THE WORLD BANK

Global Development Finance

The Globalization of Corporate Finance in Developing Countries

I: REVIEW, ANALYSIS, AND OUTLOOK

2007

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Foreword

The economic environment facing developing countries remained highly favorable in 2006. Global gross domestic product (GDP) expanded by 4 percent, although signs of moderation emerged toward year-end. Developing economies grew by 7.3 percent, and international financial markets remained supportive of their financing needs despite several episodes of heightened volatility. Oil prices appear to have peaked, while markets for most other commodities produced by developing countries remained high—or rose still further. Combined, these conditions created the context for the continued expansion of private capital flows to developing countries, which reached a record $647 billion in 2006—5.7 percent of the aggregate GDP of these countries.

Strong private capital flows to developing countries reflect both these cyclical elements and improvements in the fundamentals of these economies. A wide range of middle-income countries has benefited from these flows, but access to private capital in many low-income developing countries remains limited and is dominated by trade financing and the resource sector. Sub-Saharan Africa, for example, was the destination of only 6 percent ($292 billion) of the $4.9 trillion in private capital that flowed to developing economies between 1990 and 2006. Low-income countries, benefiting from recent international debt-relief initiatives, must face the challenge of adopting prudent borrowing practices to ensure long-term growth and debt sustainability. Complementary efforts to increase aid flows have stalled—the amount of official development assistance provided by the 22 members of the Development Assistance Committee of the Organisation for Economic Co-operation and Development declined by almost $3 billion in 2006, following a large $27 billion increase in 2005. Donors must enrich development assistance significantly over the next few years in order to meet their commitments, notably the pledge made by G-8 and other donor countries to double the amount of aid provided to Sub-Saharan Africa by 2010.

Although oil import bills have risen, the past five years have presented a highly favorable mix of economic and financial conditions for most developing countries: low international interest rates, ample global liquidity, and strong global demand for exports. Many middle-income countries have taken advantage of this opportunity to enhance their creditworthiness by accumulating foreign exchange reserves, improving current account balances, reducing external debt burdens, and improving debt management by issuing longer maturities. Several large borrowers have bought back significant amounts of outstanding debt using abundant foreign exchange reserves. Many governments have turned from external to domestic markets, where most debt is denominated in local currency. Partly as a consequence, creditors' assessment of developing countries is very positive, as reflected in near record-low spreads on emerging-market bonds and bank loans.

These favorable conditions and the gains that have accrued are not grounds for complacency in assessing future risks. History suggests that market conditions and sentiment can shift with dizzying speed. Sustaining the discipline and sound policy that have contributed to the current favorable phase must remain in the forefront of decision makers' objectives.

The increasing share of corporate finance in emerging-market economies' external borrowing has introduced its own risks. For much of the postwar era, foreign borrowing by sovereigns has been the dominant feature of development finance. Since 2002, however, a different picture has emerged. The past few years of strong developing-country growth has brought the leading companies of the developing world to the attention of an ever-wider set of investors. Together with the liberalization of capital controls and the pressures facing international portfolio managers to enhance returns, the globalization of corporate finance is now reaching a larger segment of the developing world. This in turn strengthens the case for a more coherent and global approach to regulating cross-border public offerings and securities listings. Domestic regulators must pay greater attention to the transparency and stringency of accounting standards, the credibility of financial reporting, and the integrity of corporate governance. In all cases, there must be a balance between official regulations and market incentives for enhancing the efficiency of global capital allocation.

The globalization of corporate finance also points to other challenges. As emerging-market corporations have expanded their international operations, they have increased their exposure to interest rate and currency risks. Concerns are growing that several countries in emerging Europe and Central Asia are experiencing a credit boom engendered by cross-border borrowing by banks of untested financial health and stamina. Some of these banks have increased their foreign exchange exposure to worrisome levels, a concern that warrants special attention from national policymakers. Given banks' critical role in domestic monetary systems, policy makers should step up their regulation of foreign borrowing by banks.

The projected slowdown in global growth and tighter monetary policy in high-income countries are expected to make financing conditions for developing countries somewhat less favorable in coming years. While a soft landing is the most likely outcome, there are risks. For example, if the economic downturn in the United States is deeper than forecast, demand for developing economies' exports (and commodity prices) may fall enough to contribute to reduced confidence and induce financial sector disruption. Conversely, should growth fail to moderate, financial stability in some fast-growing developing economies could be threatened by rising inflation and high current account deficits.

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 capital raised by developing country based corporations. A separate volume contains detailed standardized external debt statistics for 136 countries as well as summary data for regions and income groups. More information, including additional material, 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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Selected Abbreviations

ADR	American Depositary Receipt
ASW	Asset swap
CDS	Credit default swap
DAC	Development Assistance Committee
EMBI Global	JPMorgan Emerging Markets Bond Index Global
EU	European Union
FASB	Financial Accounting Standards Board
FDI	Foreign direct investment
G-7	Group of Seven (Canada, France, Germany, Italy, Japan, United Kingdom, United States)
GAAP	Generally Accepted Accounting Principles
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GDR	Global Depositary Receipt
HIPC	Heavily indebted poor countries
IASB	International Accounting Standards Board
ICRG	International Consulting Resources Group
IFRS	International Financial Reporting Standards
IFS	*International Financial Statistics* (IMF)
IMF	International Monetary Fund
IPO	Initial public offering
LSE	London Stock Exchange
M&A	Mergers and acquisitions
MDRI	Multilateral Debt Relief Initiative
MSCI	Morgan Stanley Capital International
mbpd	Million barrels per day
NYSE	New York Stock Exchange
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of Petroleum-Exporting Countries
PPP	Purchasing power parity
SIC	Standard Industrial Classification
UN	United Nations
WDI	*World Development Indicators* (World Bank)
WTO	World Trade Organization

Overview

WORLD GROWTH IS MODERATING, and financial markets are signaling a turn in the financing conditions facing the developing world. As these developments make themselves felt, 2007 is likely to be a year of adjustment for capital flows to developing countries.

After recovering from the sharp contraction of 2001–02, private flows weathered several episodes of global financial volatility and passed through a full cycle of global monetary easing and tightening to reach a record level of $647 billion in 2006, up 17 percent from 2005. Total capital flows, including lending by official creditors, leveled off at 5 percent of gross domestic product (GDP) in 2005–06, just below the 5.25 percent level reached in 1995–97, before the East Asian crisis.

Developing countries have come to account for a large share of the growth of world output and trade, a fact that is increasingly recognized by international investors. Their economies grew more than 7 percent in 2006—more than twice the 3 percent rate of growth in high-income countries. The expansion was particularly evident in China, where output increased 10.7 percent, and India, which grew 9.2 percent. But the strong performance was broadly based, with all developing regions growing at least 5 percent. Even oil-importing developing countries recorded robust growth of almost 5 percent, despite high oil prices for the third consecutive year.

Most developing countries have taken advantage of favorable external conditions to implement domestic policies designed to reduce their vulnerability to financial turmoil and reversals in capital flows. In particular, countries have reduced their external debt burdens and lengthened the maturity structure of their debt. Several have bought back large amounts of outstanding debt, using abundant foreign exchange reserves, and refinanced existing debt on more favorable terms. The market for sovereign debt has evolved significantly, as governments have turned from borrowing externally to borrowing domestically, usually in local currency. Creditors' assessment of the creditworthiness of developing-country borrowers remains positive, as reflected in spreads on emerging market bonds and bank loans, which have hovered near record lows.

By these measures, most developing countries have clearly improved their ability to deal with the moderate shocks that may accompany changes in the international credit environment. However, the buoyancy of financial markets, combined with the slowing of growth and the trend toward continued monetary tightening, provide grounds for caution. In particular, although the smooth adjustment toward slower, more sustainable, growth that is outlined in the baseline projection presented in this report is the most likely outcome, such turning points are risky in nature. The extent to which the U.S. housing-sector correction spreads to other sectors in the economy, the success with which those developing countries that are overheating are able to contain inflation and reduce current account imbalances, and the durability of financial markets' current benign assessment of long-term risks are all areas of uncertainty that could result in a more abrupt and disruptive adjustment toward slower growth.

Strong growth in 2006 probably represents a cyclical peak

Global GDP expanded 4 percent in 2006, despite signs of a moderation of the current expansion. Tighter monetary policy, further emerging capacity constraints in many countries, and a generalized maturation of the investment cycle contributed to a slowing of industrial production toward the end of the year in the major high-income countries and China. The more marked slowdown in the United States has contributed to some easing of major tensions. U.S. housing prices have moderated or declined in some parts of the country, without (yet) triggering a disruptive sell-off. At the same time, U.S. savings have crept up, as the current account deficit fell to 5.9 percent of GDP in the last quarter of 2006.

Short- and long-term international interest rates have risen in response to policy actions and market-induced revaluations of long-term risks, while risk premiums, notably on subprime assets, have increased in recent months. Commodity prices also show signs of having reached cyclical peaks, with some easing of oil prices from the mid-2006 high point and a decline in the prices of copper and zinc, two of the metals whose prices had risen most rapidly. Financial conditions remain supportive by historical measures, however, and liquidity remains ample. As a result, the transition to slower growth is expected to be relatively smooth. The expansion of developing economies is projected to moderate gradually, from 7.3 percent in 2006 to about 6 percent in 2009, with all regions slowing but continuing to record strong results. At the same time, growth in the high-income countries is expected to ease in 2007 (mainly reflecting slower U.S. growth) before strengthening in 2008 and 2009, as the United States recovers and the economies of Japan and Europe continue to expand at close to their potential rates.

The expansion in capital flows was led by equity, as private sources eclipsed official

The composition of capital flows continues its pronounced shift from debt to equity financing and from official to private sources of debt. Equity flows totaled $419 billion in 2006, accounting for almost three-quarters of capital flows, up from two-thirds in 2004, with strong gains in both portfolio equity and foreign direct investment (FDI). Equity prices in emerging markets continued to outperform mature markets by a wide margin while also exhibiting greater volatility. Worldwide FDI inflows reached $1.2 trillion in 2006, with about one-quarter of the total ($325 billion) going to developing countries.

Net lending from the international financial institutions and other official sources in the Paris Club of creditors dropped starkly over the past two years, while private lending surged. Several countries drew down abundant foreign exchange reserves to pay off debt owed to official creditors and to access financing from private sources on favorable terms. Principal repayments to the Paris Club and multilateral institutions (particularly the International Monetary Fund) exceeded disbursements by some $146 billion in 2005–06, as net private debt flows reached $432 billion.

The development of local and regional bond markets in low-income countries, as highlighted by the G-7 finance ministers at their meeting in February 2007, has the potential to improve financial infrastructure and provide an additional source of financing. Local bond markets in Kenya, Nigeria, Zambia, and elsewhere have already attracted the interest of foreign investors. While participation of foreign investors in these markets offers significant potential benefits, notably diversifying the investor base and enhancing liquidity, it also poses new risks, particularly in cases where segments of these markets are dominated by foreign investors, which makes them more vulnerable to a sudden swing in investor sentiment. Progress on improving the quality of institutions, governance, and economic policies will ultimately have a major influence on how effectively developing countries manage such risks. Given the high vulnerability of such countries to domestic and external shocks, governments are well advised to improve data collection and procedures for better monitoring of foreign investment flows.

The globalization of corporate finance offers significant benefits for developing countries

In the making for many years, the globalization of corporate finance in the developing world has accelerated since 2002, as governments have liberalized capital controls and international portfolio managers have enhanced returns by diversifying into emerging corporate securities. With these changes, more companies based in developing countries have entered world capital markets to broaden their funding sources, borrowing at longer maturities and improving risk management through the use of sophisticated financing instruments. Private sector companies were behind much of the increase, accounting for more than 60 percent of total bank borrowing and 75 percent of new bond issuance during 2002–06. Financial corporations, particularly commercial banks from India, Kazakhstan, the Russian Federation, and Turkey, have been on the forefront of what may well be a major foreign-credit boom in the banking industry of these countries. Banks have tapped international debt markets to fund growing domestic loan portfolios and meet increasing capital-adequacy requirements. Faced with intensified competitive pressures and highly liquid markets, international banks have been willing to narrow margins, lengthen maturities, and relax credit standards.

Growing numbers of firms are opting to cross-list their shares on major world stock exchanges as a way of facilitating trading by foreign investors and building channels through which to meet future capital needs. Companies often gain value by bypassing underdeveloped local capital markets and committing to higher standards of accounting, reporting, disclosure, and corporate governance, as mandated by major financial centers. By meeting these standards, companies can lower their cost of capital. But overreliance on international sources of capital has drawbacks, too:

- As emerging-market corporations have increased in size and expanded their international operations, they have increased their exposure to interest-rate and currency risks. Despite advances in risk management by many firms, concerns remain in two particular areas. First, growing yen-denominated liabilities held by some corporations may not be adequately hedged against currency movements. Second, in many emerging-market corporations, the capacity to develop an enterprisewide risk management framework is hampered by underdeveloped derivatives markets, making it difficult to measure, aggregate, and hedge risk. Moreover, credit risk may be substantially underestimated at the current phase of the credit cycle.
- Banks' exposure to foreign-currency borrowing warrants special attention from policy makers, given banks' critical role in domestic monetary systems. Foreign borrowing by developing-country banks can help deepen and modernize the financial sector if underlying policy and regulatory frameworks promote healthy banking practices, sound credit allocation, and proper risk management. Where supervision is less than stringent, systemic risks can be considerable—and they are rarely confined to the country in which the risky borrower is based. Several countries, particularly in the transition economies of Europe and Central Asia, are now experiencing a credit boom, spearheaded by banks of untested financial health and stamina. Concerns are growing that some of these banks—particularly in Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Russia, and Ukraine—are increasing their foreign exchange exposure to levels that have the potential to jeopardize financial stability.

Protecting the benefits of globalization for developing countries and their corporations will require appropriate policies, both macroeconomic and regulatory, by governments in the developing world. While corporate decisions to raise capital on overseas markets should depend primarily on market forces, pubic authorities must not shy away from addressing situations in which corporate financial distress could spill over to the banking sector, raising systemic risk. Policy makers must keep two realities in sharp focus. The first is that the globalization of firms based in developing countries is driven by powerful market forces and trends that are inseparable from the broader globalization of the world economy. This is a secular trend that shows no signs of abating. On balance this is a positive trend, worthy of continued support from policy makers and regulators. The second is that governments must also keep their eyes on managing short-term fluctuations and risks. Market-determined exchange rates, far greater corporate transparency, and government regulation of foreign borrowing by banks are needed to reduce the likelihood of excessive corporate foreign borrowing and financial distress.

International financial institutions and supranational organizations (notably those in the securities and accounting fields) can help by establishing clear and consistent rules for access to the financial markets of the industrial world. National and regional systems of securities regulation embrace different standards, rules, and systems. For firms, complying with multiple sets of rules can be very costly. Market pressures and action by international regulators have brought about some degree of convergence in certain areas, notably accounting rules, but the need remains to strike a balance between official regulations and market incentives in managing cross-border offerings and listings on major exchanges. Doing so will require more progress in streamlining and harmonizing national regulation of corporate governance practices, disclosure rules, financial accounting standards, and enforcement mechanisms.

Little progress has been made in scaling up aid

The wave of private finance in the developing world may represent a powerful secular trend, but it has not reached all shores. Sixty percent of all developing countries (79 of 135) never accessed the external bond market between 1980 and 2006; just eight countries did so frequently.

Most low-income countries lack ready access to private debt markets, and many continue to depend very heavily on concessional loans and grants to meet their financing needs. At the UN Conference on Financing for Development in Monterrey in 2002, official donors pledged to increase the amount of new aid they provided, over and above the substantial amounts of debt relief then being planned. Donors subsequently made commitments to enhance aid substantially over the balance of the decade, particularly to low-income countries in Sub-Saharan Africa.

Little progress was made toward meeting these objectives in 2006. Excluding debt relief, net disbursements of official development assistance were static, after growing at an average annual rate of 16 percent over the three previous years.

Several new aid donors have emerged in the past few years. Some, such as Brazil, China, India, and Russia, are now both donors and recipients of development assistance. Not much is known about the aid provided by most of the new donor countries, because their activities are not reported in a comprehensive manner. But the emergence of new players on the aid agenda has increased the need for greater coordination among donors and better monitoring of aid flows, so that aid can be directed where it is most needed and most likely to be effective.

Good policies need to be sustained and extended in managing the upcoming adjustment

Never before have conditions been so well aligned for a major push toward sustainable growth and poverty reduction. Developing countries stand to reap substantial benefits from the access their enterprises have gained to the world's major financial centers, with their deep and liquid financial resources, broad investor bases, and modern trading platforms. For the fourth consecutive year, growth in developing countries, including those in Sub-Saharan Africa, was strong. Low-income countries' ability to access private debt markets has been considerably enhanced by recent debt-relief initiatives, which have significantly reduced their debt burdens and improved their creditworthiness. These hard-won gains are worth protecting.

The key requirement for doing so is to sustain and extend the solid policies and frameworks that have provided fertile ground for developing countries' growth and that have brought emerging markets to the attention of an ever-wider set of investors. Underway in many countries since the early 1990s, these fundamental improvements include progress toward flexible exchange rates; a phased easing of capital controls, in line with improvements in institutional and regulatory capacity; and privatization of public enterprises. Greater efforts are also needed to spur the development of well-regulated and liquid local capital markets, which provide developing countries with sound protection against external shocks, and to ensure prudential regulation of foreign borrowing by domestic banks and other regulated financial entities. Such structural improvements would greatly reduce the likelihood of corporate financial distress and vulnerability while promoting the orderly growth of new market institutions and the regulatory capacity needed for effective macroeconomic management of the increasingly open economies of the developing world.

These improvements notwithstanding, the cyclical component of financial flows to developing countries means that the newly enhanced access of emerging market sovereigns and corporations to global finance could reverse itself. Global financial markets are notoriously sensitive to bad news during downturns in the global business cycle, and the possibility of an abrupt market reaction to unexpected events, economic or political, cannot be ruled out. The outlook is further clouded by large current account deficits in several middle-income developing countries (especially those in Europe and Central Asia) and uncertainty surrounding the functioning of exotically structured financial products and their ability to sustain a major reversal in investor sentiment.

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

1

The Outlook for Developing Economies

Summary of the medium-term outlook

Growth in the developing countries came in at 7.3 percent in 2006, the fourth year that their economies expanded by more than 5.5 percent. Very fast-growing countries, such as China (10.7 percent) and India (9.2 percent), contributed strongly to this overall result. But even excluding these countries, low- and middle-income countries grew 5.9 percent and gross domestic product (GDP) in every developing region expanded by more than 5 percent. This robust developing-country demand was reflected in stronger high-income country export growth, which was the main factor behind the acceleration of GDP in those countries to 3.1 percent. Overall, global output increased by 4 percent (5.3 percent using purchasing power parity [PPP] weights).

Despite these strong figures, 2006 was likely a cyclical peak, as both GDP and industrial production began slowing in mid-2006 and into 2007. This moderation of growth among developing countries is welcome, however, because it should help reduce the chance that the current growth boom could be followed by a bust.

The past few years of very strong growth have generated a number of tensions in the global economy, including increased commodity and asset prices (notably those of oil, metals, and housing) and a buildup of inflationary pressures.

The moderation of growth reflects the influence of a number of economic adjustment mechanisms that are in part a self-correcting reaction to these tensions.

Rising interest rates and tighter fiscal policy form a central part of the re-equilibrating process. Both policy action and market-induced revaluations of long-term risk have caused short-term interest rates to rise. Among developing countries, monetary tightening is most advanced in East Asia, where it has both slowed growth and contained inflationary pressures in a number of countries. In other developing economies, interest rates have risen and fiscal policy has been less procyclical than in the past, but the overall stance of macroeconomic policy in many of these countries is still relatively accommodating—leaving open the possibility of a much bumpier return to potential growth rates than is laid out in the baseline projection.

Growth in many developing countries continues to exceed potential. Partly as a consequence, there are clear signs of overheating in several middle-income countries, and inflation, which had been easing in 2005, stabilized or picked up over the past 12 months in four of six developing regions. Among high-income countries, slower growth (especially in the United States) and lower oil prices have brought down headline inflation. But core inflation is high in the United States and rising in Europe, causing monetary authorities to remain cautious.

Another factor contributing to a slowing in growth is the apparent stabilization of capital flows to developing countries. While inflows remain high, they have stabilized as a share of GDP and are no longer making a significant contribution to growth. Partly as a result, most developing countries have stopped accumulating reserves at rapid rates—although China and Russia constitute important exceptions in this regard.

Commodity prices also show signs of having reached cyclical peaks. Oil prices have eased from high points in mid-2006, as have the prices of copper and zinc, two of the metals whose prices have risen most rapidly. As growth eases, commodity prices are projected to decline further, which should support real incomes in importing countries even as output growth moderates. While a gradual decline in oil and other commodity prices is the most likely scenario, supplies remain very tight. An oil-sector supply shock could be extremely disruptive, driving up oil prices even farther while simultaneously slowing growth and weakening the prices of most nonoil commodities to the detriment of oil-importing developing countries.

These developments are also working to alleviate the global imbalances that have been building over the past nine years. Indeed, very strong domestic demand in developing countries, the recovery in Europe, rising interest rates, lower commodity prices, and an increase in U.S. savings as the housing boom recedes have brought an end to the trend rise in the U.S. current account deficit, which declined to 5.8 percent of GDP in the fourth quarter of 2006. While cyclical factors are at play, the increase in U.S. savings, the decline in commodity prices, and the shift in global growth toward developing countries reflect important structural changes that likely signal a beginning of an orderly resolution to the trend rise in global imbalances. Nevertheless, imbalances remain large, and there is a continuing low-probability risk that they will be resolved in a disruptive manner.

