBORs, and a smaller 5 basis points increase for the Yen.

<u>Figure 1: Forward LIBOR for US dollar, Yen, the Euro on August 10, 1999</u>



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[4] In fact, the Federal Reserve Board voted on 07/23/99 to establish a **Century Date Change Special Liquidity Facility**, a program for lending to depository institutions from October 1, 1999 through April 7, 2000. The interest rate on loans from this program will be 150 basis points higher than the fed funds rate. The collateral requirements will be the same as for regular discount window loans. Lending Reserve Banks will evaluate the eligibility of borrowers whose capital ratios have temporarily fallen below minimum requirements due to Y2K related problems.

While the outlook for capital flows to the emerging markets will depend largely on the evolution of investor confidence, changes in international economic developments may also have an important impact. For example, a sharp correction in the US markets could adversely affect confidence, leading to a flight to cash or Treasury securities and a withdrawal of funds from emerging markets. But a gradual slowdown in the United States and a reduction in the current account deficit (which increased to 2.75 percent of GDP in 1998 and rose further during the first half of 1999) could encourage greater lending to the developing countries.

Foreign direct investment

Foreign direct investment (FDI) flows showed considerable resiliency, falling only modestly, from $163 billion in 1997 to $155 billion in 1998. Several of the crisis countries in Asia saw an increase in FDI as investors sought to take advantage of distressed asset prices and increased international competitiveness. Also, mergers were motivated by the need to gain access to finance, restructure and reduce costs. For example, mergers and acquisitions in some of the East Asian crisis countries rose strongly during the third quarter of 1998. These incentives for increased foreign investment appeared to have offset the deterrent effects of recession and the smaller size of markets expressed in foreign currency.

Though FDI is likely to remain the largest source of finance for developing countries in the foreseeable future, the global crisis has reduced the prospects for FDI compared with a few years ago. Growth prospects have deteriorated worldwide, trade growth has slowed considerably, and the increase in uncertainty may further depress FDI flows. Thus, FDI flows this year and the next are unlikely to increase significantly from the high level reached in 1997-98, and may decline. Indeed, preliminary data indicate that there may be some reduction in FDI flows this year. FDI flows to the East Asia and Pacific region, having fallen only slightly in 1998, are expected to decline further in 1999. FDI flows to China, the largest developing country recipient of FDI, are down by 15 percent in the first quarter of 1999 compared to the first quarter of 1998. By contrast, an improvement in the policy framework governing FDI in Korea has boosted FDI flows in the first half of 1999 to twice the level of the comparable period in 1997.

FDI to the other major recipient regions appears to be more stable. FDI to Latin America may increase somewhat in 1999. Brazil received an estimated $12 billion inflow in the first half of 1999, more than one-third above the first half of 1998 (although 30 percent of the first half flows is reported to be the advance payment by Spain's Telefonica and its partners, Iberdrola SA and Portugal Telecom, of their installment for telecommunications companies acquired in the Telebras privatization in 1998). FDI flows in Argentina almost tripled in the first quarter of 1999, whereas Mexico, another major recipient of FDI in the region, maintained a steady level of inflows. The level of FDI to Europe and Central Asia is expected to remain stable, if not decline, as inflows in two primary recipient countries, Russia and Hungary, show little sign of recovery from the downturn in 1998. FDI flows to Poland appear to keep the high level achieved in 1998.

Table 2: FDI in selected countries (US$ billions)

	1998	Q1	Q2	Q3	Q4	1999Q1
China	45.3	8.5	12.0	10.9	13.9	7.3
Indonesia	-0.3	-0.5	0.4	-0.1	-0.1	0.0
Korea	5.1	0.5	1.2	2.1	1.3	1.0
Thailand	7.7	2.3	2.5	1.3	1.0	1.1
Argentina	5.7	1.3	1.0	2.0	1.4	4.4
Brazil	26.3	3.2	5.9	9.4	8.2	7.2
Mexico	10.2	2.5	2.9	2.3	2.6	2.6
Hungary	1.9	0.4	0.3	0.4	0.9	0.3
Poland	5.1	1.0	1.3	1.7	1.1	1.1
Russia	2.2	0.6	0.5	0.4	0.7	0.6
India	2.3	0.7	0.9	0.3	0.4	0.7

Source: Central banks and World Bank staff estimates.
Note: Estimates of FDI in 1998 shown in this table have been updated since publication of Global Development Finance 1999. The data on aggregate FDI flows to developing countries (shown on the previous page and in the annex tables) reflect the estimates shown in Global Development Finance 1999, because sufficient data are not yet available to revise the 1998 estimates for all developing countries.

