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(Joint Ministerial Committee  
of the  
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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 28, 2002 Development Committee meeting is a background note entitled "Recent Trends in the Transfer of Resources to Developing Countries". This note was prepared by the members of the International Finance Team of the Development Prospects Group of the World Bank. It focuses on developments in 2002 to date – developments that have occurred after the publication of the 2002 issue of Global Development Finance.

**Recent Trends in the Transfer of Resources to Developing Countries**  
**A Background Note for the Development Committee Meeting of September 2002**  
**Prepared by Staff of the World Bank<sup>1</sup>**

**Summary**

The first half was a difficult environment for financial flows to developing countries, even though the global economy entered a recovery phase. One factor weighing on flows was the continued fall out from Argentina's debt default in December 2001. Although the effects of Argentina's decline on other emerging markets had been surprisingly modest through the second half of 2001, the spillover effects have become more prominent as 2002 has unfolded. Compounding these problems, however, has been a rise in political uncertainty surrounding the outcomes of elections in Brazil (in October) and Turkey (in November). These countries were poorly placed to deal with adverse political developments in view of their vulnerable domestic and external debt structures. As a result, private sector debt investors – both banks and non-banks - have become more wary about maintaining exposure.

It is important to note that, to date, these pressures have been evident only in parts of Latin America and Turkey. Other parts of the developing world have been under far less stress. Indeed, based on limited information, flows to most developing countries in Europe seem to have held up well so far in 2002, although there has been something of a shift away from equity-related flows to debt. Net flows to Asia have been outright strong, allowing most countries in the region to build reserves, allow their currencies to appreciate, trim local interest rates and thus ride out the recent softening in global growth far better than in 2001 and, especially, in 1997-98.

Moreover, foreign direct investment – which now provides the backbone of private sector external financial flows to developing countries – has been maintained at a relatively high level through the first half of 2002, despite a substantial decline in global outlays for mergers and acquisitions over that period.

The IMF has become more important again in providing finance to key borrowing countries. There were significant net disbursements to Turkey and Brazil in the first half of 2002. More recently, a sizeable new arrangement has been put in place for Uruguay, and Brazil's program (which was due to expire at the end of 2002) has been extended through the spring of 2004. Commitments by industrial countries to provide more aid were made ahead of the Monterrey Conference, although it is too early to know whether the declining trend in aid in recent years has yet been arrested.

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<sup>1</sup> This report was prepared by the members of the International Finance Team of the Development Prospects Group. The note focuses on developments in 2002 to date – developments that have occurred after the publication of the 2002 issue of *Global Development Finance*. In order to provide a broader perspective to these recent developments, a detailed table of longer-term trends in financial flows to developing countries is provided at the end of this note.

## Flows from international capital markets

It will be some time before full information on net debt flows to developing countries from private sector creditors is available, but what data are available suggest that net debt flows have been negative so far this year, and that this drain has worsened as the year has progressed:

- In the period January-July 2002, gross market-based debt flows have averaged \$10.7 billion per month, down about 22% from the average monthly flow of 2001. Of this total, about an equal amount (\$5.35 billion per month) has come from banks and from bond issuance. Gross bank lending is down about 33% from the average flow of last year, and gross bond issuance is down about 6% from the 2001 monthly average.
- Credit losses in Argentina and in the major markets compounded by weak performance in bank stock prices have made bank behavior far more cautious than last year. Data available from the BIS on changes in cross-border bank exposure to developing countries show that net claims fell by about \$29 billion, or 3.4%, through the first quarter. Within this total, claims on Latin American borrowers fell the most (by \$24.5 billion, or 9%). Judging from the gross flow data, net claims probably continued to contract through Q2, probably at a similar pace to that of Q1. Most recently, there have been anecdotal reports of banks trimming Latin American exposure further, especially to Brazil.
- Bond market conditions were favorable early in the year, but have since deteriorated significantly. Gross flows in the first five months of the year averaged \$6.2 billion per month, up from the average monthly flow for 2001. Since the middle of May, however, these flows have ebbed considerably, averaging just \$3.25 billion per month in June and July. Again, the drop to Latin America has been most pronounced. This was one region where issuance was below the 2001 pace even between January and May (no surprise in view of Argentina's disappearance from the market). But this more moderate flow stopped to a trickle in June, July and the first part of August. This shift in conditions is also plainly evident in bond yield spreads (chart below).