Although interest rates have increased, financial conditions remain supportive by historical measures, and liquidity is ample.[1] As a result, the transition to slower growth is expected to be relatively smooth. The expansion in developing countries is projected to moderate gradually, to about 6 percent in 2009, with all regions slowing but continuing to record strong results. At the same time, growth in the high-income countries is expected to ease in 2007 (mainly reflecting slower U.S. growth) before strengthening in 2008 and 2009, as the United States recovers and the economies of Europe and Japan continue to expand at close to their potential rates.

This positive outlook is subject to significant tensions and uncertainties. Overheating (high inflation and large current account deficits) in a number of middle-income countries increases the risk of a hard landing for at least some of them. Should financial markets react to a sudden policy-induced slowdown (or an increase in internal or external imbalances) in one or more of these countries by re-evaluating the riskiness of emerging market assets, there could be a sharp reversal in capital flows. This, in turn, could provoke significant real-side adjustments among those countries with the largest current account deficits.

The risk of a steep recession in the United States appears to have declined, but the effects of weakness in the housing sector are increasingly being felt in other sectors, and a much sharper than projected slowdown cannot be ruled out. Such a slowdown would have consequences for developing countries, through traditional trade channels but also potentially via financial markets. If, for example, difficulties in the U.S. subprime market were to deepen or spread to other sectors, investors might be forced to close positions in emerging markets to meet obligations in the United States, with adverse effects on developing-market valuations.

For the poorest countries, significantly slower growth could cause commodity prices to weaken more rapidly than projected, potentially placing many developing countries that have so far avoided current account problems in difficulty. Private sector funding of resource-based projects would likely dry up, and lower revenues might make it difficult for some countries to repay some of the private sector and short-term lending that has accounted for much of the increase in financial flows to developing countries in recent years.

The diversion of land and produce into the production of biofuels has greatly reduced global stocks of wheat, rice, and maize. Should 2007 be a poor crop year, the prices of these basic foods could rise by as much as 100 percent. This could have serious near-term consequences for the urban poor in those developing countries where these products represent a large share of total consumption. Estimates suggest that a 40 percent increase in the price of one of these grains could reduce real incomes among the poor in some countries by 6 percent or more.

The global outlook

Despite oil prices that topped $75 a barrel during the course of 2006, world GDP rose 4 percent (5.3 percent in PPP terms), up from 3.5 percent in 2005 (table 1.1). This strong global performance reflects the very rapid expansion of

Table 1.1 The global outlook in summary
% change from previous year, except interest rates and oil price

	1960–80	1980–2000	2005	2006e	2007f	2008f	2009f
Global conditions							
World trade volume	—	5.8	7.6	10.2	7.5	8.2	7.9
Consumer prices							
G-7 countries[a,b]	—	3.6	2.5	2.6	1.6	1.7	1.7
United States	—	3.8	3.4	3.2	1.9	1.5	1.9
Commodity prices ($ terms)							
Non-oil commodities	6.0	−1.8	13.4	24.7	6.3	−8.6	−8.4
Oil price ($ per barrel)[c]	7.1	22.2	53.4	64.3	60.4	58.4	55.2
Oil price (percent change)	16.9	−1.3	41.5	20.4	−6.0	−3.4	−5.4
Manufactures unit export value[d]	6.3	1.1	0	1.6	0.8	0.8	0.8
Interest rates							
$, 6-month (percent)	—	7.9	3.6	5.2	5.4	4.8	4.7
€, 6-month (percent)	—	6.9	2.2	3.1	3.8	4.3	4.3
Real GDP growth[e]							
World	4.7	3.0	3.5	4.0	3.3	3.6	3.5
Memo item: World (PPP weights)[f]	4.7	3.0	4.7	5.3	4.7	4.8	4.7
High-income countries	4.5	2.9	2.6	3.1	2.4	2.8	2.8
OECD	4.4	2.8	2.5	2.9	2.3	2.7	2.7
Euro Area	4.3	2.3	1.3	2.7	2.5	2.2	2.0
Japan	7.4	2.6	2.6	2.2	2.3	2.4	2.1
United States	3.5	3.3	3.2	3.3	1.9	3.0	3.1
Non-OECD	4.5	2.9	5.8	5.7	4.9	5.1	5.0
Developing countries	6.2	3.3	6.7	7.3	6.7	6.2	6.1
East Asia and Pacific	5.6	8.0	9.0	9.5	8.7	8.0	7.9
China	4.9	9.9	10.2	10.7	9.6	8.7	8.5
Indonesia	6.0	5.3	5.7	5.5	6.3	6.5	6.4
Thailand	7.5	6.1	4.5	5.3	4.5	4.5	5.0
Europe and Central Asia	—	—	6.0	6.8	6.0	5.7	5.8
Russia	—	—	6.4	6.7	6.3	5.6	5.8
Turkey	3.6	4.4	7.4	6.0	4.5	5.5	5.4
Poland	5.8	1.7	3.5	6.1	6.5	5.7	5.0
Latin America and the Caribbean	5.5	2.2	4.7	5.6	4.8	4.3	3.9
Brazil	7.3	2.1	2.9	3.7	4.2	4.1	3.9
Mexico	6.7	2.6	2.8	4.8	3.5	3.7	3.6
Argentina	3.4	1.5	9.2	8.5	7.5	5.6	3.8
Middle East and North Africa	6.0	3.9	4.3	5.0	4.5	4.6	4.8
Egypt, Arab Rep. of	6.0	4.9	4.6	6.9	5.3	5.4	6.0
Iran, Islamic Rep. of	6.5	2.9	4.4	5.8	5.0	4.7	4.5
Algeria	4.8	2.2	5.3	1.4	2.5	3.5	4.0
South Asia	3.7	5.4	8.7	8.6	7.9	7.5	7.2
India	3.5	5.6	9.2	9.2	8.4	7.8	7.5
Pakistan	5.9	5.1	7.8	6.6	6.4	6.3	6.1
Bangladesh	2.4	4.3	6.0	6.2	6.0	6.1	6.4
Sub-Saharan Africa	4.3	2.1	5.8	5.6	5.8	5.8	5.4
South Africa	4.7	1.7	5.1	5.0	4.4	5.2	4.9
Nigeria	4.6	1.9	6.9	5.6	6.4	6.6	5.9
Kenya	6.2	3.0	5.8	5.9	5.1	5.2	4.9
Memorandum items							
Developing countries							
excluding transition countries	5.2	4.1	6.9	7.4	6.7	6.3	6.1
excluding China and India	6.5	2.2	5.2	5.9	5.3	5.0	4.9

Source: World Bank.
Note: PPP = purchasing power parity; e = estimate; f = forecast; — = not available.
a. Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
b. In local currency, aggregated using 2000 GDP weights.
c. Simple average of Dubai, Brent, and West Texas Intermediate.
d. Unit value index of manufactured exports from major economies, expressed in U.S. dollars.
e. GDP in 2000 constant dollars; 2000 prices and market exchange rates.
f. GDP measured at 2000 PPP weights.

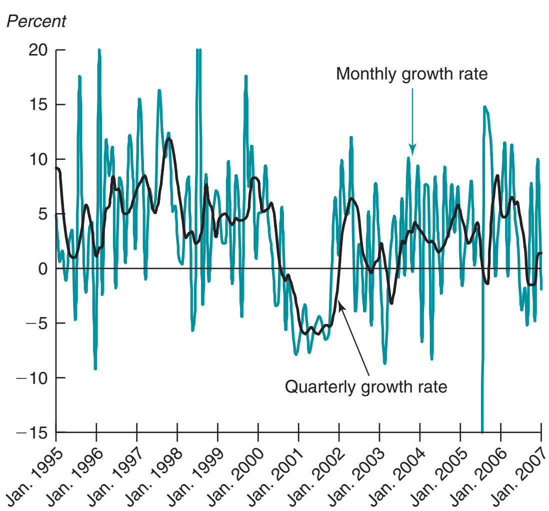
developing economies, which grew 7.3 percent—more than twice the rate in high-income countries (3.1 percent).

Robust growth in China (10.7 percent) and India (9.2 percent) played a significant role in the recent strength of developing countries. Nevertheless, the pickup was broadly based. Even excluding these two countries, developing countries grew 5.9 percent (5.2 percent for small oil exporters), and all regions grew by more than 5 percent.

The outlook for high-income countries

In the *United States,* GDP expanded 3.3 percent in 2006. Output grew very rapidly at the beginning of the year, before higher short-term interest rates, brought on by tighter monetary policy, prompted a sharp correction in the housing market. The ensuing sectoral recession caused economic activity in the housing sector to begin contracting in the second quarter. Residential investment fell 17 percent during the six quarters ending March 2007, contributing to significantly slower GDP growth. Preliminary estimates indicate that the U.S. economy expanded only 1.3 percent in the first quarter of 2007, as weakness in the housing sector weighed upon investment expenditures elsewhere in the economy and falling residential investment slowed orders and industrial production in related sectors (figure 1.1).

Figure 1.1 U.S. industrial production growth



Sources: World Bank; Datastream.

Note: Quarterly and monthly percentages are seasonally-adjusted annualized rates.

These developments were concentrated in the goods sector (including structures, computers, and vehicles), whose contribution to growth fell to zero in both the final quarter of 2006 and the first quarter of 2007 and was reflected in very weak import demand. Consumer demand and production of services have remained robust, partly because the jobs picture remains good and inflation is falling. Export volumes rose 6.6 percent in the six months ending in the first quarter of 2007, rising sharply in the fourth quarter of 2006 before falling in the first quarter of 2007 (seasonally-adjusted annualized rates). In contrast, imports rose just 0.6 percent over this period. Coupled with lower fuel prices, these developments helped reduce the U.S. current account deficit to 5.8 percent of GDP in the fourth quarter of 2006, down from an average of 6.7 percent in the preceding three quarters.

In *Europe* GDP grew 2.8 percent in 2006, driven by strong export growth and a resurgence in domestic demand toward the end of the year.[2] After slowing during the third quarter, GDP accelerated in the fourth quarter, to a 3.1 percent annualized pace, as falling unemployment and strong profitability boosted consumer demand and investment activity. A pickup in private consumption in Germany before a 3 percent hike in the value added tax (VAT) in January 2007 provided an additional fillip to growth, while robust exports to the countries of the former Soviet bloc helped propel economic activity throughout the year.

Data for the first quarter of 2007 indicate that German industrial production was up strongly in the first two months of the year but that retail sales declined 4.5 percent on an annualized basis in response to the increased VAT rate. Nevertheless, consumer confidence improved. Private consumption in France was robust during the first quarter. In contrast to the United States, industrial production in Europe picked up in the final months of 2006 and into 2007. Business sentiment and orders point to continued strong growth in the months to come. Overall, GDP decelerated somewhat, although excluding Germany it picked up in the first quarter of 2007.

In *Japan* GDP increased 2.2 percent in 2006, boosted by investment spending and a modest recovery in consumer demand. As in Europe, growth started the year very strong, weakened toward the third quarter, and strengthened in the fourth quarter. Reflecting falling unemployment and rising wages, consumer demand rose 4.2 percent in the fourth quarter, with private investment also increasing rapidly (these data may be revised). Export growth, which had led the expansion earlier in the year, eased in the fourth quarter, reflecting a stagnant high-tech market and weaker import demand from the United States and the Middle East. Data for the first few months of 2007 suggest that exports have picked up, while indicators for consumer demand and imports suggest that domestic demand has stagnated.

Order books and business sector confidence are strong in both Europe and Japan, suggesting that industrial activity should remain robust for the remainder of the year. In the United States, however, these leading indicators suggest further weakening in investment and industrial activity. Short-term forecasting models based on these data suggest that output in the United States will grow at a less than 2 percent annual pace during the second quarter of 2007. Annualized growth rates could average 2.5 percent in the European Union and 2 percent in Japan during the first half of the year.[3]

Solid growth in Europe and Japan is expected to compensate for slower U.S. growth

In the *United States,* the sharp decline in housing-sector activity, which has already reduced investment in other sectors, is projected to continue to slow economic activity in the second quarter of 2007. However, as activity in the housing sector gradually stabilizes in the second half of the year, growth should pick up, even though knock-on effects in the construction and manufacturing sectors may continue to be felt. Going into 2008, lower stocks, the elimination of the drag on growth from the housing sector, and relatively accommodative interest rates are expected to prompt a recovery in investment, and growth should accelerate to 3 percent in 2008 and 3.1 percent in 2009.

Lower oil prices, slower growth, and higher interest rates in many countries are expected to contain inflationary pressures, obviating the need for further increases in policy interest rates. However, the recent tendency for long-term interest rates to rise in the United States is expected to continue, as expectations for a depreciation of the dollar firm. This should help promote domestic savings, which, along with the weaker condition of the economy in 2007, should be reflected in slower import growth and a further decline in the trade and current account deficits, with the current account deficit reaching about 5.3 percent of GDP in 2009.

Prospects for *Europe* appear increasingly robust. Improved consumer confidence, lower unemployment, high capacity utilization rates, and still-strong order books should translate into solid domestic demand growth, while continued integration of new member states into the European Union should fuel exports. While inflationary pressures are present, lower commodity prices and a gradual tightening of monetary conditions by the European Central Bank should contain them without endangering the expansion. As a result, GDP among European countries is projected to moderate only modestly, to about 2.6 percent (2.5 percent for the Euro Area) in 2007, before easing toward more sustainable growth rates of about 2.2 percent (2 percent for the Euro Area) by 2009.

In *Japan* vigorous growth in developing East Asia, strong business confidence indicators, and reduced drag from corporate consolidation are expected to help maintain growth at 2.3 percent in 2007. Very low interest rates are projected to sustain investment and industrial production as the main drivers of the economy, while tightening labor market conditions should boost consumer demand, permitting the economy to accelerate to a 2.4 percent annual pace in 2008.

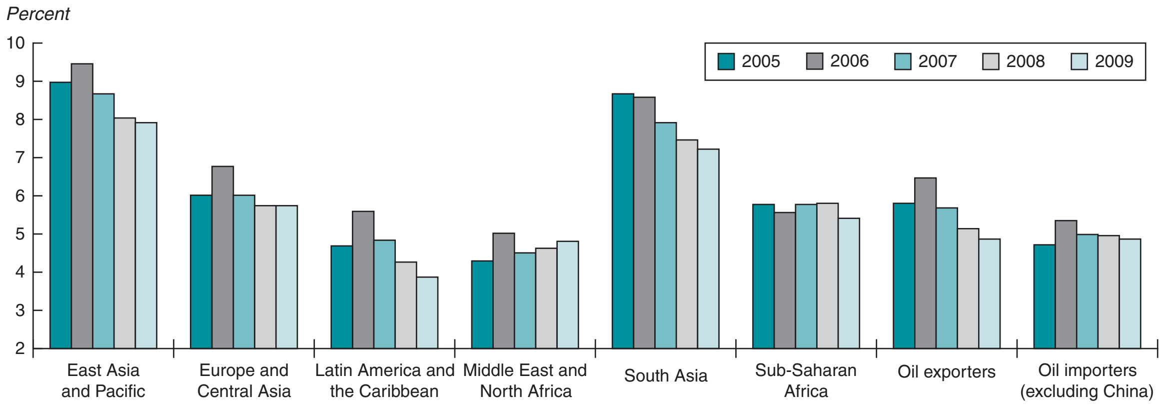
Still-modest consumer demand is expected to bolster Japan's current account surplus in 2007. As private spending increases in 2008 and 2009, however, the current account surplus is projected to ease toward 3.1 percent of GDP by 2009. The recent return to positive inflation is expected to persist, allowing short-term interest rates to gradually rise to about 2 percent by the end of 2008.

The outlook for developing countries

Buoyant external demand (as a result of stronger European and continued robust Japanese growth), low real interest rates, and low bond market interest-rate spreads helped the developing world expand by 7.3 percent in 2006, the fourth consecutive year in which growth exceeded 5 percent.

Growth was particularly strong in China, which grew 10.7 percent, and India, where output rose 9.2 percent. But the strong performance was broadly based, with all developing regions growing more than 5 percent (figure 1.2). Despite

Figure 1.2 Regional growth



Source: World Bank.

the substantial increases in the price of oil during the first half of 2006, growth among the remaining oil-importing developing countries actually strengthened, reaching 5.3 percent for the year as a whole.

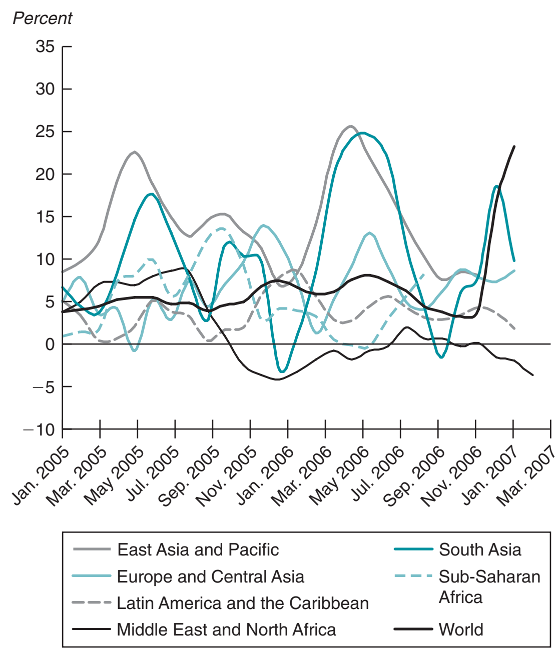
While industrial production and growth in developing countries eased during the third quarter of 2006, activity recovered somewhat in the final quarter and into the early months of 2007 in East Asia and Pacific, South Asia, and Europe and Central Asia (figure 1.3). For the moment, the knock-on effects of the slowdown in U.S. imports have been concentrated in Latin America (the slowdown in the Middle East and North Africa region mainly reflects reduced oil production resulting from OPEC quotas and capacity constraints).

Slower import demand from high-income countries, a weakening of commodity revenues, capacity constraints, and an expected increase in interest rates in response to rising inflation in some countries are expected to ease the pace of growth of developing countries through 2009. As a group, however, low- and middle-income countries should continue to outperform high-income economies by a wide margin. Their strong performance will continue to be a critical driver of global growth.

Administrative restrictions on investment and reduced import demand from the United States are expected to bring Chinese growth down to a more sustainable 8.5 percent by 2009. Higher interest rates and some further fiscal tightening are expected to slow the expansion in India to about 7.5 percent.

Prospects for the remaining oil importers are varied. Many economies, particularly in Eastern

Figure 1.3 Developing-country industrial production growth



Sources: World Bank; Datastream.

Note: Percentages are 3-month/3-month seasonally-adjusted annualized rates.

and Central Europe, have overheated (or are overheating) and have entered a phase of policy tightening. Economic activity in these countries is projected to slow. Notwithstanding weaker import demand from the United States, growth in other developing countries, including Brazil and Mexico, is projected to accelerate or stabilize at high rates, as they continue to benefit from a favorable external climate, including low long-term real interest rates and interest-rate spreads. Overall, growth in developing oil importers, excluding China and India, is projected to slow only gradually, falling from 5.3 percent in 2006 to 4.9 percent in 2009.

For oil exporters (and other large commodity exporters), strong revenue inflows should continue to fuel domestic demand, despite lower prices. These inflows are projected to result in rapid growth of both imports and the noncommodity sectors of these economies.

Meanwhile, capacity constraints (particularly for oil exporters) are projected to limit volume increases in the export sector. As a result, while 2007–09 are expected to be solid years for commodity exporters, the combination of weaker export growth, lower commodity prices, and strong import demand should result in declining current account surpluses and a gradual slowing of growth toward more sustainable long-term rates (4.9 percent for developing-country oil exporters).

Regional outlooks

The regional appendix describes economic developments in low- and middle-income countries in more detail, providing regional forecast summaries and country-specific forecasts (see also http://www.worldbank.org/globaloutlook).

In the *East Asia and Pacific* region, growth, led by China, was once again very strong. While efforts to contain investment and credit growth in some sectors moderated the pace of the expansion toward midyear, it has since picked up. Growth in other countries in the region strengthened, in part because of a relaxation of monetary policy in several countries following the successful dampening of emerging inflationary pressures.

Countries in the region have continued to benefit from strong inflows of foreign direct investment (FDI), with the bulk of FDI going to China. Nevertheless, FDI inflows were down for the year, having been partially replaced by larger equity and portfolio inflows, with the region attracting more than half of all portfolio flows to developing countries. Net capital inflows to East Asia totaled $167 billion in 2006, almost unchanged from 2005.

Partly as a reaction to these strong inflows over the past four to five years, policy makers in the region have adopted increasingly flexible exchange rate regimes. The Chinese authorities have allowed the renminbi to appreciate steadily against the U.S. dollar and appear to have increased the underlying rate of appreciation of the currency from 3 percent to 6 percent during the course of 2006.

Regional growth is projected to slow through 2009, reflecting a tighter policy environment in China and weaker U.S. import demand, especially in 2007. While currencies are expected to appreciate modestly over the forecast period, recent large current account surpluses are expected to decline only marginally.