Official Development Finance

Net official flows received by developing countries rose from $39 billion in 1997 to $48 billion in 1998. While net concessional flows were roughly stable at $33 billion, net nonconcessional finance rose from $6 billion in 1997 to $12 billion in 1998 due to large rescue packages for the countries most affected by the crisis. This figure excludes net IMF lending of $15 billion in 1997 and $21 billion in 1998, up from $1 billion in 1996. From August 1997 to December 1998 the international community made financial commitments of almost $190 billion to Brazil, Indonesia, the Republic of Korea and Thailand, with $63 billion disbursed. Net nonconcessional flows may remain stable in 1999, in part due to large disbursements to Brazil. IBRD commitments increased from $21.1 billion in FY98 to $22.2 billion in FY99; disbursements were $19.2 billion and $18.2 billion respectively in FY98 and FY99, compared with an average of $16.5 billion for FY96-97.[5]

Net official development assistance (ODA) from countries belonging to the OECD’s Development Assistance Committee (DAC) increased in 1998, for the first time since 1992. Preliminary data from the DAC show a rise in net ODA to developing countries and multilateral development agencies of $3.2 billion in 1998, to $51.5 billion.[6] This represented an increase of 8.9 percent in real terms over the previous year compared to a 21 percent decline in real terms during 1992-1997. Higher ODA flows were in part due to temporary factors, including increased concessional flows to countries affected by the Asian crisis and the timing of contributions to

[5] IBRD fiscal year is July-June. The slightly lower disbursement in FY99 is due to postponement of some loans to the current fiscal year, so disbursements are expected to be higher in FY00.

[6] Data on net ODA are based on reports of flows provided by donor countries, while the data reported above on net official flows are based on receipts by developing countries. An explanation of these different reporting systems is given in the annex to chapter 4 of Global Development Finance 1999.

multilateral development banks. The rise also reflects an increased commitment on the part of some of the major donors to maintain or increase their ODA levels. Thus prospects for ODA have improved somewhat over the past year, although budgetary constraints in some of the major countries are likely to continue to limit their ODA contributions. Progress on the HIPC Initiative is summarized in a separate paper prepared for the Development Committee meeting.

Annex Table 1. 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
Official Development Finance	36.0	41.1	41.1	40.1	41.5	56.9	62.6	54.0	53.3	45.5	53.4	32.2	39.1	47.9
Concessional Flows	25.7	29.2	33.3	34.0	34.4	44.8	51.0	44.0	41.5	45.7	44.6	40.1	33.4	32.7
Official Grants [1]	13.6	16.0	16.9	18.3	19.4	29.2	35.3	30.5	28.3	32.4	32.3	28.9	25.7	23.0
Official Concessional Loans	12.1	13.2	16.4	15.7	15.0	15.6	15.7	13.5	13.2	13.3	12.3	11.2	7.7	9.7
Official Non-concessional Loans	10.3	11.9	7.9	6.1	7.1	12.1	11.6	10.0	11.8	-0.3	8.8	-7.9	5.7	15.2
Private Flows	31.6	23.5	24.8	39.1	38.5	43.9	60.6	98.3	167.0	178.1	201.5	275.9	298.9	227.1
Private Debt Flows	20.6	13.5	10.7	18.7	11.9	15.7	18.6	38.1	49.0	54.4	60.0	100.3	105.3	58.0
Foreign Direct Investment [2]	10.9	9.4	13.4	19.3	23.2	24.5	34.4	46.1	67.0	88.5	105.4	126.4	163.4	155.0
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	14.1
AGGREGATE NET FLOWS	67.7	64.6	65.9	79.2	80.0	100.8	123.1	152.3	220.2	223.6	254.9	308.1	338.0	275.0
Memorandum Items:														
Interest payments	72.4	67.4	66.6	75.4	72.3	70.5	72.3	68.5	68.7	78.6	101.4	106.8	109.1	125.3
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	30.0	31.8	35.3
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
Related Data:														
Net Use of IMF Credit [3]	-0.2	-2.9	-5.5	-5.0	-2.3	0.1	3.2	1.2	1.7	1.6	16.8	1.0	14.7	21.0
Technical Coop. Grants	7.7	9.1	10.8	12.2	12.2	14.3	15.9	18.0	18.6	17.3	20.6	19.4	17.0	16.1
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	6.8
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	4.6