### Spread on emerging market benchmark bonds

*Basis points over U.S. Treasuries*



Explaining this deterioration in the bond market financing environment is inevitably somewhat conjectural but, at this point, two factors seem important:

- Growing concern about the robustness of the global economic recovery. In the early months of 2002, market participants became increasingly optimistic about the prospects for a global rebound, and this optimism was validated by strong global economic data in the first quarter (both the United States and Japan grew at rates exceeding 5%, saar, in Q1). By late April, however, concerns about the sustainability of this expansion were beginning to be evident, mainly because of worries about high levels of corporate leverage. These were compounded by concerns about the quality of companies' accounts. Although most of this worry centered on firms and markets in the developed world, the high degree of trade and capital flow linkage with the developing world means that weakness in the OECD is a clear negative for the incipient recovery in the developing world.
- Deteriorating domestic political conditions in key developing countries. Three specific concerns stand out:
  - o The failure of the Argentine authorities to put in place a policy framework that would allow for the resumption of IMF support, the reopening of the banks, and the regularization of relationships with private external creditors. The result has been sustained weakness in Argentine economic performance, and a further deterioration in already poor social conditions. Argentina's difficulties have spilled over most graphically into Uruguay, where they developed into a full fledged run on the banks and the country's reserves through July. This run was stopped only by the provision of a substantial, IMF-led support package.
  - o The looming October elections in Brazil (the first round is on October 6<sup>th</sup>; a likely second round will be on October 27<sup>th</sup>). The failure of the ruling coalition's candidate to make much headway in early opinion polls led to market fears that there would be a sudden reversal of policy under a new President. Although all four leading candidates have voiced some support for maintaining the policy guidelines of the recent IMF agreement, considerable uncertainties persist. Moreover, recent turmoil heightened concern among domestic and foreign investors regarding Brazil's domestic debt, which is heavily concentrated in short-term maturities, and with most debt-service payments linked to either short-term interest rates or the exchange rate.
  - o The collapse of the governing coalition in Turkey. Turkey's economy and markets were showing clear signs of recovery through the Spring, but have faltered in recent months as concerns about the Prime Minister's health led to a focus on succession and, eventually, the collapse of the government and the resignation of the Economics Minister. Elections have been called for November 3<sup>rd</sup>.

## Equity-related investment flows

Net foreign direct investment (inward flows less profit repatriation) to developing countries was about \$170 billion in 2001. In terms of aggregate external financing, FDI has become the key vehicle, although it should be noted that FDI flows are relatively highly concentrated.

The availability of data on FDI flows is somewhat lagged, so it is hard to be definitive about what has happened so far in 2002. Nonetheless, available information, gleaned from a sample of monthly and quarterly balance of payments reports from countries that have typically been the major recipients of FDI, suggests that flows have held up fairly well so far in 2002. Specifically:

- Net FDI inflows of this sample of 16 countries were an estimated \$56 billion in the first half of 2002, down 11.3% from the same period a year earlier.<sup>2</sup> This is an impressively strong performance in view of the weakness in global mergers and acquisition activity so far in 2002; the lack of privatization activity in developing countries; the problems of the corporate sectors in developing countries (especially in sectors such as telecom and energy that had shown a high propensity to invest in developing countries in recent years); and the reticence of private sector debt investors discussed above. Based on these flows and normal seasonal patterns, net FDI *inflows* to developing countries seems on track for about \$150-\$160 billion in 2002 as a whole (compared to net private debt *outflows*).<sup>3</sup>
- As with debt, there is significant regional diversity:
  - o Net FDI flows to Latin America were down by 24% in the first half of the year, although much of this decline reflected the virtual drying up of flows to Argentina.
  - o Net flows to Eastern Europe were also down sharply, a decline that was broad-based and which probably reflects the weakness of capital spending by companies in Western Europe, as well as a generalized slowdown in the zeal for completing the privatization process. Partly as a result of this reduction in net equity capital, the economies of Eastern Europe have become more dependent on net debt financing so far in 2002 – a development made possible by the region’s relatively low starting levels of debt, relatively high credit ratings and investors’ optimism about membership of the European Union. This increased debt dependence bears watching, however, especially since some countries in the region are struggling to rein in budget deficits.