Economic activity in *Europe and Central Asia* continues to reflect very strong capital inflows into countries that have acceded or expect to accede to the European Union and the direct and indirect effects of very strong spending by regional oil exporters. This very buoyant environment exacerbated internal and external imbalances in a number of countries, with inflation exceeding 5 percent and current account deficits reaching more than 5 percent of GDP in many countries.

Net capital inflows to the region surged in 2006, reaching a record $241 billion, dominated by private flows (both FDI and equity), as countries continued to prepay Soviet-era debts. Corporations headquartered in the region contracted $135 billion in foreign debt in 2006, with most of the funds going into the finance and oil and gas sectors. Significant bank borrowing in several countries has financed a surge in credit growth, accompanied by mounting inflationary pressures and concerns about exchange rate risk. While reserve ratios in most countries have stabilized, in Russia they increased by $120 billion.

Lower oil prices, a diminishing stimulus to growth from EU accession, and a tightening of macroeconomic policy should result in slower but still-robust growth in 2009 of about 6.8 percent for regional oil exporters and 5.2 percent for oil importers.

The expansion in the *Latin America and the Caribbean* region entered its fourth year in 2006, with most economies growing at 4 percent or more. A relaxation of monetary policy in Brazil and Mexico saw output in the region's two largest economies pick up, even as growth in Argentina and República Bolivariana de Venezuela eased toward more sustainable rates.

Net capital inflows to the region increased slightly in 2006, although they fell from 2.8 percent to 2.5 percent of GDP. The decline reflected an absolute decrease in private inflows and an offsetting reduction in the extent to which countries in the region paid off official debt. Net FDI inflows also declined as a percentage of GDP. Large debt buybacks have reduced the average cost of capital of many countries and significantly improved their debt-servicing profiles. Despite improved external debt statistics, uncertainty over the ownership of locally issued bonds makes the extent to which dependence on foreign capital has declined unclear.

Weak import demand in the United States is expected to moderate regional export growth in 2007, but high prices for metals and minerals should sustain the expansion at close to potential rates through 2009. However, a number of countries in the region have recently introduced policy measures that could undermine longer-term growth prospects.

The developing economies of the *Middle East and North Africa* also enjoyed strong growth, despite the conflict in Lebanon, which saw GDP in that country decline by 5.5 percent. While OPEC cut oil output during the course of the year, slowing GDP growth among oil exporters, a 20 percent hike in oil prices fueled domestic demand and imports. This boosted exports of goods and services among the diversified countries of the region, which, along with a rebound in agricultural production following a severe drought in 2005, propelled their GDP growth to 5.6 percent—a 10-year record. Several years of very rapid growth and the removal of some price subsidies have contributed to an uptick in inflation in several countries and a decline in the current account and government balances of oil exporters (which nevertheless remain in surplus).

Booming oil revenues have fueled strong financial flows within the region. FDI flows, which reached 3 percent of regional GDP in 2006, have been associated with a revival in privatization activity and cross-border mergers and acquisitions, particularly in the banking sector. Equity prices in Iraq and the Islamic Republic of Iran remain depressed following global turbulence in May and June 2006, but they have recovered in other markets in the region. Official development assistance to the region has surged, but more than 40 percent of the total went to Iraq.

Increased output by non–OPEC oil producers is expected to keep OPEC quotas tight (see below), which should restrain GDP growth among oil exporters through 2009. However, even if prices and production decline, oil revenues will remain high, fueling domestic demand and contributing to an expected decline in the current account and government surpluses of oil exporters. Spillovers from this strong demand, in the form of investment and remittance inflows, coupled with robust European demand for goods and tourist services should help sustain strong growth among the region's diversified economies.

South Asia also recorded vigorous GDP growth in 2006, propelled by strong exports and burgeoning domestic demand, caused in part by low real interest rates and strong capital and remittance inflows. Central banks in the region reacted to strong growth and rising inflation by increasing nominal interest rates. However, real rates remain negative or close to zero in several countries.

Net capital inflows to the region reached \$40.1 billion (3.6 percent of GDP) in 2006, with most of the funds going to India. Net private debt flows were responsible for more than 100 percent of the \$11.8 billion dollar increase, as prepayment of public sector debt reduced the overall total. FDI was up (particularly in the Indian service sector, in response to new legislation), as were FDI outflows from India, which reflected an increase in cross-border merger and acquisition purchases by Indian companies, mainly in advanced economies. Portfolio inflows fell by more than the increase in net FDI, causing net equity flows to decline, although they still represent almost 60 percent of net private inflows to the region. Despite a sharp increase in the dollar value of reserves, import cover declined as a result of exchange rate movements and robust increases in import volumes.

While falling oil prices should contribute to a stabilization of the region's current account balance and a reduction in government deficits, they are expected to offer only limited inflation relief, because much of the initial hike in oil prices has yet to be passed through to consumers. Weaker U.S. import demand, the removal of temporary restrictions on Chinese exports of selected clothing and textiles, and rising interest rates are projected to reduce GDP growth in the region from 8.6 percent in 2006 to about 7.2 percent in 2009.

Sub-Saharan Africa also benefited from strong global growth. High oil prices have fueled an investment boom among regional oil exporters, supporting a 6.9 percent increase in their GDP. Increased aid flows over the past several years, strong commodity prices, a period of relative peace, improved macroeconomic policies, and the cumulative effects of several years of microeconomic policy reform have combined to yield three years of growth of 5 percent or more among oil importers. This robust performance has been broadly based, with more than half the countries in the region growing by 5 percent or more and only six growing by less than 2 percent.

Net capital inflows to Sub-Saharan Africa reached $39.8 billion, or 5.6 percent of GDP, in 2006. Reflecting high commodity prices and improved fundamentals, net private capital inflows exceeded bilateral aid grants for the first time since 1999. Aid, at $13.2 billion (excluding debt relief) in 2005, remains important, representing more than 5 percent of GDP for 80 percent of countries in the region and exceeding 10 percent in several.

The increase in private flows reflects increased FDI (principally into extractive sectors), portfolio investment, and bank lending (particularly from other developing-country banks). Despite improved fundamentals, only two countries (the Seychelles and South Africa) have accessed the international bond market in the past two decades, although several are expected to issue bonds in 2007 and there has been growing investor interest in local currency bond markets.

Several countries in the region show signs of overheating. While the higher investment rates of the past few years are expected to boost supply, infrastructural weaknesses and capacity constraints in the energy sector are endemic. As a result, while growth is expected to remain robust and per capita incomes should continue to rise, growth is projected to ease to about 5.4 percent by 2009.

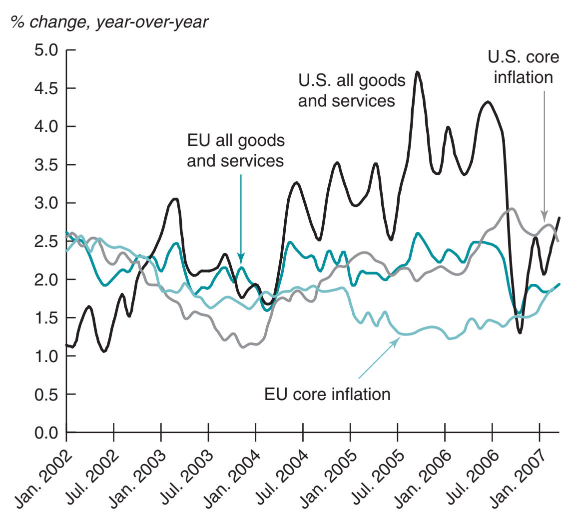
Inflation, interest rates, and global imbalances

The uninterrupted growth of the past several years has been reflected in growing capacity constraints, rising prices in commodity markets (see below), and significant internal and external imbalances in a number of countries. At the same time, a main contributor to the longevity of the current expansion has been the muted response of inflation to high oil prices—particularly in high-income countries—which has allowed monetary policy to remain relatively relaxed and interest rates low.

However, headline inflation is above the comfort levels of central banks in high-income countries, and notwithstanding some easing as a result of the recent decline in oil prices, core inflation remains high in the United States and is rising in Europe (figure 1.4). As a consequence, monetary authorities remain vigilant, and additional hikes of policy rates are expected in both Europe and Japan.

Inflation in low- and middle-income countries has also been generally muted, although recent trends raise some concerns. While inflation in developing countries picked up in response to the initial hike in oil prices in 2003, it began declining soon afterward, in response to monetary policy tightening and limited pass-through. More recently, there are signs that price pressures are

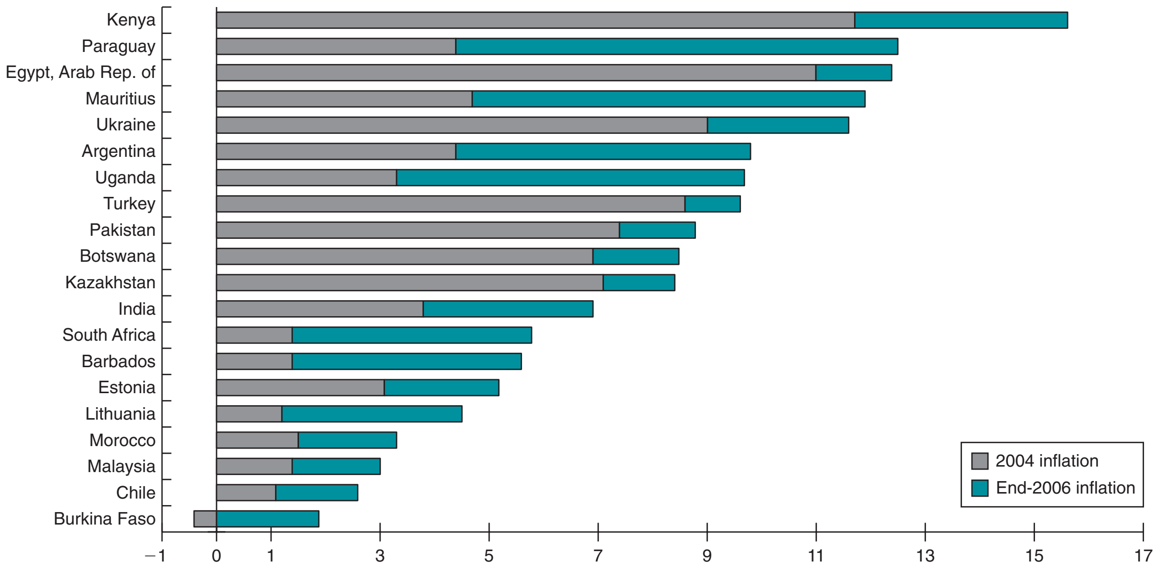
Figure 1.4 Inflation in high-income countries



Sources: World Bank; Datastream.

Figure 1.5 Inflation in selected countries

% change in consumer price index, year-over-year



Source: World Bank.

building in several regions and in a number of countries that have been growing very rapidly (figure 1.5). These increases likely reflect the direct impact of higher oil prices during the first half of 2006, but they may not yet show the full impact of the decline in the second half. Indeed, though year-over-year inflation is up compared with last year, rates are declining in several countries that have experienced an uptick. Higher inflation does appear to reflect overheating in several middle-income countries, including Argentina, India, South Africa, and República Bolivariana de Venezuela, as well as several smaller countries in Europe and Central Asia, the Middle East and North Africa, and South Asia.

At the regional level, inflation has increased in each of the past three years in the Middle East and North Africa and in each of the past six years in South Asia. Developments in Sub-Saharan Africa are also worrisome, though the large weight of food prices in the consumer price basket in that region makes it difficult to determine whether recent increases represent a trend. In Europe and Central Asia, some countries have combated rising inflation with tighter monetary policies, while in others policy has either been neutralized by capital inflows or too timid in response to increased price pressures. The trend toward higher inflation over the past few years is of concern, because it may result in a significant increase in inflation expectations, which can—given the blunt instruments available to monetary authorities—be difficult to lower without a sharp deceleration in economic growth.

Financial conditions for developing countries remain favorable

The pickup in inflation over the past several years, coupled with very rapid growth, has contributed to rising short-term interest rates and the gradual removal of monetary policy stimulus in many countries, most notably in high-income countries, where short-term real interest rates have increased some 200 basis points since mid-2005.[4] Many developing countries have also acted to restrain credit and contain inflation. Policy rates have risen sharply and appear to be slowing inflation in Bulgaria, Indonesia, Thailand, and Turkey. In other countries (Argentina, India, Pakistan, South Africa, and República Bolivariana de Venezuela), the tightening cycle is less advanced. As a result, real interest rates remain low and inflation high.

Despite increases in inflation, real short-term interest rates in most regions are low by historical standards and have been relatively stable or even falling (notably in South Asia) in recent months (figure 1.6). Long-term interest rates are also low. Yields on U.S. government bonds remain about 4.5 percent, and spreads on emerging-market debt are near record lows (figure 1.7).

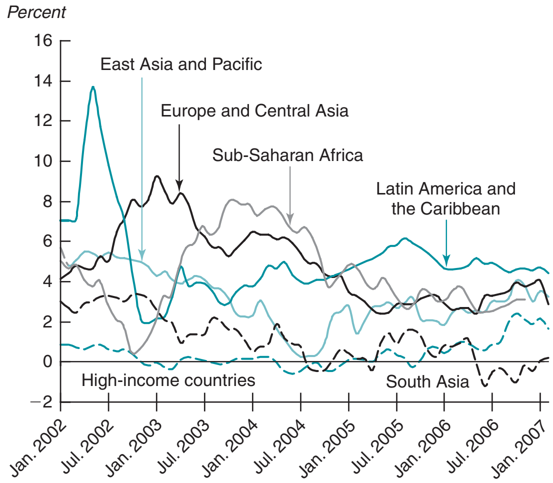
The extended period of low interest rates and low spreads on emerging-market and subprime corporate bonds has led many observers to worry that global liquidity levels are too high—or interest rates too low. Several factors help explain why interest rates are lower than in the past (see World Bank 2005, pp. 11–13). One is the relative stability of inflation, especially in the face of higher oil prices, caused partly by more credible monetary policy and partly by the entrance of China and the former Soviet Union into the world trading system. The extended period of very accommodative monetary policy in high-income countries and the recycling of oil revenues have also had a dampening effect on interest rates. While there is no universally accepted measure of liquidity, measures produced by the OECD (2006) based on global money supply or bank lending suggest that liquidity may be as much as 15 percent higher than normal given the current level of economic activity.

Many observers worry that, should the expectations of investors change rapidly or their evaluations of underlying risk change, interest rates could increase rapidly and capital inflows, which have been strong, could reverse (see chapter 2). Indeed, the sensitivity of financial markets to changes in perceptions was illustrated in May and June 2006, when markets became uncertain of the future conduct of U.S. monetary policy, and more recently in February and March 2007, following the recognition of problems in the U.S. subprime mortgage market and concerns of currency undervaluation in some Asian markets.

While developing-country bond markets were shaken and volatility in both bond and equity markets increased (particularly among the most vulnerable countries and those with large current account deficits, such as Turkey), emerging markets suffered relatively minor ill effects from these episodes. Indeed, the 21–basis point increase in emerging-market spreads in February and March 2007 compares favorably with the 39–basis point increase in the yield on high-income country subprime corporate debt (emerging-market spreads remain 100 basis points higher than those of subprime corporates) (figure 1.8). Moreover, while emerging-market spreads have fallen below their previous levels, subprime spreads remain elevated.

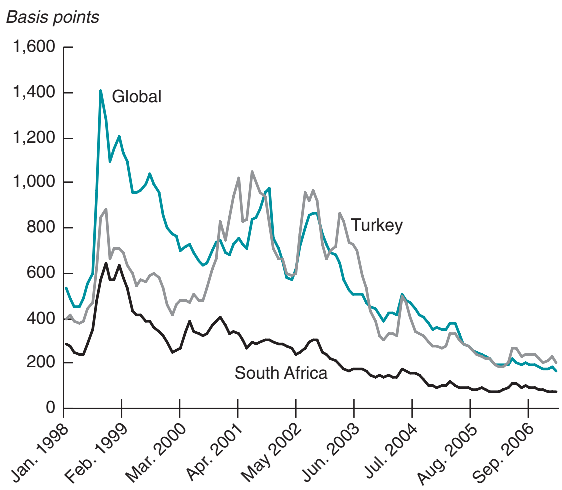
If the increase in spreads reflected investors' revaluation of risk, the smaller upward adjustment for emerging-market debt (and its subsequent decline) supports the view that improved fundamentals explain at least part of the decline in

Figure 1.6 Real policy interest rates, by region



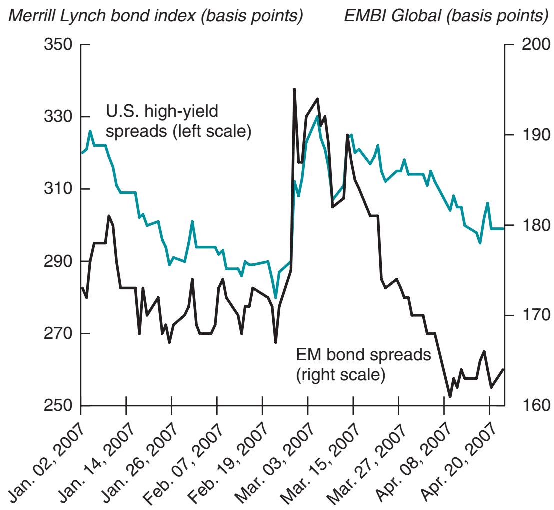
Sources: World Bank; Datastream.
Note: Percentages are GDP-weighted averages, deflated by CPI inflation.

Figure 1.7 Spreads on emerging-market bonds compared with 10-year U.S. Treasuries



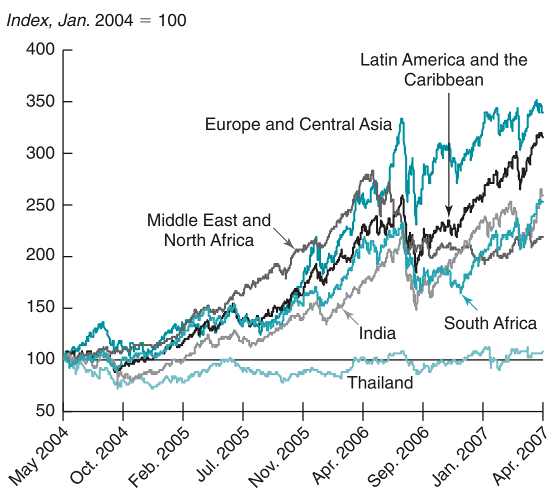
Sources: Datastream; JPMorgan Chase; World Bank.

Figure 1.8 Spreads on emerging-market debt and subprime corporate bonds in 2007



Sources: World Bank; JPMorgan Chase.

Figure 1.9 Emerging-market stock market valuations



Sources: Datastream; Standard & Poors; World Bank.

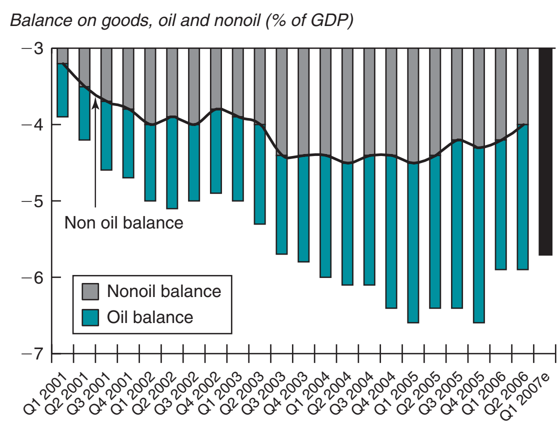
emerging-market spreads over the past several years. Despite the increase in volatility in emerging stock markets, valuations remain very high, up 100–400 percent since 2003 (figure 1.9). Emerging-market spreads are at very low levels, and financial conditions for developing countries remain very favorable, factors reflected in the strong capital inflows (see chapter 2) that have been fueling these countries' growth.

Global imbalances begin to narrow

The imbalances in global spending patterns that have characterized the world economy over the past five years showed signs of stabilizing in 2006. Following several years of steady increases, the U.S. current account deficit declined in the fourth quarter of 2006, coming in at 5.8 percent of GDP, down considerably from the 7 percent level recorded in the same quarter of 2005, when oil prices were lower.[5] Preliminary data for the first three months of 2007 suggest that the current account deficit has fallen even farther, to about 5.7 percent of GDP. Indeed, the nonoil trade deficit, which had been broadly stable, at about 4.4 percent of GDP since 2004, has been declining since early 2006 and stood at 4 percent of GDP in the first quarter of 2007 (figure 1.10).

While the cyclical slowdown in U.S. growth was a factor in the improvement in the nonoil balance, structural adjustments are also at work. The pattern in the nonoil balance mirrors the stabilization of the savings rate in the United States that began in 2004 and its subsequent rise beginning in 2006.[6] Overall, the savings rate has increased by 1 percent of GDP. This is likely a permanent increase in savings, reflecting a return to more normal levels following the artificial decline in savings caused by higher consumer spending from increased wealth during the housing boom. The increase in savings also reflected the decline in the government deficit, from 3.7 percent of GDP in 2005 to 2.4 percent of GDP in 2006.

Figure 1.10 U.S. trade balance is improving



Sources: U.S. Department of Commerce; World Bank.
Note: e = estimate.