Sources: DRS and OECD.

Note: 1998 numbers are estimates.

1/ Excludes Technical Cooperation.

2/ Source: IMF.

3/ Includes IMF Trust Fund and EASF.

Annex Table 2. Long-Term Aggregate Net Resource Flows to Developing Countries

(US$ billions, at constant 1998 prices)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Official Development Finance	46.4	50.6	46.8	43.5	44.1	56.2	62.8	51.9	52.8	44.7	47.9	28.8	36.8	47.9
Concessional Flows	33.1	36.0	37.9	36.9	36.6	44.2	51.1	42.3	41.1	44.9	40.0	35.9	31.5	32.7
Official Grants [1]	17.5	19.7	19.2	19.8	20.6	28.8	35.4	29.3	28.0	31.8	29.0	25.8	24.2	23.0
Official Concessional Loans	15.6	16.3	18.7	17.0	15.9	15.4	15.7	13.0	13.1	13.1	11.0	10.0	7.3	9.7
Official Non-concessional Loans	13.3	14.7	9.0	6.6	7.5	11.9	11.6	9.6	11.7	-0.3	7.9	-7.1	5.4	15.2
Private Flows	40.7	28.9	28.2	42.4	40.9	43.3	60.8	94.5	165.5	174.8	180.9	246.7	281.7	227.1
Private Debt Flows	26.6	16.6	12.2	20.3	12.6	15.5	18.6	36.6	48.6	53.4	53.9	89.7	99.2	58.0
Foreign Direct Investment [2]	14.0	11.6	15.2	20.9	24.7	24.2	34.5	44.3	66.4	86.9	94.6	113.0	154.0	155.0
Portfolio Equity Investment	0.1	0.7	0.8	1.2	3.6	3.7	7.6	13.5	50.5	34.5	32.4	44.0	28.5	14.1
AGGREGATE NET FLOWS	87.3	79.6	75.0	85.9	85.0	99.5	123.4	146.3	218.2	219.4	228.8	275.5	318.5	275.0
Memorandum Items:														
Interest payments	93.3	83.0	75.8	81.8	76.8	69.6	72.5	65.8	68.1	77.1	91.0	95.5	102.8	125.3
Profits on Foreign Direct Investment	15.3	14.0	14.1	14.4	18.2	17.4	18.3	20.1	22.7	24.4	23.8	26.8	30.0	35.3
Private Grants	3.7	4.1	4.6	4.7	4.3	5.0	5.4	5.7	6.2	6.9	5.9	5.6	6.5	2.0
Related Data:														
Net Use of IMF Credit [3]	-0.3	-3.6	-6.3	-5.4	-2.4	0.1	3.2	1.2	1.7	1.6	15.1	0.9	13.9	21.0
Technical Coop. Grants	9.9	11.2	12.3	13.2	13.0	14.1	15.9	17.3	18.4	17.0	18.5	17.3	16.0	16.1
World Bank Net Flows	6.7	6.9	5.5	3.1	3.3	5.0	2.6	0.1	2.8	-0.3	1.0	1.3	6.3	6.8
IDA-Net Flows	3.6	3.8	4.3	4.0	3.6	4.0	4.3	4.6	4.5	5.5	4.4	5.1	5.0	4.6

Sources: DRS and OECD.
Note: 1998 numbers are estimates.
1/ Excludes Technical Cooperation.
2/ Source: IMF.
3/ Includes IMF Trust Fund and EASF.