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<sup>2</sup> The 16 countries are: Argentina, Mexico, Colombia, Czech Republic, Russia, Venezuela, Brazil, Korea, Philippines, Bulgaria, China, Chile, Hungary, Poland, Malaysia and Thailand. The sample accounts for about 80% of net inward FDI to developing countries.

<sup>3</sup> FDI flows are typically stronger in the second half of the calendar year than the first.

- Net flows to Asia were up by 7.7%, although this was dominated by China. Flows to South-East Asia have generally been less vigorous.
- China's already large share of net FDI flows is getting larger. Flows to China accounted for the rise in Asia, and were up strongly about optimism for the local economy and prospects following China's accession to the WTO.
- The stabilizing benefits of FDI were best illustrated by Brazil. As noted earlier, there were significant net debt outflows from Brazil in the first half of this year that seem to have accelerated so far in Q3. By contrast, net inward FDI was fairly stable, at \$9.6 billion, relative to last year (when FDI was \$9.9 billion in the first half of the year).

Despite the resilience of FDI so far this year, there are good reasons for caution looking ahead. The persistence of pressures on companies in developed countries may well make them cautious about capacity expansion, even though the global recovery is projected to strengthen into 2003. Moreover, the difficult experience of many FDI investors in Argentina could have spillover effects, especially in the rest of Latin America. On the other hand, many developing countries remain attractive options for expansion and diversification. The importance of FDI to the financing flows only serves to underline how critical it is for policy makers to promote an attractive investment climate and foster a environment of free trade.

International equity placements by developing country issuers (a proxy for portfolio equity flows) have also risen so far in 2002. In the first 7 months of the year, they averaged \$1.3 billion per month, up from the \$0.8 billion monthly average of 2001. Again, most of this increase was accounted for by China.

### **Official sector flows**

Data are not yet available to provide a full picture of non-concessional lending from official creditors in the first half of this year. However, the major multilateral lenders increased their lending to developing countries in the first half of 2002. Largely thanks to drawings by Brazil and Turkey, Fund credit outstanding rose from SDR53.5 billion at the end of 2001 to SDR59.6 billion at the end of June 2002. While Asian borrowers continued to repay credit, credit to Brazil rose from SDR 6.6 billion at the end of 2001 to SDR10.9 billion at mid year; and credit to Turkey rose from SDR11.2 billion at the end of 2001 to SDR14.5 billion at mid year.<sup>4</sup> The World Bank's net lending in first half of fiscal year was a modest \$418 million. Net IDA flows were \$3 billion, but there were net repayments to the IBRD of \$2.6 billion.

Even less timely information is available on aid flows, making it difficult to track whether commitments to step up aid are, in fact, being realized. According the data released by the OECD Development Assistance Committee in May, official development assistance (ODA) to developing countries from members of the DAC fell from \$53.7 billion in 2000 to \$51.4

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<sup>4</sup> Note the \$/SDR exchange rate was \$1.2567/SDR at end 2001 and \$1.3305/SDR at the end of June 2002.

billion in 2001.<sup>5</sup> This decline in part reflected the appreciation of the dollar, which reduces the dollar value of ODA flows recorded in other currencies. Net ODA fell by 1.4 percent in 2001 at constant prices, and remained at the 2000 level of 0.22 percent of DAC members' combined gross national income (GNI). The decline in dollar terms was driven by an almost \$4 billion fall in ODA from Japan, due to the depreciation of the yen, the timing of disbursements to multilateral organizations, and loan repayments from Asian countries affected by the 1997-98 financial crisis. By contrast, ODA from the United States rose by \$900 million (in large part due to a \$600 million disbursement to Pakistan for economic support in the aftermath of the September 11 attacks) and by \$700 million from the members of the European Union.

The disparity in ODA effort by the G7 countries and many of the smaller donors widened in 2001. Net ODA from the G7 countries fell by 3 percent in real terms, to only 0.18 percent of their gross national income. By contrast, ODA from the smaller countries rose by 4 percent in real terms, to 0.46 percent of their gross national income. Denmark remained the only DAC member country with ODA that exceeded 1 percent of national income, while Luxembourg, the Netherlands, Norway and Sweden provided more than 0.75 percent of national income in ODA. The ratio of ODA to national income was less than 0.4 percent in every other DAC member country. The United States had the lowest ratio (0.11 percent).