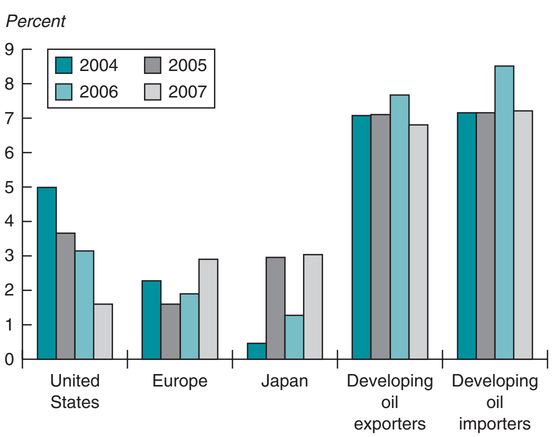
Residential investment spending declined sharply, from a peak of 6.3 percent of nominal GDP in the fourth quarter of 2005 to 5 percent of GDP in the first quarter of 2007. Assuming a return to the long-term average of 4.6 percent of GDP, investment is likely to fall farther, resulting in a concomitant reduction in the current account balance.

The decline in oil prices during the second half of 2006 also helped reduce the U.S. current account deficit. This decline was probably also structural in nature, because the lower oil prices reflect a natural response to earlier price hikes that slowed demand growth and induced additional supply (see the discussion of the commodity market below). Over the medium term, energy prices are expected to fall farther, which should provide additional relief to global imbalances by reducing both the U.S. trade deficit and the surpluses of oil-exporting countries.[7]

While higher savings in the United States remains a critical component of any long-term solution to global imbalances, demand elsewhere will have to pick up the slack. In this regard, the recovery of demand in Europe and Japan, their return toward potential output, and strong growth in the developing world should help sustain world output and reduce global imbalances (figure 1.11). This shift in growth is expected to continue into the forecast period, although it will be more moderate in 2008 and 2009, as growth in the U.S. recovers.

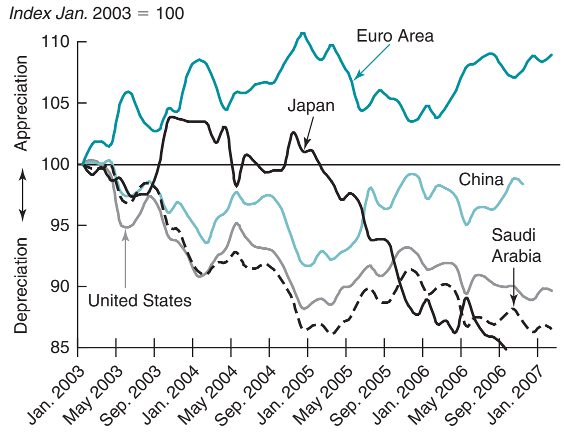
The rapid increase in import demand by oil exporters should also help reduce global imbalances. In dollar terms, the export revenues of oil exporters are up \$1.8 trillion since 2003, and their imports are up \$1.5 trillion. As oil prices decline and domestic demand catches up with the increase in revenues, these trade surpluses are projected to decline.

Figure 1.11 Growth in domestic demand, by region



Source: World Bank.

Figure 1.12 Movements in exchange rates



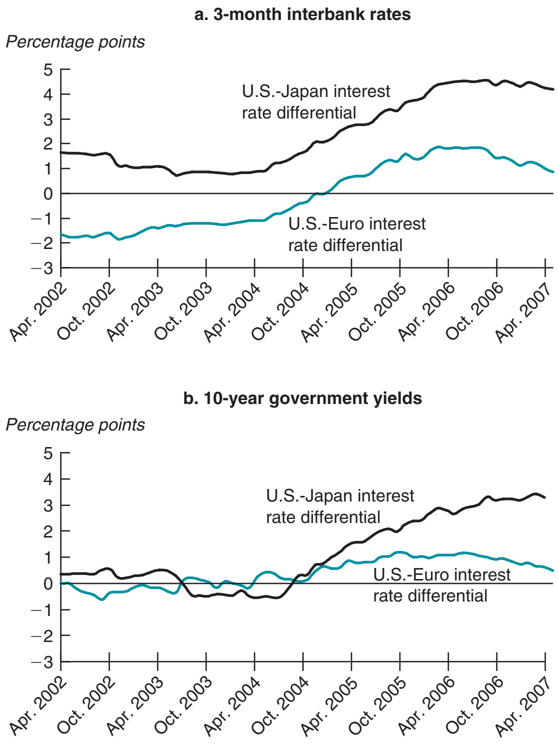
Source: World Bank.
Note: All figures in graph are real effective exchange rates.

Exchange rate movements are playing a limited role in the overall adjustment process. Since 2003 the U.S. dollar has depreciated by 10 percent in real effective terms, and the euro has appreciated by 9 percent (figure 1.12). Along with increased savings, these shifts have likely played a role in the relative strength of exports and weakness of imports in the United States over the past year. By increasing the competitiveness of U.S. exports, such shifts, which are projected to continue, should facilitate a reduction of global imbalances as long as domestic savings continue to adjust (Obstfeld and Rogoff 2004).

Exchange rates in China, Japan, and oil-exporting nations have not appreciated in real-effective terms, and, as a result, their movements have not served to support a smooth adjustment in the same way. Notwithstanding an acceleration in the steady rate at which the renminbi appreciated against the dollar to a 6 percent annual rate, the Chinese currency has remained broadly stable in real effective terms since 2003,[8] while the currencies of many oil exporters that maintain a fixed exchange rate with respect to the dollar have actually depreciated in real effective terms.

Partly as a result, China's current account surplus continues to grow, reaching \$230 billion in 2006 (9.3 percent of GDP). A reinforcement of measures being introduced to stimulate domestic

Figure 1.13 Difference between U.S. and Japanese/European interest rates



Sources: World Bank; Datastream.

demand, supported by a more flexible exchange rate regime, may be necessary before China's surplus begins to decline. In addition to contributing to a reduction in global imbalances, such steps would also distribute some of the economic fruits of its very strong growth more broadly within China.

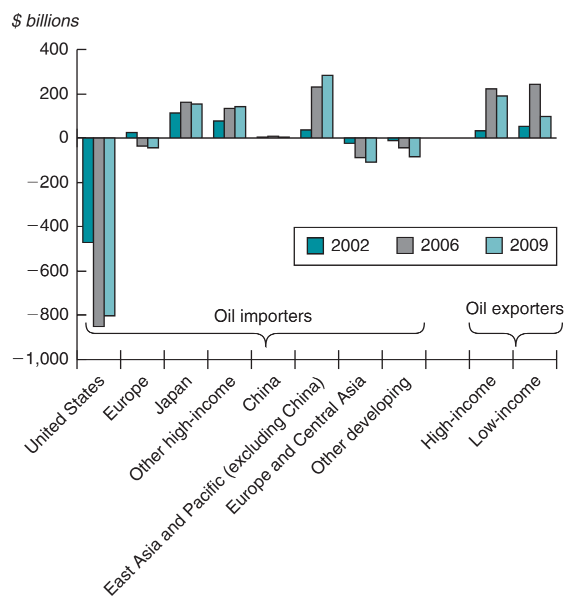
Low interest rates in Japan (and to a lesser extent in Europe) and the carry trade that they have induced partially explain the relative strength of the dollar. As of early May 2007, the interest-rate differential in favor of the dollar was some 400 basis points at the short end of the market and 300 basis points at the longer end (figure 1.13). With U.S. monetary policy near or at the end of its tightening cycle, these differences are expected to narrow. In the baseline forecast, this narrowing and slower growth in the United States are projected to cause the dollar to depreciate by about 5 percent a year against the euro through 2009, which should further facilitate the unwinding of global imbalances. Should downward pressures be more severe, however, the depreciation could be larger or the rise in U.S. interest rates greater.

Taken together, these factors suggest that a continued narrowing of global imbalances is to be expected. Nevertheless, imbalances remain large, and there are several countervailing pressures.

First, the size of the imbalance—in both China and the United States—is very large. The value of U.S. imports is 50 percent larger than the value of U.S. exports, implying that even if exports and imports were to grow at the same rate, the trade deficit would continue to widen. Therefore, for progress to be made, exports will have to increase at a substantially faster rate than imports.

Second, with each year of additional current account deficit, the stock of U.S. financial liabilities increases, as do the interest payments due on them. Thus, the longer imbalances remain at current levels, the more difficult it will be to overcome them, even if the trade balance improves. Here, two factors work in favor of reducing global imbalances. The first is the large gap between the rates the United States pays on its external debt and the returns it earns on investments abroad. The second is the fact that currency depreciation tends to increase the value of U.S. assets abroad relative to foreign-owned U.S. assets. Over the medium term, both factors are expected to continue to hold sway, improving global imbalances modestly (figure 1.14).

Figure 1.14 Current account balances



Source: World Bank.

However, as discussed in past editions of *Global Development Finance* and *Global Economic Prospects,* the possibility of a disruptive adjustment to these still-large global imbalances is real. Were global investors to revise their expectations about the future value of the U.S. currency, they could demand a significantly higher return on dollar-denominated assets. Such an increase would serve to slow U.S. growth, with serious knock-on effects on commodity prices and growth in developing economies (see the analysis surrounding table 1.6 in World Bank 2005).

Partly reflecting the stabilization of global imbalances, the rapid accumulation of reserves by developing countries during the first few years of this decade has changed character. Although developing-country reserves increased by some $630 billion in 2006 (see chapter 2), the vast majority of countries increased reserves only in line with rising imports, keeping the number of months of imports that their reserves could finance broadly stable (figure 1.15). Oil-importing countries saw their import cover ratios remain stable or decline and the import cover ratios of most countries remain well above the normally accepted benchmark of three months. Reserves among oil exporters have not risen as might have been expected because most of them have put the bulk of their surplus revenues into investment trusts, which do not count as reserves.

In contrast, China and Russia accumulated a total of $366 billion in additional reserves in 2006, 40 percent more than the total for all other developing countries, including other oil exporters. The level of reserves they currently hold—14 months of imports in China and almost 17 months of imports in Russia—exceeds normal prudential levels by a wide margin.

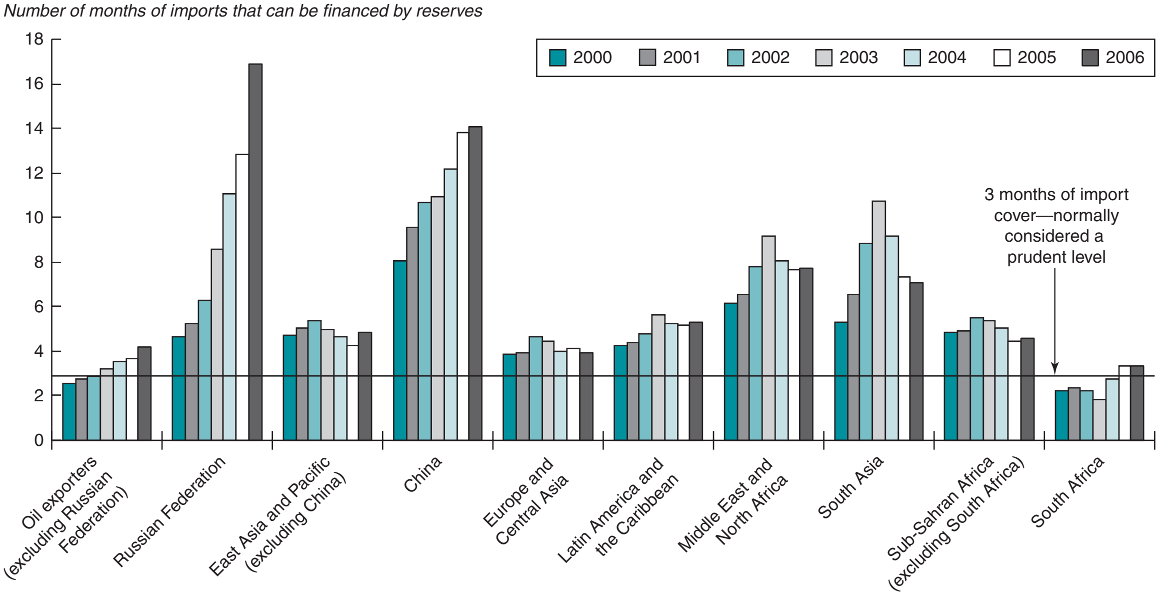
World trade

Much like industrial production, the growth in the volume of global merchandise trade slowed in the third quarter of 2006, before picking up toward the end of the year to reach year-over-year growth of 11 percent. Most of the deceleration occurred in China, Japan, and Europe. U.S. exports were relatively strong, increasing 10.5 percent for the year as a whole, while U.S. imports rose just 5.8 percent.

Weaker consumption and investment growth in the United States, combined with rising incomes among oil exporters and other developing countries boosted U.S. export volumes, which expanded at double-digit rates in the last two quarters of 2006.[9] Similar strength was observed in Europe.

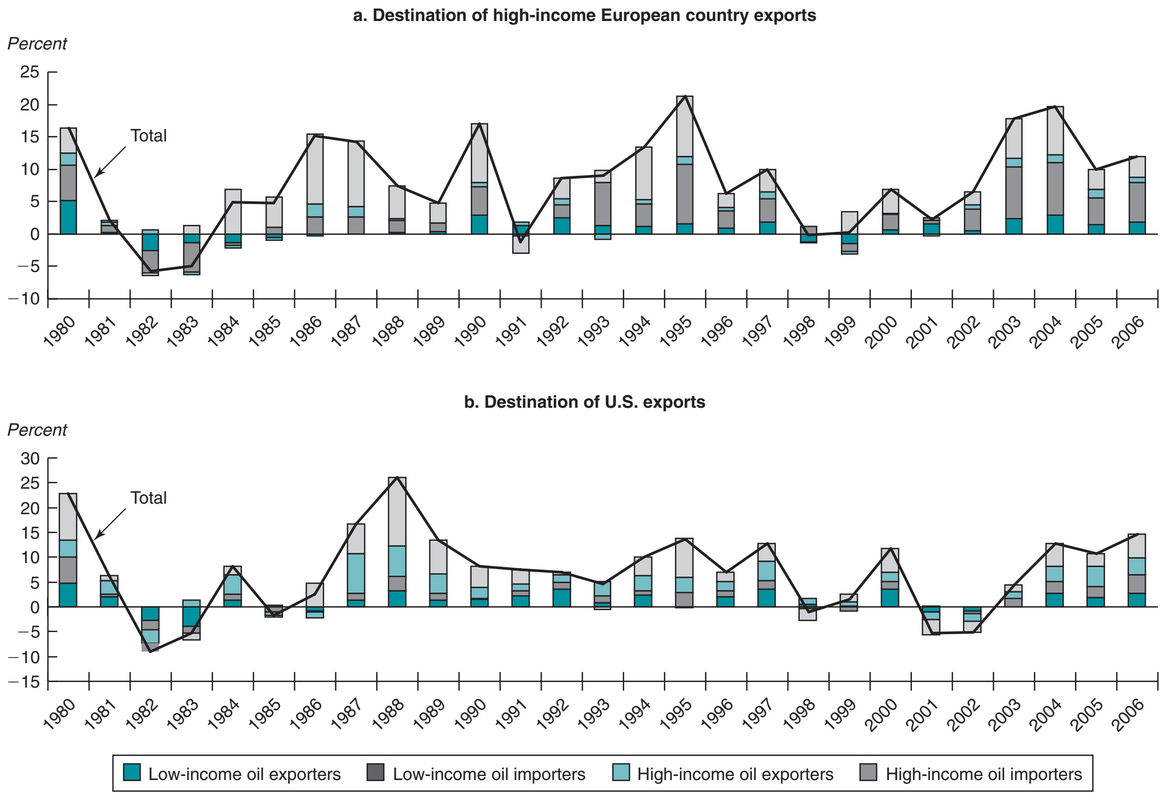
Figure 1.15 Foreign exchange reserves

Number of months of imports that can be financed by reserves



Source: World Bank.

Figure 1.16 Sources of export growth for high-income countries



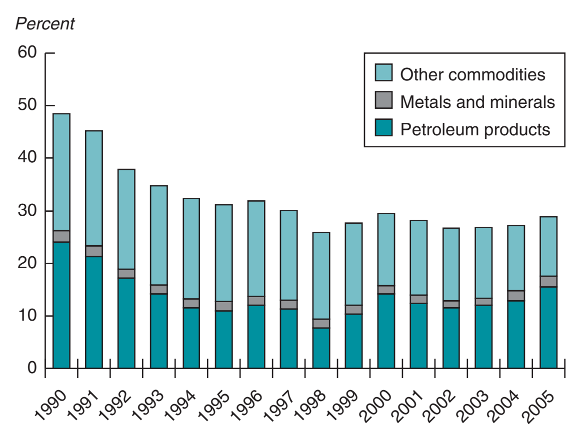
Sources: World Bank; IMF.
Note: Figures show contribution to dollar value of export growth, by aggregate.

Much of the demand for these exports originated in developing countries. Over the past three years, the average contribution of demand from oil exporters and low-income oil importers to U.S. export growth was 8.7 percentage points (5.2 percentage points for low-income countries alone). This is more than double the increment to demand from high-income countries (4 percentage points) and compares favorably with the 1990s, when these countries' contribution to U.S. exports rarely exceeded 5 percent (figure 1.16).

Oil exporters and low-income oil importers are boosting exports in Europe by even more, reflecting the expansion of trade between Europe and countries of the former Soviet bloc.

Notwithstanding the rapid rise in commodity prices over the past several years, manufacturing remains the main source of export revenue for developing countries, even when China is excluded from the data (figure 1.17). If oil exporters are excluded, the result is even stronger, with the overall weight of nonoil commodities falling from 24 percent to 12 percent of developing-country (excluding China) exports between 1990 and 2005.

Figure 1.17 Sources of export revenues for developing countries



Sources: World Bank; Comtrade.
Note: Figure shows share of commodities in total merchandise export values of developing countries (excluding China).

On the trade policy front, the Doha Round negotiations resumed at the beginning of 2007, following a six-month suspension, partly because of concerns that the United States' fast-track authority would expire and not be renewed. Progress toward sketching an outline of an accord remains limited, however, and a serious risk exists that negotiations will last several years, undermining confidence in the multilateral system. The proliferation of bilateral and regional trade agreements of the kind currently being signed is not a substitute for a multilateral accord, especially because many of the smaller and poorer developing countries are among the least likely to take effective part in them.

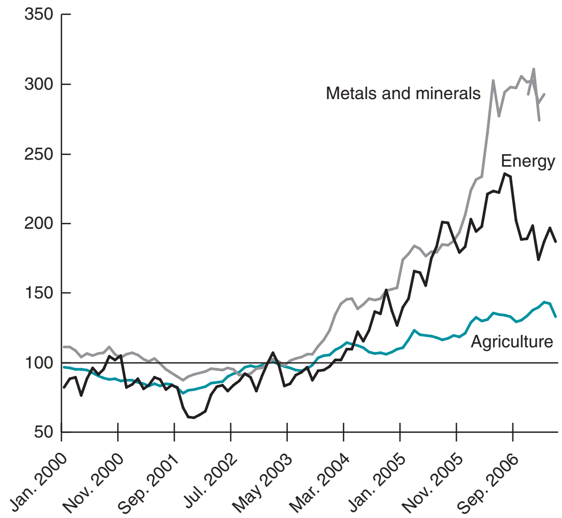
For developing countries with a strong specialization in the textiles and clothing sector, the removal of partial restrictions on Chinese exports of these goods to the European Union and the United States in 2008 is expected to dampen export volumes and prices in 2008 and 2009. However, many of these countries have succeeded surprisingly well in the face of the earlier liberalization of the sector in 2006. To the extent that they continue to achieve the kind of efficiency improvement that has underpinned this strong performance, they can be expected to survive this additional pressure relatively well—and indeed, may be well placed to exploit further scale efficiencies.

Commodity markets

Strong global growth, especially the rapid expansion of output in developing countries, is largely responsible for the rise in commodity prices over the past several years. Weaker industrial production and output growth toward the end of 2006 and into 2007 contributed to a leveling off and decline in some metals prices, as well as the more widely followed decline in oil prices. Agricultural commodity prices remain robust, in part because high oil prices have pushed up fertilizer and other production costs and increased interest in biofuels has boosted demand for many agricultural products.

While increases in oil prices received the bulk of media attention, the price of metals and minerals rose much more rapidly in 2006 (figure 1.18). Continued strong growth in global output, low stocks, numerous supply disruptions, and speculative demand pushed the prices of metals and minerals up 47 percent. Agricultural prices also posted gains in dollar terms, rising 13 percent in 2006, but they were broadly stable (up 1.3 percent) expressed in euros.

Figure 1.18 Commodity prices

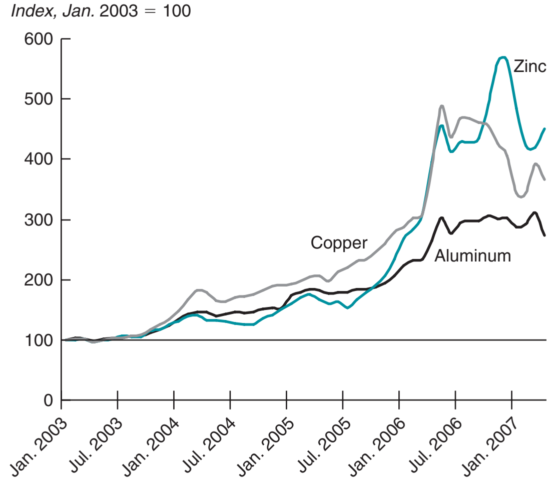


Source: World Bank.

Metals and minerals prices level off

The prices of copper and zinc, two of the metals whose prices rose most markedly in recent years, fell sharply in late 2006 and early 2007, as demand weakened and stocks increased (figure 1.19). Both

Figure 1.19 Prices of selected metals



Source: World Bank.

substitution away from these products, as a result of the sharp rise in their prices during 2006, and cyclical factors, notably the decline in demand for copper from the U.S. housing sector and reduced demand for steel from the auto sector, played a role.

Destocking in China, which accounts for 22 percent of world demand for copper, and the resulting decline in import demand also caused prices to fall. A boost in Chinese exports explains much of the 26 percent drop in the price of zinc in the early months of 2007. After strong demand and weak supply pushed the global price of zinc up 137 percent in 2006 (26 percent in the fourth quarter), China (the world's largest miner) stepped into the market, increasing apparent supply and nearly eliminating the price gains of the previous three quarters. The rising role of China may also be seen in the behavior of aluminum prices, which, unlike those of zinc and copper, rose by much less, despite rapid growth in demand, principally because China has been steadily expanding its exports.

The prices of many other metals continued to rise, as a result of low stocks, strong demand, rising costs, and supply shortfalls. Nickel prices, in particular, have soared, reflecting very strong demand for stainless steel, supply disruptions, and delays in the start-up of new projects. Stocks of other products, such as aluminum and copper, have increased, suggesting an easing of their prices going forward.

Coupled with slower global growth, notably in the U.S. housing and auto sectors, metals prices are projected to peak during 2007 (copper in 2006). They are likely to decline in 2008 and 2009, as additional supply comes on stream and capacity constraints ease, with the global supply of copper rising 7 percent, to about 1 million tons, and the supply of zinc rising 9 percent, to about 0.8 million tons (7 and 9 percent), with a 10 percent increase expected in African output. In contrast, nickel prices are not projected to ease, because no significant new supply is expected in the immediate term.

Some uncertainty remains as to the speed at which metals prices will decline, both because global growth is projected to remain relatively rapid and because supply problems that have challenged the industry over the past few years may persist.

Agricultural prices continue to rise

Agricultural prices rose 12 percent in 2006, reflecting a weaker dollar, higher energy and fertilizer prices, crop-specific supply shortfalls, droughts, low carryover stocks, and strong increases in demand, especially for biofuels. While real agricultural prices have increased substantially since their cyclical lows in 2001, the increase has done little to reverse the longer-term downward trend that has seen real agricultural prices fall 56 percent over the last 46 years (figure 1.20).[10]

High energy prices contributed directly to a surge in the price of some agricultural commodities that are either used as energy crops (biofuels) or compete with synthetic products made from petroleum. The price of sugar, which is being diverted to ethanol production for automotive fuel in Brazil, rose 50 percent, while that of natural rubber (a substitute for synthetics produced from petroleum products) was up 40 percent. The price of maize, which is used as the feedstock for ethanol production in the United States, rose 23 percent in 2006.

High energy prices also increased the price of fertilizer, raising farmers' cost of production and reducing yields as farmers use less of it. The offsetting increase in world prices likely benefits developing-country producers disproportionately, because they use less fertilizer and machinery per hectare. As a result, their overall production costs are likely to have increased by less than those of producers in high-income countries. However,

Figure 1.20 Agricultural prices

Sources: World Bank; Datastream.
Note: Figure shows real prices deflated by U.S. CPI.

higher food prices work to the detriment of the poorest households, for whom basic foodstuffs account for a significant share of total spending (see section on risk).

Lower petroleum (and fertilizer) prices should help increase agricultural yields and contribute to the weakening of agricultural prices over the next several years. Dollar prices of agricultural goods are expected to rise by about 5 percent in 2007 and to decline 1.5 percent in 2008. Commodities such as natural rubber and sugar, which saw the largest price increases during 2006, are expected to suffer the largest declines, with the price of natural rubber falling 5 percent and the price of sugar tumbling 20 percent. If it were not for continued increases in the demand for the agricultural raw materials used in the production of biofuels, the expected decline in agricultural prices would likely be more pronounced.

Although lower fuel prices should reduce the economic viability of these alternatives, government subsidies and other policy measures are expected to keep expanding, sustaining pressure on such inputs as maize and sugar cane. Twenty percent of the U.S. maize crop is already being used to produce ethanol, and the figure is expected to rise to 30 percent over the projection period. Fifty percent of Brazilian sugar cane is being diverted to ethanol production, and demand for soybean and rapeseed oils, which are used to produce biodiesel fuel, is rising.

As more land is shifted into production of biofuel inputs, price pressures on other agricultural commodities will build. Partly as a result of this process, stocks of many grains are extremely low, which could result in a sharp increase in their prices should demand rise more than expected or weather or other supply disruptions cause a poor crop year (see section on risk). Increased use of maize for ethanol production in the United States has already led to higher maize prices, which have been reflected in higher meat prices in the United States and higher tortilla prices in Mexico.

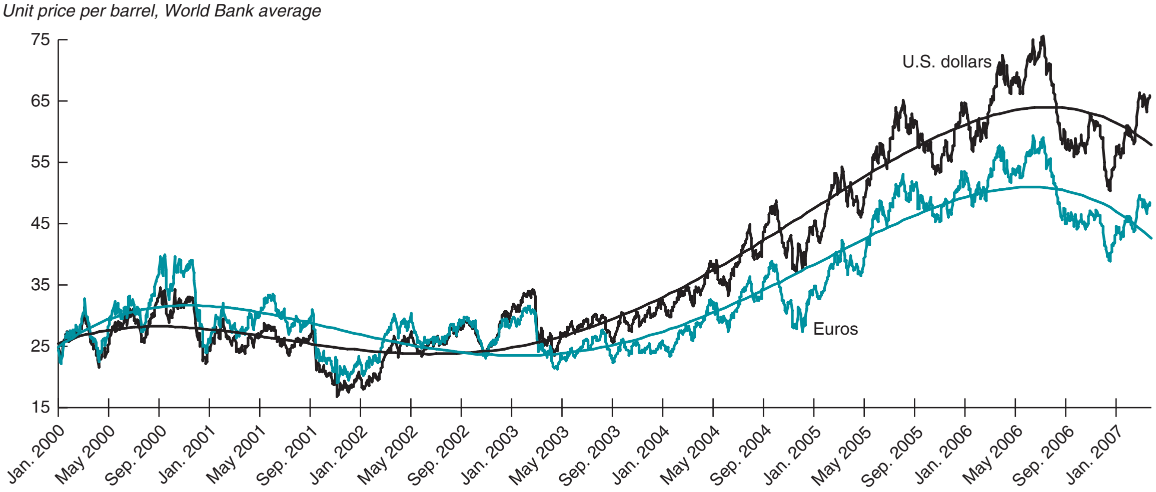
Among other agricultural commodities, coffee prices are expected to increase in 2007 (with robusta prices rising 11 percent), as demand increases in developing countries and Vietnam continues to have difficulties increasing supply. In contrast, tea prices should decline, as output in Kenya rises following last year's drought. Timber prices are expected to increase 15 percent in 2007 and an additional 5 percent in 2008, as a result of strong demand (especially from China and India) and limits on timber exports from developing countries, motivated by environmental concerns and efforts to control illegal logging.

Oil market

After shooting up in the first half of 2006, the price of oil declined in the second half of the year, falling to less than $51 a barrel during January 2007 (figure 1.21). Oil prices have since rebounded,

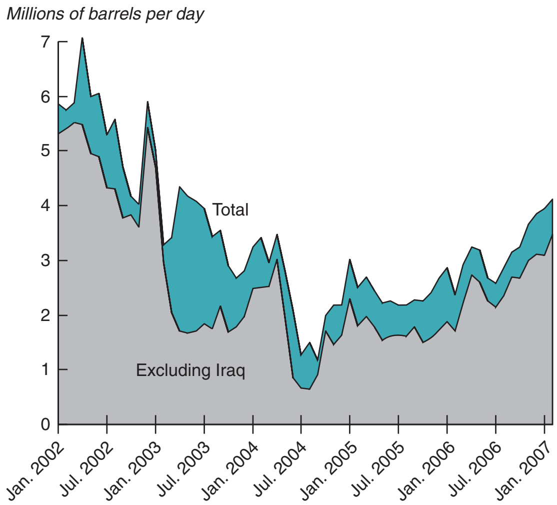
Figure 1.21 Oil prices

Unit price per barrel, World Bank average



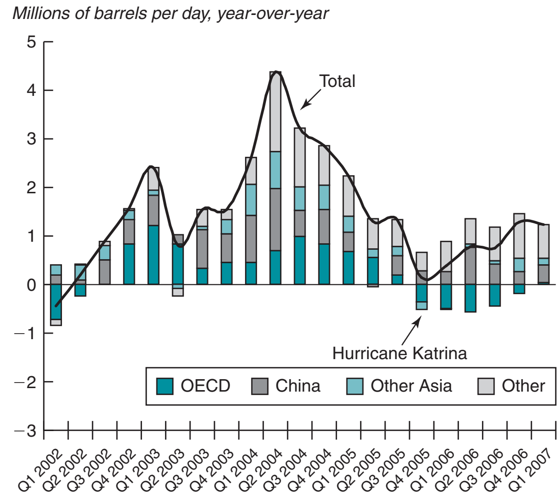
Sources: World Bank; Datastream.

Figure 1.22 Spare oil-production capacity within OPEC



Sources: World Bank; International Energy Agency.

Figure 1.23 Demand for oil



Source: International Energy Agency.

reaching about $65 a barrel in early May 2007—almost $5 less than a year before.

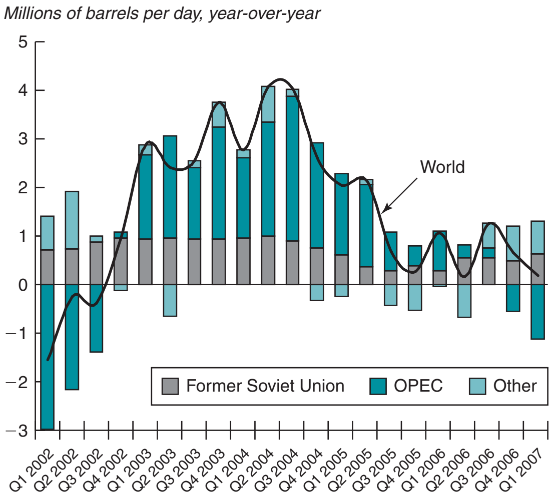
The decline in the price of oil in the second half of 2006 and early 2007 was consistent with an end of the trend rise in oil prices. However, low levels of spare capacity continue to make prices sensitive to small changes in the external environment (figure 1.22). Indeed, the decline in prices in January 2007 was associated with a relatively warm early winter. Prices reversed when colder weather arrived in February. While weather clearly affects demand, the swings observed appear to be out of step with changes in stocks and demand levels. The rise in prices toward the end of March mainly reflected concerns that supply would be disrupted because of the buildup of political tensions in the Persian Gulf. As these tensions dissipate, the price of oil is expected to begin to gradually decline.

Looking forward, the recent period of very weak growth in demand for oil shows signs of ending, suggesting that the moderating influence that higher oil prices have had on additional demand may be weakening. Energy demand has picked up somewhat, rising from 0.8 additional barrels a day in the four quarters ending the first quarter of 2006 to 1.1 additional barrels a day in the fourth quarter (figure 1.23). Nevertheless, the pace of increased demand at the end of 2006 remains well below the increase that would be expected given the growth of output during this period and well below the peak of 2.4 million barrels a day in 2004, suggesting that high prices continue to induce significant substitution and conservation efforts.

At the same time, supply is accelerating. After an extended period during which supply showed only limited responsiveness to higher prices, output among non–OPEC producers accelerated in the second half of 2006. The main change was significant increases in Canada and the United States (in particular from oil sands in Canada and deepwater Gulf fields in the United States) following two years of steady declines, as well as smaller declines in North Sea production and increased production in Australia. These changes augmented continued gains elsewhere, notably in the former Soviet Union, West Africa, and Brazil (figure 1.24). OPEC responded by agreeing in November 2006 to cut production by 1.2 million barrels a day and agreeing to an additional 0.5 million barrels a day cut in early 2007 (about 1 million barrels a day had been cut by early March 2007), reinforcing the sense that the supply constraints that underpinned the earlier rise in oil prices have eased substantially.

Over the medium-term, supply from non–OPEC countries (including new OPEC member Angola, which is not subject to production restraints this year) is projected to rise by

Figure 1.24 Change in sources of oil supply



Source: International Energy Agency.
Note: Figure shows change in oil deliveries.

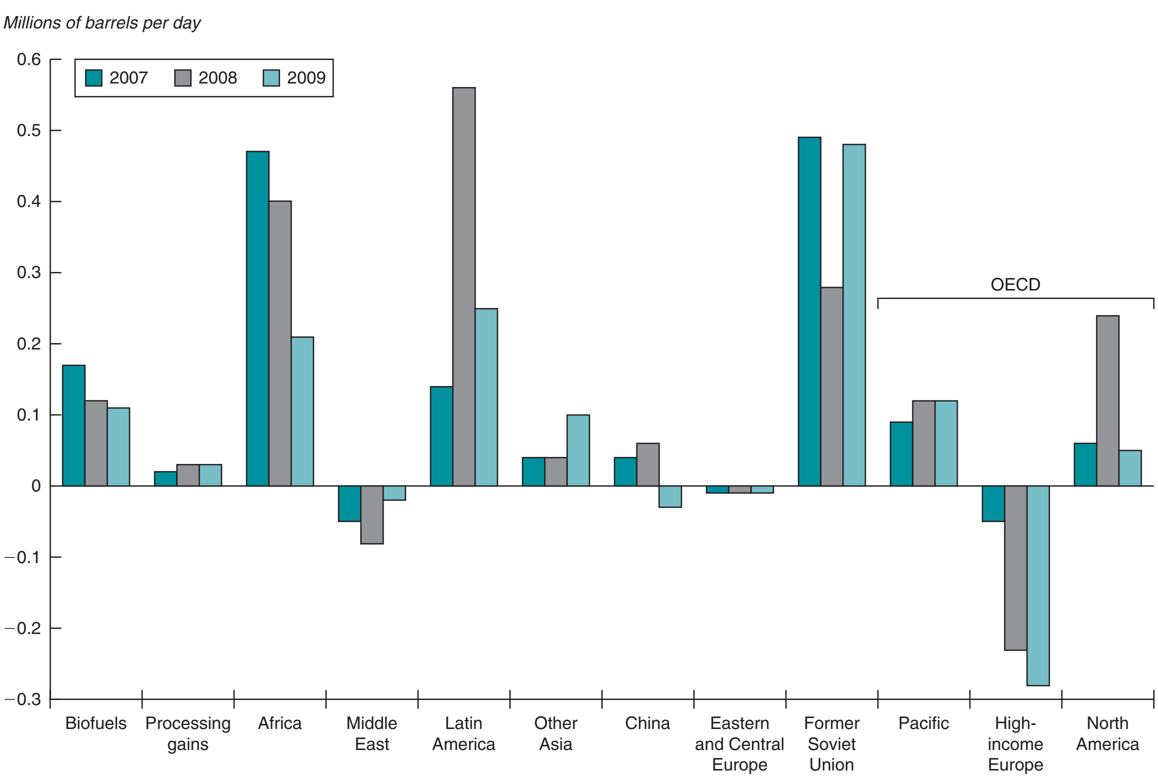
1.4–1.6 million barrels a day during 2007 and 2008. This contrasts with an annual average of only 0.5 million barrels day per between 1985 and 2006, when output gains were held back by aging fields and low investment rates caused by weak prices.

The anticipated pickup in supply reflects upstream investment projects that are already well under way (figure 1.25). Among OECD countries, new fields are expected to yield only modest net gains in production, as a result of the depletion of old fields in the North Sea, the United States, and Mexico. Production in Canada is expected to continue its climb, with additional output concentrated in oil sands.

The largest increase in production is likely to come from the former Soviet Union, with Azerbaijan and Russia each expected to increase annual output by 0.2 million barrels a day. The increase by Azerbaijan reflects the opening of the Baku-Tiblisi-Ceyhan pipeline to the Mediterranean. Production in Kazakhstan is unlikely to rise substantially before 2009, given transport capacity constraints.

Increased production in Africa is projected to yield the second-largest increment to supply, with the bulk of the additional output emanating from

Figure 1.25 Expected growth in non-OPEC oil production



Sources: World Bank; International Energy Agency.

Angola. Significant increases in output are also expected from relatively new producers Mauritania and Sudan, each of which will produce an estimated 0.2 million barrels a day.

Most of the anticipated increase in Latin America reflects the coming on stream of Brazil's deepwater fields, which will produce an additional 0.7 million barrels a day by 2008 and 1 million barrels a day by 2009. Output from other producers (notably Argentina, Colombia, Ecuador, Mexico, and República Bolivariana de Venezuela) is expected to stagnate or decline, because of production inefficiencies and underinvestment. The supply of biofuels is projected to double, from about 0.8 million barrels a day in 2006 to 1.5 million barrels a day in 2009, with the cumulative increase in supply equivalent to about 18 percent of the expected gains from traditional non–OPEC sources during the same period.

Over the near term, high oil prices should continue to moderate demand for petroleum products and sustain incentives to invest in new capacity. Projects already underway are expected to increase gross oil production by about 15 million barrels a day by 2010 (9.2 million barrels a day net), with annual expected increases in demand of 1.5–2 million barrels a day. Spare capacity can thus be expected to increase by 1–3 million barrels a day by 2010. Over the medium term, the recent buildup in additional spare capacity, additional non–OPEC supply, and slower growth should keep supply-side constraints at a minimum. As a result, the price of oil is projected to decline modestly over the next two years, reaching an average level of $55 a barrel in 2009.[11]

Supply conditions in the oil market, although relaxing, remain tight. A 2 million barrel a day supply disruption—an event whose likelihood in the next 10 years is estimated at 70 percent (Beccue and Huntington 2005)—could send oil prices as high as $100 a barrel, reducing global growth by as much as 1 percent (1.7 percent for developing countries) (see the discussion surrounding table 1.5 in World Bank 2005 for more details).

A period of uncertainty

A number of factors suggest that the soft-landing scenario outlined above is the most likely outcome. Tighter monetary policy in high-income and a number of developing countries is slowing growth, which is easing commodity prices and inflationary tensions in high-income countries. Meanwhile, interest rates and emerging-market spreads remain low. These favorable external conditions for developing countries should allow them to grow at a slower but still-robust pace of 6.1 percent in 2009.

However, the global economy is at a turning point, following several years of very strong growth. Such periods imply higher risk. As an extreme example, the period immediately preceding the Asian financial crisis in 1997 was characterized by strong growth, robust capital flows, and generalized optimism.

In the current context, the extended period of very rapid growth (particularly in developing countries) has generated a number of tensions. It has contributed to a surge in commodity prices,

Table 1.2 Simulated impact of an increase of 200 basis points in emerging-market spreads

	2007	2008	2009	2010	2011
Interest rates (percentage point change in fourth-quarter level from baseline)					
World	0.3	0.3	−0.1	−0.1	0
High-income	0	−0.3	−0.4	−0.4	−0.2
Low- and middle-income	1.6	2.7	1.3	1.3	0.8
Real GDP (% change from baseline)					
World	−0.2	−0.9	−0.4	0	0.7
High-income	−0.1	−0.6	−0.2	0	0.8
Low- and middle-income	−0.6	−1.7	−0.9	−0.3	0.6
Inflation (change in inflation rate)					
World	0	0.3	−0.6	−0.6	−0.6
High-income	0	−0.2	−0.7	−0.7	−0.6
Low- and middle-income	−0.1	−0.6	−0.3	−0.3	−0.4

Source: World Bank.

higher consumer price inflation, and increased prices in a number of asset markets (notably emerging-market equities and real estate markets in high-income countries). It has also been accompanied by unprecedentedly large imbalances in the balance of payments.

The projected slowdown in growth that has already begun in some of the world's largest economies is helping dampen these tensions in a relatively smooth manner. Oil and metals prices are declining, inflation is down in high-income countries, equity and home prices are no longer rising at unsustainable rates, and external imbalances are beginning to stabilize. Nevertheless, tensions persist and remain significant.

The rest of this chapter explores the implications for developing economies of three alternative scenarios in which these tensions resolve themselves in a more turbulent manner than projected in the baseline scenario.

Overheating in some developing countries could reverse favorable financial market conditions

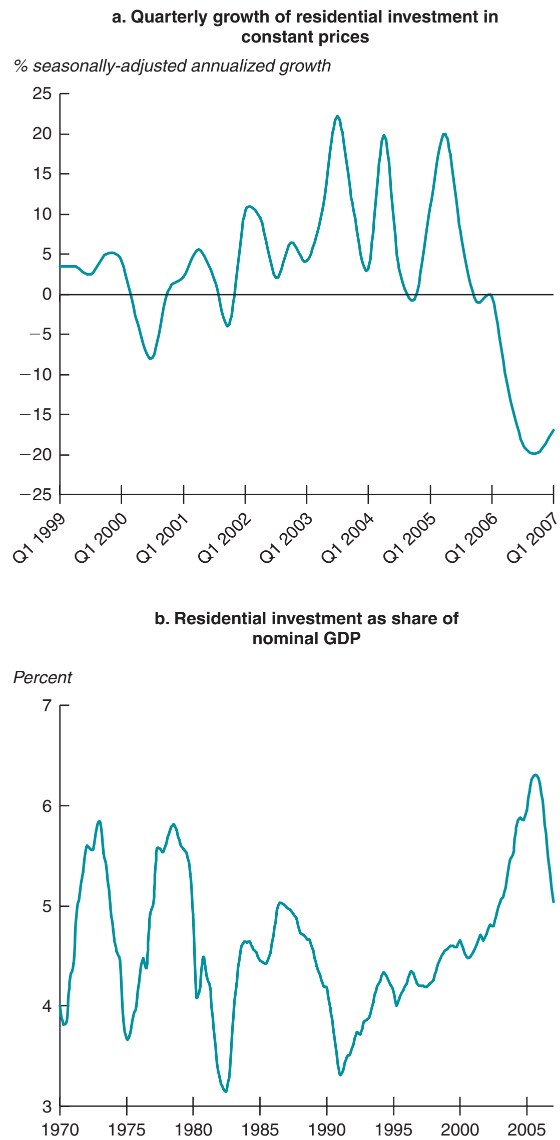
The very rapid growth of developing economies has generated significant internal and external imbalances (rising inflation and rising current account imbalances) in a number of countries. While a generalized tightening of macroeconomic policy is projected to slow growth in many economies, policy remains relatively relaxed in others, where imbalances are either growing or receding only slowly.