Despite the decline in the dollar value of ODA flows, the past year has seen some progress towards increasing efforts to assist developing countries and further their integration into the global economy. In addition, the ministerial meeting of the World Trade Organization set the stage for a "development round" of trade talks that will address the particular difficulties facing developing countries in the global trading system. The Monterrey Consensus reached at the Conference on Financing for International Development reaffirmed the international community's commitment to increasing aid and to achieving progress towards reaching the Millennium Development Goals. Some of the major donors indicated their intention to increase ODA flows: the European Union announced plans that would increase their total ODA level to 0.39 percent of national income by 2006, and the United States announced plans to raise its annual development assistance by \$5 billion (or almost a 50 percent increase) by 2006.

The decline in aid over the past few years comes on top of falling aid through much of the 1990s. Expressed as a share of donors' GNP, aid fell from 0.33 percent in 1990 to 0.22 percent in 2000. Only five donor countries reached (or surpassed) the United Nation's target of 0.7 percent of GNP which was endorsed by the G7 countries at the Earth Summit in Rio in 1992. At the same time, the need for aid continues to grow. Developing countries' population rose by 17 percent during the 1990s, and the number of people (outside of China) living on less than \$1 a day has remained roughly the same. Some 60 million people in developing countries are infected with HIV. The Millennium Development Goals cannot be met without increased aid. Preliminary calculations indicate that a doubling of aid, coupled with improved developing country policies and increased allocation of aid to countries with good policies, will be required to halve poverty by 2015. Vigorous steps to increase the availability of aid resources, in conjunction with

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<sup>5</sup> The Development Assistance Committee of the OECD is composed of the 22 industrial countries. DAC member countries account for at least 95 percent of total ODA flows to developing countries.

improved donor policies to support increased aid effectiveness and the removal of barriers to trade in industrial countries that restrain developing countries' exports, should be the top priorities for the international community.

## Long-Term Financial Flows to Developing Countries

\$ billions

	Average								
	<u>1985-89</u>	<u>1990-94</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
Official Development Finance	40.0	54.9	55.3	31.2	43.0	54.5	46.1	37.9	36.0
Concessional Flows	31.3	45.9	46.3	39.7	36.1	39.0	42.3	40.7	39.3
Official Grants <sup>1</sup>	16.7	31.0	32.8	28.1	26.6	27.9	30.2	29.9	29.6
Official Concessional Loans	14.6	14.9	13.5	11.6	9.5	11.1	12.1	10.8	9.7
Official Non-concessional Loans	8.7	9.0	9.0	-8.5	6.9	15.5	3.8	-2.8	-3.3
Private Flows	31.4	109.5	206.1	276.5	300.8	283.2	224.4	225.8	160.0
Private Loans	15.0	34.5	63.3	96.5	98.1	89.4	5.6	8.2	-26.8
Foreign Direct Investment <sup>2</sup>	15.2	52.7	106.8	130.8	172.5	178.3	184.4	166.7	168.2
Portfolio Equity Investment	1.2	22.3	36.1	49.2	30.2	15.6	34.5	50.9	18.5
AGGREGATE NET FLOWS	71.4	164.4	261.5	307.7	343.8	337.7	270.5	263.7	196.0
Memorandum Items:									
Interest payments	70.8	71.3	100.8	106.6	112.9	118.7	121.9	126.7	122.2
Profits on Foreign Direct Investment	13.2	19.3	26.5	30.0	31.8	35.2	40.3	45.4	55.3
Private Grants	3.7	5.7	6.0	5.6	5.2	5.6	5.7	5.5	5.4
Related Data:									
Net Use of IMF Credit <sup>3</sup>	-3.2	1.6	17.3	0.6	14.5	19.2	-12.6	-10.8	13.5
Technical Coop. Grants	10.4	16.5	20.1	18.7	15.7	16.3	16.6	15.5	15.2
World Bank Net Flows	4.3	2.1	1.1	1.4	6.7	6.8	5.1	3.4	2.2
IDA-Net Flows	3.3	4.6	4.9	5.7	5.3	4.8	4.5	4.2	4.7

Sources : *Global Development Finance Country Tables* and sources cited therein, World Bank Global Economic Model, OECD Development Assistance Committee's *Geographic Distribution of Flows*.

Note: 2001 numbers are estimates.

1/ Excludes Technical Cooperation.

2/ Source: IMF.

3/ Includes IMF Trust Fund and EASF.