Should these imbalances continue to grow or international investors' tolerance (or expectations) for them change abruptly, significant financial market turmoil could ensue. Both the May 2006 and February–March 2007 episodes of increased financial volatility offer insights into the possible consequences. In each case, valuations in equity markets declined abruptly and risk premiums in debt markets jumped, with countries with large debt burdens and current account deficits suffering the largest declines. While in both instances the turmoil proved short-lived and currency adjustments were largely limited to unwinding earlier (arguably excessive) appreciations, a future shock could be more severe, with longer-term consequences.

Table 1.2 outlines the impact of a scenario in which some event (political or economic) undermines confidence in a large emerging-market economy, generating a generalized flight of capital toward "quality." The scenario is assumed to boost average spreads by some 200 basis points, with more-heavily indebted countries affected most severely. Increased perceptions of risk cause long-term interest rates in high-income countries to rise by 100 basis points.

The overall impact of this scenario is to reduce global output by 0.9 percent compared with the

Figure 1.26 Housing sector investment



Source: World Bank.

Table 1.3 Simulated impact of a prolonged recession in the United States

	2007	2008	2009	2010	2011
Interest rates (percentage point change from baseline)					
World	0	−0.2	−0.1	−0.1	−0.2
High-income	0	−0.2	−0.3	−0.3	−0.3
Low- and middle-income	−0.1	−0.1	0.5	0.5	0.4
Real GDP (% change from baseline)					
World	−0.2	−1.0	−1.5	−1.6	−1.5
High-income	−0.3	−1.1	−1.7	−1.8	−1.7
Low- and middle-income	−0.1	−0.6	−1.0	−1.0	−0.9
Inflation (change in inflation rate)					
World	0	−0.4	−1.1	−1.1	−1.4
High-income	0	−0.4	−1.3	−1.3	−1.6
Low- and middle-income	0	−0.4	−0.4	−0.4	−0.5

Source: World Bank.

baseline by 2008. Developing countries are more severely affected, with output down an estimated 1.7 percent. Slower growth eases inflationary pressures in developing countries, which means that nominal interest rates decline relatively quickly, although real rates remain elevated. Weaker global growth lowers commodity prices as compared with the baseline, which causes the current account balances of developing countries as a whole to deteriorate by 0.1 percent of GDP.

In general, lower debt-to-GDP ratios, the prepayment of sovereign debt obligations, and the adoption of more flexible exchange rate regimes should make most developing countries less sensitive to such a scenario than they would have been in the past. As a result, the contagion and real-side consequences are expected to be more moderate than they were during the Asian crisis. However, impacts on more-heavily indebted countries, such as Brazil and Turkey, are more marked, with increased debt-servicing charges causing the current account to deteriorate by 0.4 percent of GDP in Brazil and 0.9 of GDP in Turkey.

Table 1.4 Grain price forecast

	2006	2007	
		Baseline	High scenario
Wheat	$192	$220	$275
Maize	$122	$140	$175
Rice	$305	$320	$400
% increase			
Wheat		14.6	43.2
Maize		14.8	43.4
Rice		4.9	31.1

Source: World Bank.

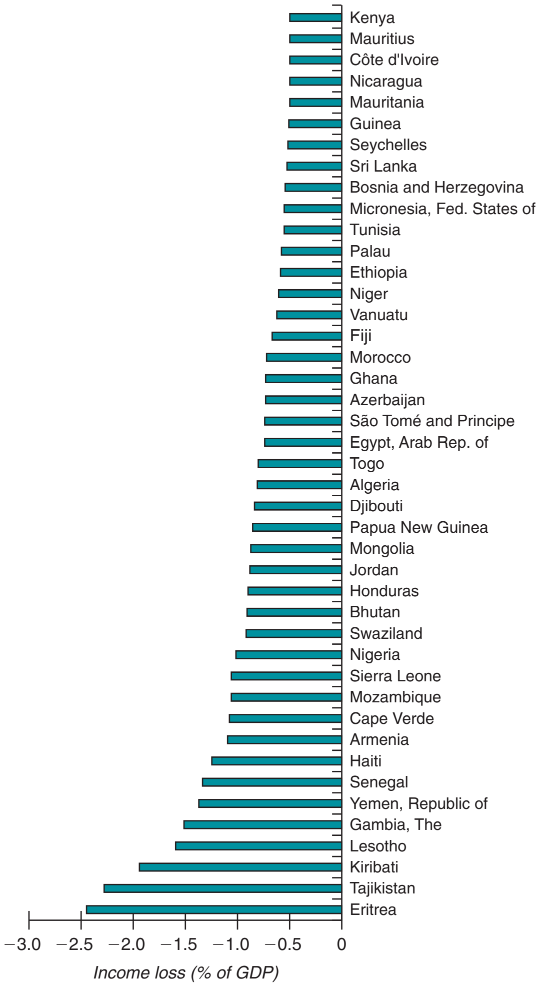
Housing-sector adjustment in the United States could be more severe

A significant uncertainty for the outlook concerns the depth and durability of the adjustment in the U.S. housing sector. While the adjustment process is already well advanced (housing starts increased in February 2007, following several months of decline), the stock of unsold homes remains large. Current inventories currently represent about six months of sales—much more than the normal level of two to four months. Moreover, while the pace at which residential investment is declining has stabilized, both real and nominal investment levels remain high suggesting that a prolonged period of rapidly falling housing-sector investment and prices cannot be ruled out.

Should residential investment continue to decline, bringing it back to levels (as a percent of GDP) consistent with long-term averages (figure 1.26), spillovers to other parts of the economy are likely to intensify. Indeed, there are already increasing signs of spillover from the construction sector to other parts of the economy, notably durable goods consumption and investment.

Table 1.3 outlines the expected impact of a scenario in which spillovers from the construction sector to other parts of the economy intensify. Under this scenario, the United States experiences a prolonged recession. The recession in residential investment, which in the baseline is expected to begin easing in the third quarter of 2007, deepens and extends to other investments. As a result, aggregate investment declines at a 5 percent annualized rate throughout 2007 and 2008, with GDP in the United States increasing by only 1 percent a

Figure 1.27 Simulated impact of a grain-sector supply shock on selected developing countries



Source: World Bank.

year during this period. Slower import growth in the United States transmits to the rest of the world as reduced export demand. It also generates a decline in interest rates, which has a positive effect on global output.

For heavily indebted countries, the slower growth and larger current account deficits translate into increased risk perceptions and higher interest rates beginning in 2009, intensifying the slowdown in growth in these countries. Consistent with the results recently produced by the International Monetary Fund (IMF 2006), those countries, such as China and Mexico, that have the closest trade ties with the United States experience the sharpest declines in growth. These declines are about half as intense as in the United States itself, and in the case of China they are minor compared with its baseline growth rate of 8–9 percent. The impact on other developing countries is weaker and takes longer to materialize, partly because the slowdown in these economies reflects the secondary impacts of import demand in China.

Low grain stocks pose a risk for the poor in developing countries

Partly because of the diversion of a substantial proportion of maize to the production of biofuels, stocks of and supply conditions for a number of grains are very low. In the United States, the world's largest producer and exporter of maize, ethanol production in 2007 is projected to consume 25 percent more maize than in 2006, when

Table 1.5 Estimated poverty impact of a 40 percent increase in rice and wheat prices in selected countries

	Initial poverty headcount	Change in poverty headcount		Percent change in the incomes of the poor	
		Rice	Wheat	Rice	Wheat
Rural population					
Pakistan	16.4	−0.1	0.6	0.1	−2.4
Vietnam	2.4	−0.1	0	0.2	−0.2
Nicaragua	61.1	1.9	0	−3.7	0
Zambia	80.0	0.1	0.1	−0.4	−1.0
Urban population					
Pakistan	8.0	0.1	0.9	−0.4	−3.8
Vietnam	0.9	0.1	0	−6.3	−0.3
Nicaragua	32.1	1.5	0	−3.6	0
Zambia	46.9	0.3	0	−0.6	−0.1

Source: World Bank.
Note: Poverty defined as $1.08 per day in PPP terms.

20 percent of the crop was used for this purpose. Although plantings are expected to rise another 15 percent (at the expense of other crops, notably soybeans), supply remains constrained As result, maize prices are up 75 percent since the summer of 2006.

This reorientation of agricultural output toward biofuels, together with a change in stocking policy in China, has reduced global grain stocks to 16 percent of annual consumption. Low stocks are a principal factor behind the 15 percent increase in wheat and maize prices incorporated into the baseline. But supply conditions are so tight that a major supply shock could result in the price of these grains rising much more rapidly, with wheat and maize prices possibly rising more than 40 percent (table 1.4). Indeed, stocks are currently only slightly higher than the levels observed before the more than doubling of grain prices in 1972–74 and the roughly 40 percent increase in 1994–96.

A hike of 40 percent or more, such as outlined in table 1.4, would have serious consequences for major importing countries. Simulations suggest that the first-round income effects (before substitution effects) would be more than 0.5 percent of GDP for a wide range of developing countries, with as many as 13 enduring a loss of 1 percent of GDP or more (figure 1.27). Among these countries, Armenia, Cape Verde, Eritrea, Mozambique, Senegal, and Sierra Leone already have current account deficits that exceed 5 percent of GDP. For these countries, the additional import costs may be particularly disruptive, requiring substantial real-side adjustments.

The impacts would be much more pronounced for nonfarm poor families, because of the importance of grain products in their consumption.[12] In Kenya, for example, maize accounts for 36 percent of households' caloric intake (58 percent for the poorest households) and 28 percent of total food expenditures.

Calculations based on estimates of the share of various grains in the overall expenditures of poor households suggest that a 40 percent increase in grain prices could reduce real incomes among households living at or below the extreme poverty line of $1 a day by as much as 6.3 percent for some urban populations (table 1.5). In countries such as Nicaragua, a 40 percent increase in grain prices could be enough to push an additional 2 percent of the population into extreme poverty.

Notes

1. The Organisation for Economic Co-operation and Development (OECD 2006) estimates liquidity, as measured by the sum of global M3 or outstanding loans, to be about 15 percent above normal levels.

2. For the purposes of this publication, "Europe" includes only high-income European countries. Developments among middle-income European countries are discussed in the context of the Europe and Central Asia Region.

3. The European Commission publishes quarterly forecasts based on such indicators every month (see http://ec.europa.eu/economy_finance/indicators/euroareagdp_en.htm). The OECD does so on a quarterly basis.

4. As of early May 2007, real policy interest rates were about 3 percent in the United States, about 2 percent in Europe, and about 2 percent in Japan.

5. Crude oil prices averaged $69 a barrel in the fourth quarter of 2006, up from $56 in the same period of 2005 (although the comparison is skewed by the disruptions caused by Hurricane Katrina). The rise boosted imports of gasoline while slowing imports of crude oil. Net import volume growth was probably about 2 percent higher than normal in the fourth quarter of 2005.

6. Low interest rates in the wake of the bursting of the Internet bubble and the subsequent housing boom contributed to a sharp decline in the national net savings rate in the United States, from an average of 6.2 percent in 1999 to less than 1 percent in 2004. During most of 2004 and 2005, it remained at about 1 percent. In 2006 it rose again, to an average of 2 percent, as a result of higher interest rates and the ending of the housing-market boom.

7. Assuming oil prices decline as projected, the U.S. current account deficit could fall by another 0.2 percent of GDP.

8. Relatively low inflation in China and the fact that the currencies of its other trading partners appreciated with respect to the dollar explain this result.

9. Preliminary data suggest that U.S. export growth in the first quarter of 2007 was much weaker. Unfortunately, direction of trade is not yet available to extend the analysis to cover this period.

10. Agricultural prices are quoted in U.S. dollars and have therefore been deflated by U.S. inflation.

11. For the past few years, the World Bank has used a technical assumption for its oil forecasts, because, given low stocks, a wide range of short-term outcomes was judged to be consistent with fundamentals. Accordingly, the price of oil is assumed here to decline gradually toward a long-term real price of $40 a barrel (2006 dollars) in 2015. This real price is then converted into a nominal price using long-term projections for the unit value of manufactures.

12. To the extent that they produce more than they consume, farm households benefit from the higher costs of food products.

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2

Financial Flows to Developing Countries: Recent Trends and Prospects

CAPITAL INFLOWS TO DEVELOPING countries continued to expand in 2006, albeit at a more modest pace than in the previous three years. Total private and official flows reached a record $571 billion, up 19 percent from 2005, following three years of strong gains averaging 40 percent. In a year characterized by heightened uncertainty over the course of global economic growth, inflationary pressures, and interest rates, episodes of turbulence in financial markets were telling reminders of the risks faced by borrowers and lenders. The expansion in capital flows over the year as a whole speaks well for the resiliency of developing economies and for the ability of international financial markets to manage risks, though the outcomes so far should not be grounds for complacency.

Private sector flows rebounded from the sharp contraction of 2001–02, with four consecutive years of strong gains supported by a combination of cyclical and structural factors. Global factors—low interest rates and ample liquidity—teamed with robust growth to sustain strong foreign interest in debt and equity investments in emerging markets and other developing countries. Investor confidence in emerging markets was not shaken by the turbulence that buffeted financial markets from time to time. Bond spreads widened in the wake of such episodes but quickly recovered, and credit ratings continued to improve, indicating that financial markets continue to take a favorable view of the fundamentals underlying most emerging-market economies. The swelling demand for emerging-market assets received an additional boost from innovative derivative products (notably credit default swaps), which have greatly expanded the menu of options available for managing risk, and from new sources of lending and equity investment (notably hedge funds and private equity firms).

For their part, developing countries have continued to take advantage of favorable external conditions by implementing domestic policies designed to reduce their vulnerability to large fluctuations in interest rates, exchange rates, and private capital flows—fluctuations that have triggered so many of the financial crises of the past few decades. Countries have reduced their external debt burdens and lengthened the maturity structure of their debt. Several have bought back large amounts of outstanding debt using abundant foreign exchange reserves, refinancing existing debt by issuing longer maturities on more favorable terms. The market for sovereign debt has evolved significantly, as governments have turned from the external to the domestic market, where debt is typically denominated in local currency. Most developing countries continue to hold abundant foreign exchange reserves; few have acute current account imbalances. Creditors' assessment of their creditworthiness remains very positive, as reflected in the near-record low spreads on emerging-market bonds and bank loans. Lenders appear to be increasingly willing to take on greater risk in the form of unsecured bank loans and bonds issued by unrated borrowers.

As global growth recedes to more sustainable rates, the probability of a turn in the credit cycle rises. Looking ahead, the key challenge facing developing countries is to manage the transition by taking preemptive measures aimed at lessening the risk of a sharp, unexpected reversal in capital flows. The repercussions of such a reversal would be felt most acutely in countries that have experienced large capital inflows, unsustainably rapid economic and credit growth, mounting inflationary pressures, and growing fiscal and external imbalances. These conditions have been made possible in part by circumstances in the industrial world, where long-term interest rates have remained low by historical standards and ample liquidity has sent investors in search of higher yields. Aggressive competition among lenders has made them more willing to take on riskier positions. Many of the factors supporting the expansion in capital flows over the past few years could turn out to have strong cyclical components, which could create strong headwinds for even the most resilient countries.

These conditions, familiar from previous episodes, are cause for concern. But some features of the current landscape are new. Development finance has evolved in ways that alter the conventional assessment of risks. Sovereign borrowers are meeting a growing portion of their financing needs by issuing bonds in domestic markets, while corporate borrowing in the external debt market has expanded considerably. These developments have changed the nature of the risks in international and domestic financial markets, increasing the importance of sound monetary, fiscal, and exchange rate policies; a well-regulated domestic financial system; and effective standards of corporate governance and accounting. Data on sovereign borrowing in domestic markets and corporate borrowing abroad are scarce and spotty, making it much more difficult for investors and multilateral institutions to monitor developments and assess the risks posed by the significant new trends in development finance.

This chapter reviews financial flows to developing countries, analyzing recent developments and assessing short-term prospects. The key messages are highlighted below.

- *Capital inflows to developing countries have continued to keep pace with these countries' robust rates of growth*. Developing economies have showed impressive resilience to turbulence in international financial markets; most are well placed to withstand an abrupt deterioration in economic and financial conditions, a key risk in the current phase of the credit cycle. There are exceptions, however. Some countries appear particularly vulnerable to a sudden deterioration in global economic conditions, especially when accompanied by wide fluctuations in interest rates, exchange rates, and equity prices, or an abrupt fall in commodity prices, in the case of exporting countries.
- *Equity continues to account for the bulk of capital inflows to developing countries, as equity prices in emerging markets continue to outperform those in mature markets,* despite episodes of turbulence. The higher volatility has not suppressed investors' interest in emerging-market assets. Portfolio equity flows to developing countries have continued their surge, reaching a record \$94 billion in 2006, up from less than \$6 billion in 2001–02. The strength of investors' interest was well demonstrated by initial public offerings (IPOs) by two Chinese banks (the Industrial and Commercial Bank of China and the Bank of China) totaling \$21 billion. Both issues were greatly oversubscribed, despite being launched in the midst of the turbulence that gripped financial markets in May–June 2006.
- *The surge in private capital inflows to developing countries over the past few years has coincided with a dramatic decline in net official lending*. Repayments on loans owed to governments and multilateral institutions outstripped lending by a wide margin (\$145 billion) in 2005–06, as middle-income countries made voluntary prepayments to the Paris Club of creditors and multilateral institutions, especially the International Monetary Fund (IMF). High oil prices have enabled several major oil-exporting countries (led by Algeria, Nigeria, and Russia) to prepay such debt. Favorable economic and financial conditions have virtually eliminated IMF lending to countries in need of emergency financing, permitting several countries (notably Argentina, Indonesia, and Turkey) to repay their outstanding debt ahead of schedule. As a result of these repayments, the IMF's outstanding credit has fallen to levels not seen since before the Latin American debt crisis of the 1980s.
- *Despite favorable financing conditions, many developing countries have not accessed private debt markets over the past few years and remain heavily dependent on development assistance to meet their financing needs.* Official development assistance (ODA) decreased by almost \$3 billion in 2006, following a record

$27 billion increase in 2005. The change largely reflects an extraordinary amount of debt relief provided to Iraq and Nigeria by their Paris Club creditors, totaling more than $19 billion in 2005 and $14 billion in 2006. At the UN Conference on Financing for Development in Monterrey in 2002, donors pledged that debt relief would not displace other components of ODA. Donors subsequently made commitments to enhance aid substantially over the balance of the decade, particularly to low-income countries in Sub-Saharan Africa. Little progress was made toward meeting these commitments in 2006: excluding debt relief, net ODA disbursements were static.

- *Uncertain whether donors will meet their commitments to enhance development assistance, some low-income countries may opt to meet their financing needs by borrowing on nonconcessional terms.* Doing so could erode debt sustainability over the long term and erase the benefits of recent debt-relief initiatives. Because such borrowing is not reported in a comprehensive and timely manner, creditors and policy makers have difficulty assessing its potential impact on debt sustainability.

Capital market developments in 2006

The expansion in capital flows continues . . .

The expansion in net capital flows to developing countries continues to keep pace with economic growth, with total (private and official) flows increasing slightly, from about 5 percent of GDP in 2005 to 5.1 percent in 2006, up from 3 percent in 2001 and equal to the level reached in 1995 before the Asian crisis (table 2.1 and figure 2.1).

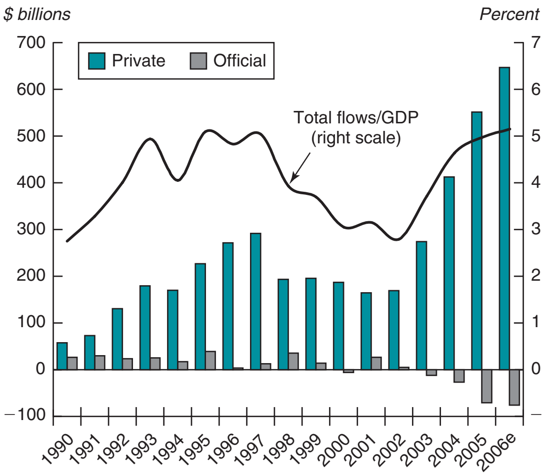
Table 2.1 Net capital flows to developing countries, 1998–2006

$ billions

	1998	1999	2000	2001	2002	2003	2004	2005	2006e
Current account balance	−96.7	−19.1	34.4	12.1	60.5	101.9	113.6	256.4	348.5
as % of GDP	−1.7	−0.3	0.6	0.2	1.0	1.5	1.4	2.7	3.1
Financial flows									
Net private and official flows	228.9	209.6	181.1	191.1	174.2	262.0	385.9	480.7	571.0
Net private flows (debt + equity)	193.4	195.6	187.0	164.5	169.2	274.1	412.5	551.4	646.8
Net equity flows	175.8	189.6	179.9	176.6	162.9	184.3	257.7	347.5	418.8
Net FDI inflows	170.0	178.0	166.5	171.0	157.1	160.0	217.8	280.8	324.7
Net portfolio equity inflows	5.8	11.6	13.4	5.6	5.8	24.3	39.9	66.7	94.1
Net debt flows	53.1	20.0	1.2	14.5	11.3	77.7	128.2	133.2	152.2
Official creditors	35.5	14.0	−5.9	26.6	5.0	−12.1	−26.6	−70.7	−75.8
World Bank	8.7	8.8	7.9	7.5	−0.2	−0.8	1.4	2.5	−2.4
IMF	14.1	−2.2	−10.7	19.5	14.0	2.4	−14.7	−40.2	−25.1
Others	12.7	7.4	−3.1	−0.4	−8.8	−13.7	−13.3	−33.0	−48.3
Private creditors	17.6	6.0	7.1	−12.1	6.3	89.8	154.8	203.9	228.0
Net medium- and long-term debt flows	82.9	23.3	13.4	11.6	5.8	34.8	86.4	136.2	156.0
Bonds	38.8	30.1	20.9	10.3	10.4	24.7	39.8	55.1	49.3
Banks	49.4	−5.3	−3.8	7.8	2.3	14.5	50.6	86.0	112.2
Others	−5.3	−1.5	−3.7	−6.5	−6.9	−4.4	−4.0	−4.9	−5.5
Net short-term debt flows	−65.3	−17.3	−6.3	−23.7	0.5	55.0	68.4	67.7	72.0
Balancing item[a]	−114.6	−158.1	−170.4	−122.4	−60.2	−69.1	−95.5	−345.4	−286.5
Change in reserves (− = increase)	−17.6	−32.4	−45.1	−80.8	−174.4	−294.7	−404.0	−391.7	−633.1
Memo items:									
Bilateral aid grants	42.5	44.4	43.3	43.7	50.6	63.6	70.5	71.3	70.6
of which:									
Technical cooperation grants	15.8	16.0	14.7	15.8	18.2	20.1	20.4	19.3	19.9
Other	26.7	28.4	28.6	27.9	32.4	43.5	50.1	52	50.7
Net official flows (aid + debt)	78.0	58.4	37.4	70.3	55.6	51.5	43.9	0.6	−5.2
Workers' remittances	72.7	76.6	83.8	95.3	116.2	143.8	163.7	189.5	199.0
Repatriated earnings on FDI	28.7	27.8	34.6	43.8	43.2	53.4	73.8	107.0	125.0

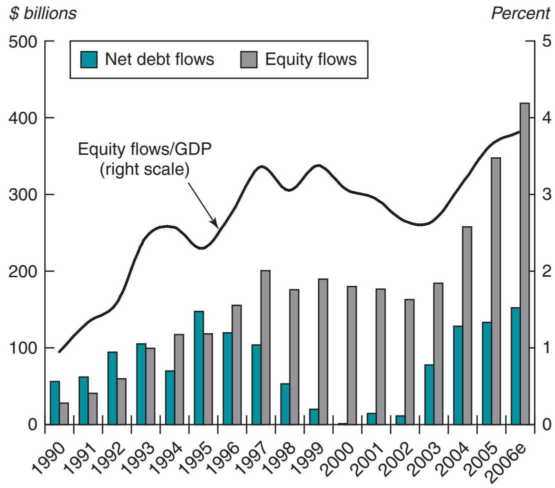
Sources: World Bank Debt Reporting System and staff estimates.
Note: e = estimate.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

Figure 2.1 Net capital flows to developing countries, 1990–2006



Sources: World Bank Debt Reporting System and staff estimates.
Note: e = estimate.

Figure 2.2 Net debt and equity flows, 1990–2006



Sources: World Bank Debt Reporting System and staff estimates.
Note: e = estimate.

The composition of capital flows continues to shift from official to private sources, as net capital inflows from private creditors continue to expand, partially offset by net capital outflows to official creditors. Private debt and equity inflows reached a record $647 billion in 2006, up 17 percent from 2005, following three years of gains averaging almost 50 percent. Meanwhile, net official lending declined sharply over the past two years, as principal repayments to official creditors exceeded disbursements by $70 billion in 2005 and $75 billion in 2006. Net capital *outflows* to official creditors totaled $185 billion between 2003 and 2006, while net capital *inflows* from private creditors reached $1.9 trillion.

. . . led by a surge in equity flows . . .

Equity continued to account for the bulk of capital flows, averaging 70 percent of the total during 2004–06. Foreign direct and portfolio equity flows increased by $235 billion over this period, while net private and official debt flows increased by just $75 billion (figure 2.2). The expansion in equity flows kept pace with economic growth, increasing slightly from 3.6 percent of GDP in 2005 to a record 3.8 percent, above the previous peak (3.35 percent) attained in 1999.

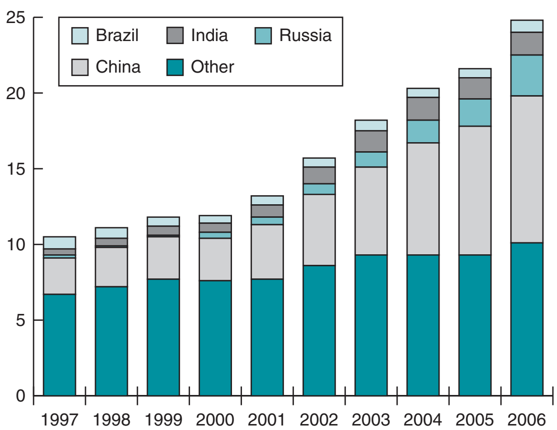
. . . supported by favorable external and domestic conditions

The continued expansion in capital flows has been buoyed by a benign economic and financial environment. Demand from industrial countries has remained strong, with GDP growth of 3.1 percent in 2006 (up from 2.6 percent in 2005) boosting developing countries' exports. High commodity prices have continued to benefit exporting countries. Although world oil prices eased in the second half of 2006, they remained well above the levels of previous years (figure 1.21). Prices for metals and minerals surged to record levels in 2006, while those of agricultural products continued to rise steadily (figure 1.20). Although short-term interest rates increased in many countries in response to strong growth and mounting inflationary pressures, long-term rates remained relatively low, holding down borrowing costs for developing countries while fueling investors' search for yield in emerging-market assets.

Current account balances for developing countries as a group continued to improve in 2006, reaching a record 3.1 percent of GDP, up from 2.7 percent in 2005. These balances rose by $247 billion between 2003 and 2006, with most of the increase concentrated in China ($162 billion) and Russia ($63 billion). World oil prices continued to have a major influence, with current account balances as a share of GDP rising more than three percentage points in 11 of the 24 oil-exporting countries and declining more than three percentage points in 33 of 96 oil-importing countries during this period. Two-thirds of oil-importing countries ran current account *deficits* of more

Figure 2.3 Foreign exchange reserves relative to GDP in developing countries, 1998–2006

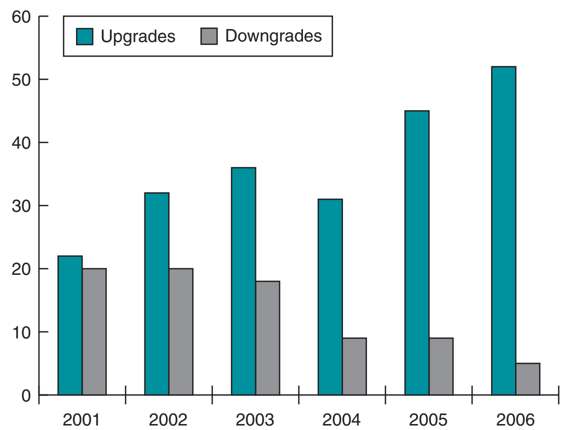
Percent



Source: IMF *International Financial Statistics.*

Figure 2.4 Changes in credit ratings of sovereign debt issued by emerging-market economies, 2001–06

Number of rating changes



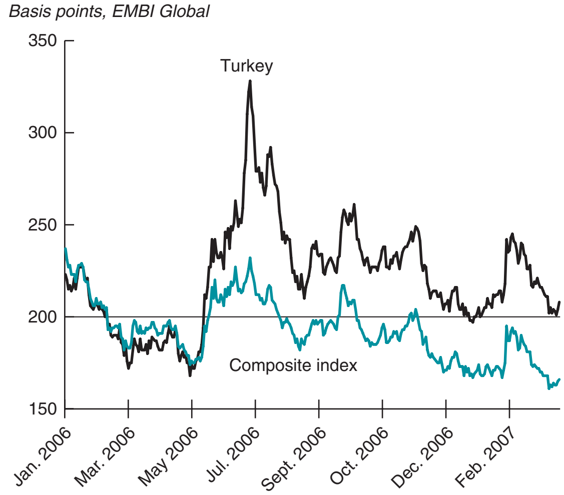
Sources: World Bank staff calculations based on ratings by Fitch, Moody's, and Standard & Poor's.

than 3 percent of GDP in 2006, while half of oil-exporting countries ran *surpluses* of more than 3 percent of GDP.

The pace of reserve accumulation by developing countries picked up significantly in 2006. Foreign exchange reserves rose by $633 billion, up from about $400 billion in 2004 and 2005. The BRICs (Brazil, Russia, India, and China) accounted for 70 percent of the increase, with reserves rising by $247 billion in China, $120 billion in Russia, $39 billion in India, and $32 billion in Brazil. International reserves held by all developing countries increased from less than 10 percent to almost 25 percent of their GDP over the past 10 years (figure 2.3).[1] China's share rose from 25 percent in the late 1990s to 40 percent in 2006, while the share held by Russia increased from under 2 percent to 11 percent.

Figure 2.5 Emerging-market bond spreads, January 2006–March 2007

Basis points, EMBI Global



Source: JPMorgan Chase.

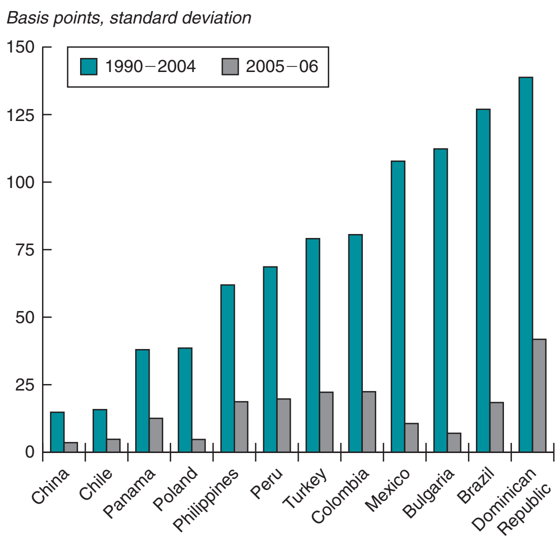
Markets maintain favorable view on emerging-market assets

Financial markets' assessment of emerging-markets' creditworthiness has remained positive for the most part, despite turbulence in May–June 2006 and in late February and early March 2007. Credit ratings of sovereign debt issued by emerging-market economies continued to improve in 2006, with upgrades exceeding downgrades by an increasing margin (figure 2.4). Average spreads on emerging-market sovereign bonds remained near record lows. The EMBI Global declined to 175 basis points in early May 2006 before widening to about 225 basis points in late June, as investors sold off emerging-market debt and equity (figure 2.5). The turbulence encountered in May–June was sparked by heightened uncertainty about the course of interest rates, growth, and inflationary pressures in advanced countries—and the effect a contraction would have on emerging markets. In response, international investors reduced their holdings of emerging-market assets. Bond spreads were most affected in the countries deemed to be most vulnerable, such as Turkey, where spreads widened by about 150 basis points, three times the increase for the composite index.

The sell-off turned out to be short-lived, demonstrating the resiliency of the emerging-market asset class. Spreads recovered quickly. The composite index narrowed to 170 basis points in early 2007. In late February 2007, spreads abruptly widened again in the midst of more turbulence in financial markets, increasing 25 basis points before quickly recovering, reaching record lows below 165 basis points in April 2007. These events must be viewed in perspective. In 2002 only one in five countries in the index had bond spreads below 200 basis points; by April 2007 the proportion had risen to three in four.

Emerging-market bond spreads have also become much less volatile. The daily standard deviation of the EMBI Global was less than 15 basis points in 2006 and 7.5 basis points in the first quarter of 2007, down from almost 200 basis points over the 2000–05 period. The volatility of month-to-month changes in bond spreads also declined considerably in several countries. In Mexico, for example, the standard deviation of monthly changes in bond spreads (measured using the EMBI Global) fell from more than 100 basis points in 1994–2004 to less than 10 basis points in 2005–06 (figure 2.6). Thus, from a historical perspective, the volatility observed over the past few years has been relatively minor.

Figure 2.6 Monthly changes in emerging-market bond spreads in select countries since 1990



Source: JPMorgan Chase.

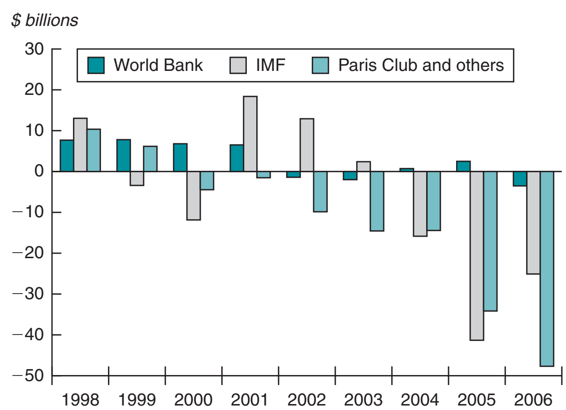
Official capital flows continue their sharp decline

The continued decline in net official lending in 2006 reflects substantial repayments by developing-country borrowers to their Paris Club creditors and the IMF (figure 2.7 and table 2.2). Such repayments totaled \$65 billion in 2006, up from \$50 billion in 2005. Plentiful oil revenues enabled Russia to finish paying off its Soviet-era debts with a \$22 billion prepayment to Paris Club creditors in 2006, following a \$15 billion prepayment in 2005. Oil revenues enabled Algeria to prepay \$8 billion to the Paris Club and Nigeria to prepay \$6 billion to Paris Club creditors and \$1.5 billion to London Club creditors, following a \$6.4 billion repayment to the Paris Club in 2005.[2]

Most countries making these large prepayments nevertheless managed to accumulate substantial foreign exchange reserves and to reduce their external debt burdens, indicating that the prepayments made to official creditors were not financed by additional borrowing from private creditors. In 2006, for example, Russia accumulated \$120 billion in international reserves, providing 17 months of import cover at the end of 2006, up from 13 months at the end of 2005. The country's external debt declined from 30 percent of GDP in December 2005 to 25 percent in December 2006. Exceptions are Turkey, where external debt rose from from 48 to 57 percent of GDP, and Uruguay, where the reserve import cover declined from over 8 months to less than 7 months.

Repayments to the IMF continued to outstrip lending by a wide margin, reflecting a marked

Figure 2.7 Net official debt flows to developing countries, 1998–2006



Sources: World Bank Debt Reporting System and staff estimates.

Table 2.2 Repayments by selected developing countries to official creditors, 2006

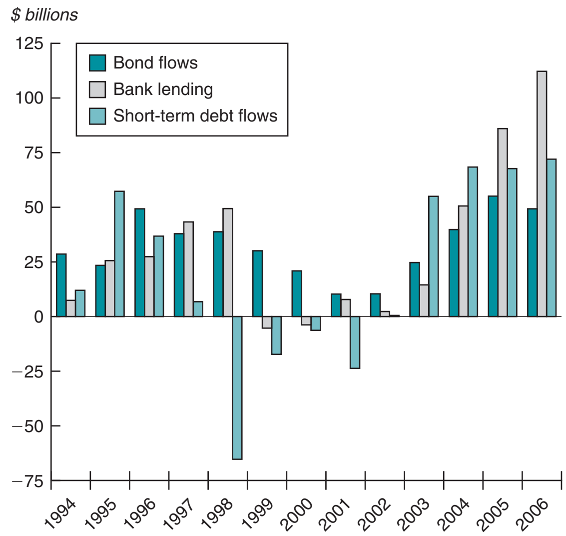
	Repayment in 2006 (*$ billions*)	Official creditor	External debt/GDP (*percent*)		Foreign reserves (*$ billions*)		Reserve import cover (*months*)	
			2005	2006	Dec. 2005	Dec. 2006	Dec. 2005	Dec. 2006
Russian Federation	22.0	Paris Club	30.0	25.4	175.9	295.6	15.4	18.2
Argentina	9.6	IMF	60.2	45.6	27.2	30.9	10.6	11.0
Mexico	9.0	IDB/World Bank	22.1	19.1	74.1	76.3	3.7	3.5
Algeria	8.0	Paris Club	22.3	21.8	56.3	77.9	27.7	28.7
Indonesia	8.0	IMF	50.6	37.9	33.0	40.9	6.8	8.4
Turkey	7.5	IMF	48.0	56.7	50.6	61.1	4.6	4.9
Nigeria	7.5	Paris/London Club	22.5	5.9	28.3	42.4	12.0	16.2
Uruguay	2.5	IMF	90.5	64.5	3.1	3.1	8.7	8.7
Brazil	2.0	Paris Club	25.6	22.4	53.6	85.6	6.7	11.3

Sources: World Bank Debt Reporting System and staff estimates.

improvement in international financial stability. Lending by the IMF (purchases) declined from an average of $32 billion in 2001–03, during the major financial crises in Argentina, Brazil, and Turkey, to an average of $5 billion in 2004–06. Repayments totaled $28 billion in 2006, largely as a result of sizable prepayments by Argentina ($9.6 billion), and Indonesia ($8 billion), and a large repayment by Turkey ($4.5 billion), following a record $44 billion in repayments in 2005. IMF credit outstanding declined to under $18 billion at end-March 2007, down from a high of just under $100 billion in 2003. With such a low level of credit outstanding, it is unlikely that repayments will continue to exceed disbursements in the coming years.

Most of the large repayments made to official creditors over the past few years involve nonconcessional loans to middle-income countries. Concessional loans and grants to low-income countries—a better measure of development assistance—are reviewed later in this chapter.

Figure 2.8 Net private debt flows to developing countries, 1994–2006



Sources: World Bank Debt Reporting System and staff estimates.

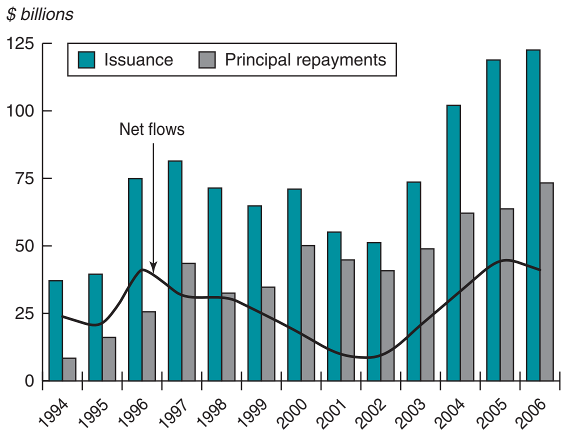
Private debt market developments

Net private debt flows increased by $24 billion (12 percent) in 2006, led by a $26 billion expansion in net bank lending, partly offset by a decline in net bond flows (figure 2.8)

Private bond flows declined

Net private bond flows (bond issuance less principal repayments) declined by $6 billion (10 percent) in 2006, to $49 billion (figure 2.9). The decline followed three years of strong expansion in net bond flows. The 2006 figure was still higher than the level reached in 1996, just before the Asian crisis. Private bond flows averaged just 0.5 percent of GDP in 2004–06, however, well below the peak of 0.9 percent attained in 1996. The decline in 2006 was driven by an estimated $30 billion in sovereign debt buybacks ($27 billion in Latin America), although some of the buybacks were financed by other issues and thus did not affect net bond flows.[3] In Latin America, principal repayments on sovereign bonds increased by almost $20 billion in 2006, while sovereign bond issuance declined by $2 billion. The decline in net flows to Latin America was balanced by a $20 billion rise in Europe and Central Asia. Other regions recorded relatively small changes in net flows (table 2.3).

Figure 2.9 Private bond flows to developing countries, 1994–2006



Sources: World Bank Debt Reporting System and staff estimates.

Bank lending continues to expand . . .

Net commercial bank lending rose by $26 billion in 2006, reaching a record $112 billion (table 2.4). The greatest increase (more than $12 billion) occurred in Latin America and the Caribbean, largely as a result of the record $17.6 billion bridge loan contracted by the Brazilian mining company Compania Vale do Rio Doce (CVRD) to acquire the Canadian mining company Inco. The bridge loan involves substantial repayments over the next few years, to be financed through the issuance of global bonds, which will change the composition of private debt flows in the region (through a shift from bank to bond lending).

Net bank lending to Europe and Central Asia declined by $10 billion in 2006. The region still accounted for 60 percent of the total, down from 90 percent in 2005. Relative to GDP, net bank lending increased to a record 1 percent, surpassing the previous high of 0.9 percent in 1998.

Syndicated bank loan commitments to developing countries totaled $246 billion in 2006, up $47 billion from 2005 (table 2.5).[4] The CVRD loan accounted for most of the increase. The number of loan commitments increased from 1,261 in 2005 to 1,469 in 2006, while the average loan size increased from $158 million to $167 million.

Table 2.3 Private bond flows to developing countries, 1998–2006
$ billions

	1998	1999	2000	2001	2002	2003	2004	2005	2006e
Bond issuance									
All developing countries:	71.4	64.8	71.0	55.1	51.2	73.6	102.0	118.8	122.5
By region									
East Asia and Pacific	3.5	7.4	5.6	6.7	8.0	6.8	16.4	16.5	14.3
Europe and Central Asia	20.7	12.5	12.2	7.7	11.7	22.1	35.2	46.0	61.3
Latin America and the Caribbean	40.7	41.6	43.9	33.0	21.2	34.7	35.0	43.5	38.2
Middle East and North Africa	..	1.6	2.1	5.1	6.2	2.9	6.6	4.7	1.2
South Asia	4.6	..	..	..	..	1.5	7.1	6.2	3.3
Sub-Saharan Africa	0.4	1.6	1.5	2.5	4.1	5.6	1.8	1.7	4.3
Principal repayments									
All developing countries:	32.5	34.7	50.1	44.8	40.8	48.9	62.1	63.7	73.3
By region									
East Asia and Pacific	2.5	6.6	6.4	6.3	7.9	4.8	6.7	6.6	7.2
Europe and Central Asia	6.3	4.7	6.6	6.5	8.0	12.6	11.8	17.6	12.9
Latin America and the Caribbean	23.0	21.6	35.5	30.2	21.6	23.7	36.9	26.9	45.3
Middle East and North Africa	0.1	0.2	1.0	0.7	1.2	2.2	3.2	2.2	3.5
South Asia	0.4	1.2	0.1	0.5	0.8	4.7	3.0	9.1	1.3
Sub-Saharan Africa	0.1	0.5	0.5	0.5	1.3	1.1	0.5	1.3	2.9
Net bond flows (bond issuance less principal repayments)									
All developing countries:	38.8	30.1	20.9	10.3	10.4	24.8	39.8	55.1	49.3
By region									
East Asia and Pacific	0.9	0.9	−0.8	0.4	0.1	2.0	9.7	9.9	7.0
Europe and Central Asia	14.3	7.8	5.7	1.2	3.6	9.5	23.3	28.4	48.3
Latin America and the Caribbean	17.7	20.0	8.4	2.9	−0.4	11.0	−1.9	16.6	−7.1
Middle East and North Africa	1.3	1.4	1.2	4.4	5.0	0.7	3.3	2.6	−2.3
South Asia	4.2	−1.2	5.5	−0.5	−0.7	−3.1	4.1	−2.9	2.0
Sub-Saharan Africa	0.3	1.1	1.0	1.9	2.7	4.5	1.2	0.4	1.4

Sources: World Bank Debt Reporting System and staff estimates.
Note: .. = negligible. e = estimate.

Table 2.4 Cross-border bank lending to developing countries, by region, 1998–2006

$ billions

	1998	1999	2000	2001	2002	2003	2004	2005	2006e
Gross bank lending									
Total	130.4	120.3	116.9	147.6	150.0	176.5	237.1	290.8	313.1
By region									
East Asia and Pacific	18.4	16.6	14.8	20.6	27.4	37.2	34.8	44.4	44.8
Europe and Central Asia	26.5	38.1	38.1	47.1	63.0	78.3	131.7	173.6	170.8
Latin America and the Caribbean	77.3	59.7	56.7	72.4	49.7	47.6	53.1	48.6	58.5
Middle East and North Africa	4.0	2.0	2.6	2.3	2.9	2.7	2.1	6.8	9.3
South Asia	2.1	1.5	1.5	3.1	5.6	8.7	11.8	11.0	18.2
Sub-Saharan Africa	2.2	2.3	3.2	2.1	1.4	2.0	3.6	6.3	11.5
Principal repayments									
Total	81.0	125.6	120.7	139.8	147.7	162.0	186.5	204.8	200.9
By region									
East Asia and Pacific	23.2	28.5	26.1	32.3	37.6	45.6	34.6	45.0	41.4
Europe and Central Asia	12.7	26.2	28.8	39.8	46.0	56.5	83.0	96.9	103.8
Latin America and the Caribbean	38.2	61.1	56.3	57.3	52.4	48.7	52.1	48.5	46.1
Middle East and North Africa	2.0	3.7	2.1	2.4	3.1	3.7	2.8	3.4	4.9
South Asia	1.4	2.1	3.5	4.2	4.6	4.3	10.7	6.8	8.3
Sub-Saharan Africa	3.5	4.0	3.9	3.7	4.0	3.4	3.3	4.1	5.1
Net bank lending (gross lending less principal repayments)									
Total	49.4	−5.3	−3.8	7.8	2.3	14.5	50.6	86.0	112.2
By region									
East Asia and Pacific	−4.8	−11.9	−11.3	−11.7	−10.2	−8.4	0.2	−0.6	3.4
Europe and Central Asia	13.8	11.9	9.3	7.3	17.0	21.8	48.7	76.7	66.9
Latin America and the Caribbean	39.1	−1.4	0.4	15.1	−2.7	−1.1	0.9	0.1	12.4
Middle East and North Africa	2.0	−1.7	0.5	−0.1	−0.2	−1.0	−0.8	3.4	4.4
South Asia	0.7	−0.6	−2.0	−1.1	1.0	4.4	1.1	4.2	9.9
Sub-Saharan Africa	−1.3	−1.7	−0.7	−1.6	−2.6	−1.4	0.4	2.2	6.4

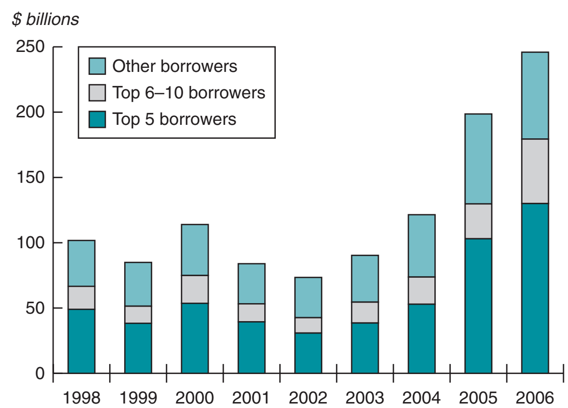
Sources: World Bank Debt Reporting System and staff estimates.
Note: e = estimate.

Table 2.5 Cross-border loan commitments to developing countries, by region, 2006

	Amount (*$ billions*)	Share of total (*percent*)	Number of loans	Average loan amount (*$ millions*)
Total	245.8	100.0	1,469	167
By region				
East Asia and Pacific	37.3	15.2	207	180
Europe and Central Asia	93.6	38.1	410	228
Latin America and the Caribbean	59.2	24.1	577	103
Middle East and North Africa	10.3	4.2	67	153
South Asia	26.6	10.8	121	219
Sub-Saharan Africa	18.8	7.6	87	216

Source: World Bank staff calculations based on data from Dealogic Loanware.

Figure 2.10 Concentration of cross-border loan commitments, 1998–2006



Source: World Bank staff estimates based on Dealogic Loanware.

Large middle-income countries continue to dominate cross-border loan commitments. Lending became more concentrated over the past two years, with just 10 countries accounting for almost three-quarters of all borrowing in 2006, up from 60 percent in 2002–04 (figure 2.10).

Significant shifts also occurred in the allocation of loan commitments across sectors. Commitments to the oil and gas sector declined, from almost $60 billion in 2005 to $30 billion in 2006, while commitments to the mining sector increased, from $5 billion to $25 billion (reflecting the

Table 2.6 Net short-term debt flows to developing countries, 2006
$ billions

	1998	1999	2000	2001	2002	2003	2004	2005	2006e
Total	−65.3	−17.3	−6.3	−23.7	0.5	55.0	68.4	67.7	72.0
By region									
East Asia and Pacific	−44.7	−13.3	−9.9	1.7	6.8	18.5	32.6	39.5	31.8
Europe and Central Asia	6.1	0.5	8.4	−5.9	4.7	31.0	19.9	23.0	30.1
Latin America and the Caribbean	−28.3	−4.9	−0.9	−14.6	−10.5	2.6	7.3	−2.8	2.1
Middle East and North Africa	3.3	1.0	−1.9	−1.8	−0.6	3.1	4.5	3.2	1.9
South Asia	−1.3	0.1	−0.9	−0.9	1.8	0.7	2.6	1.6	2.8
Sub-Saharan Africa	−0.5	−0.6	−1.1	−2.1	−1.8	−1.0	1.6	3.2	3.3

Sources: World Bank Debt Reporting System and staff estimates.
Note: e = estimate.

CVRD bridge loan). Loan commitments to the banking sector totaled $32 billion in 2006, exceeding for the first time the value of commitments to the oil and gas sector.

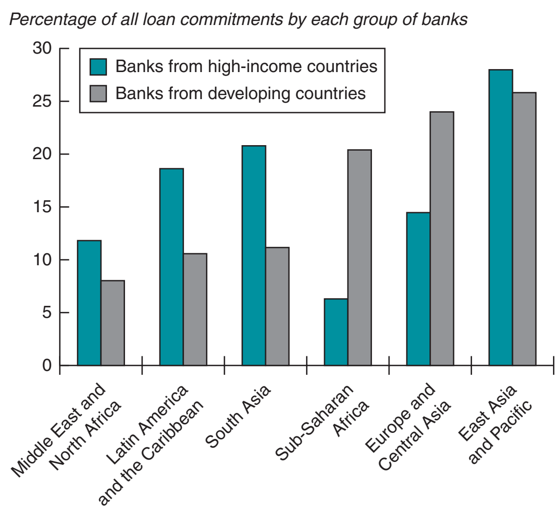
Short-term debt flows (bank loans and bond issues coming due within a year) increased by $4 billion (6 percent) in 2006, reaching $72 billion, just under one-third of private debt flows (table 2.6). Short-term debt flows are highly concentrated in the East Asia and Pacific region and in Europe and Central Asia, which accounted for 85 percent of the total in 2006, equal to the average over the three previous years.

Banks from developing countries are playing an active role

Banks in developing countries continue to be actively involved in syndicated lending to other developing countries (so-called "South–South" bank lending—see World Bank 2006, pp. 118–23). Because South–South cross-border bank lending is often dominated by a few large transactions, regional and country allocations tend to vary widely from year to year. In 2004–06 banks in developing countries accounted for just 4.5 percent of cross-border syndicated loan commitments to borrowers domiciled in low- and lower-middle-income countries. Half of the amount loaned went to borrowers in East Asia and Pacific and Europe and Central Asia, with more than half going to borrowers in resource-rich countries. Four oil-producing countries—Angola, the Arab Republic of Egypt, Indonesia, and Kazakhstan—received almost half of the total amount.

Although South–South lending makes up less than 5 percent of bank lending to the developing world, it is prominent in some regions, particularly Sub-Saharan Africa, which received 20 percent of

Figure 2.11 Cross-border syndicated lending to low- and lower-middle-income countries, by region, 2004–06



Sources: Dealogic Loanware and World Bank staff estimates.

all such loan commitments by banks from developing countries in 2004–06. About three-quarters of these loans were made by Chinese banks. In contrast, Sub-Saharan Africa received just 6 percent of such commitments made by banks located in high-income countries (figure 2.11).[5]

Banks in developing countries made an estimated $5.3 billion in syndicated loan commitments to low- and lower-middle-income countries in 2006. Banks in China, India, Malaysia, and South Africa accounted for nearly three-quarters of the amount loaned. About half of the loans ($2.2 billion) financed oil and gas projects, with Chinese banks providing $2 billion. Overall, Chinese banks provided $2.4 billion in loan commitments to low- and lower-middle-income countries, with nearly two-thirds of these commitments

($1.3 billion) involving two Chinese policy banks (Export-Import Bank of China and the China Development Bank). The Chinese commitments included $700 million in syndicated loan commitments to Angola ($405 million from China's policy banks) and $326 million to Kazakhstan (all but $4 million from the policy banks). These amounts refer only to syndicated loan commitments and do not include bilateral loan commitments; hence, they understate the total amount of lending by banks located in developing countries.[6]

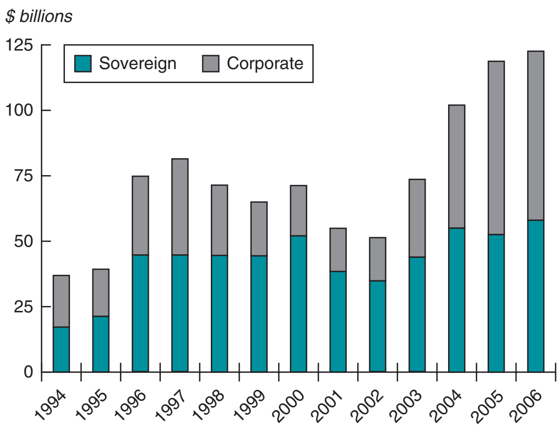
Bond issuance is shifting toward the private sector

The private sector has emerged as the major source of developing countries' borrowing over the past few years (figure 2.12). In 2005–06 corporate bond issues (including corporate bonds guaranteed by the public sector) accounted for over half of the value of all issues, up from less than one-quarter percent in 2000. The corporate share of long-term external debt has increased from less than 20 percent in the late 1990s to over half in 2006 (figure 2.13).

The dramatic decline in external sovereign debt in recent years is partly the result of fiscal restraint, as reflected in the modest decline in the ratio of public sector debt to GDP. But lower external sovereign debt also reflects massive buybacks of external debt and a shift in public sector borrowing to the domestic bond market.

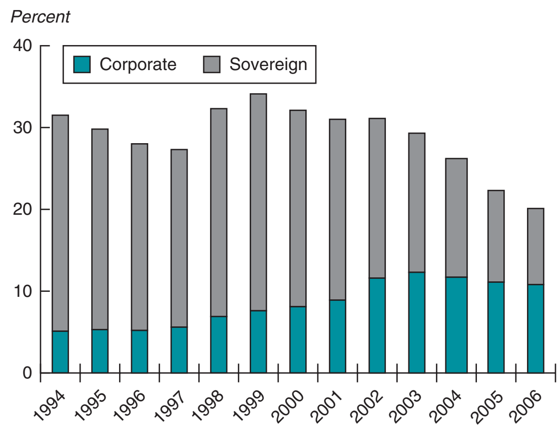
Brazil, Colombia, Mexico, and República Bolivariana de Venezuela bought back almost $30 billion in sovereign debt in 2006 (table 2.7). Brazil accounted for $15 billion, an amount equal to more than 60 percent of its external debt at the end of 2005. These debt-management operations reduced Brazil's average cost of capital, substantially improving its debt-servicing profile in the process. Brady bonds, once the mainstay of the emerging-market asset class, have been almost completely retired: less than $6 billion remains

Figure 2.12 Bond issuance by sovereign and corporate sectors, 1994–2006



Sources: World Bank Debt Reporting System and staff estimates.

Figure 2.13 Long-term external debt as a share of GDP in developing countries, by type of debt, 1994–2006



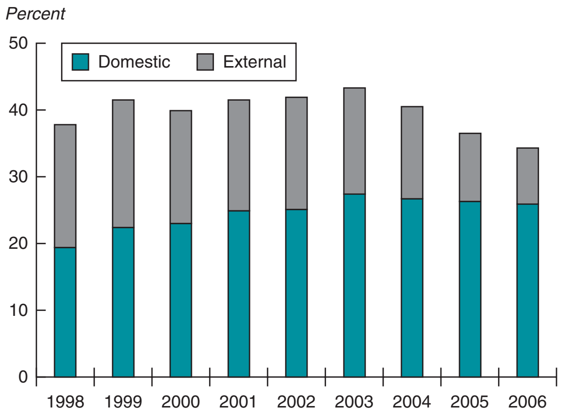
Sources: World Bank Debt Reporting System and staff estimates.

Table 2.7 Major prepayments to private creditors, 2006

		External debt/GDP *(percent)*		Foreign reserves *($ billions)*		Reserve import cover *(months)*	
	Prepayment	2005	2006	Dec. 2005	Dec. 2006	Dec. 2005	Dec. 2006
Brazil	15.0	25.6	22.4	53.6	85.6	6.7	8.7
Mexico	5.4	22.1	19.1	74.1	76.3	3.6	3.2
Venezuela, R. B. de	4.6	32.1	20.7	23.9	29.4	9.2	8.4
Colombia	4.3	33.0	29.9	14.8	15.3	7.5	5.9

Sources: World Bank Debt Reporting System and staff estimates.

Figure 2.14 Public debt as a share of GDP in 28 largest emerging-market economies, 1998–2006



Source: JPMorgan Chase (2007).

outstanding, an amount equal to about 4 percent of the original value issued in the early 1990s.

The increase in domestic debt since the mid-1990s has been more prominent in middle-income countries than in low-income countries. The average level of domestic debt as a share of GDP in 33 low-income countries increased from 17 to 20 percent over the period 1995 to 2005, compared to 20 to 29 percent in 28 middle-income countries.[7]

The growth of developing countries' domestic debt markets and the newfound ability of several governments to issue long-term bonds in local currency have provided an alternative source to meet public sector borrowing requirements. For the 28 largest emerging-market economies, the domestic portion of the outstanding stock of public debt rose from a little more than half in 1998 to three-quarters in 2006 (figure 2.14).[8] External public debt declined from 16 percent of GDP in 1998–99 to an estimated 10 percent in 2006, while domestic public debt climbed from 18 percent to 28 percent.

Foreign investors continue to purchase domestic bonds

The rise in sovereign demand for financing has been partially met by foreign investors in the sovereigns' domestic debt markets. Foreign investors have been attracted by a combination of factors, including higher yields, opportunities for portfolio diversification, improved economic fundamentals in most emerging-market economies, and the perception of lower currency risk.

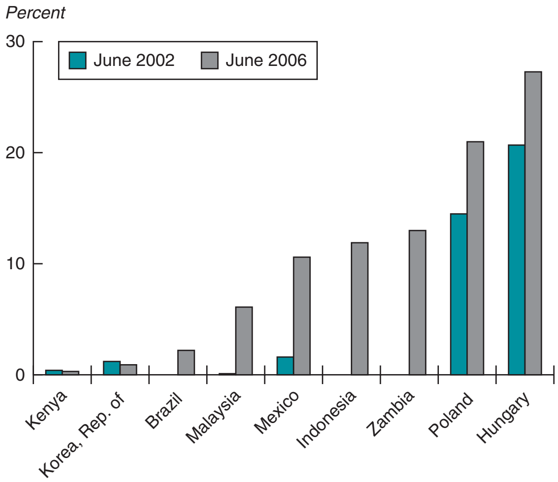
Returns on emerging-market sovereign bonds issued in local markets (measured by JPMorgan's GBI-EM composite index) averaged 13 percent in 2006 (in dollar terms), about 3 percentage points above the average return on emerging-market sovereign bonds issued in external markets (measured by JPMorgan's EMBI Global composite index) and 6 percentage points above sovereign bonds issued by advanced countries (measured by JPMorgan's GBI composite index). Country returns ranged from 46 percent in Indonesia to –5 percent in South Africa (in dollar terms). Returns on local currency bonds in commodity-exporting countries (notably Nigeria and Zambia) have been supported by high commodity prices, which have raised expectations of currency appreciations.

Foreign investors have gained more confidence in several countries that have improved their monetary and fiscal policy frameworks and adopted more flexible exchange rate regimes. Confidence in other countries rose after substantial declines in their debt burdens owing to major debt-relief initiatives (the Heavily Indebted Poor Countries [HIPC] Initiative and the Multilateral Debt Relief Initiative [MDRI]) as well as additional debt relief from Paris Club creditors.

Comprehensive data on the extent of foreign participation in domestic debt markets are not available, making it difficult to draw general conclusions. The available data indicate that nonresidents purchased about $9 billion in domestic debt in 2006. About two-thirds of this debt was acquired by foreign institutional investors (including pension funds, central banks, and government agencies), with the rest purchased by foreign retail investors. In many countries, foreign participation has been overshadowed by growing demand from domestic institutional investors. But the extent of foreign participation varies widely across countries, ranging from less than 1 percent in China, India, Kenya, and the Republic of Korea to more than 20 percent in Hungary and Poland (figure 2.15). A recent address by the managing director of the Monetary Authority of Singapore indicated that on average, nonresident investors hold less than 5 percent of local bonds in Asia.

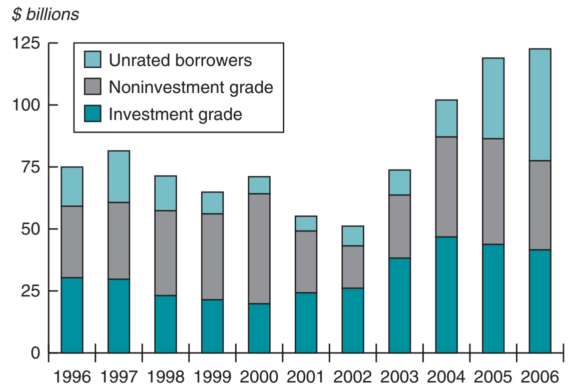
Foreign participation has risen substantially over the past few years in some countries. In Mexico, for example, foreign holdings of domestic debt increased from less than 2 percent in 2002 to more than 10 percent in 2006. In Brazil foreign

Figure 2.15 Share of domestic debt held by nonresidents, selected countries, 2002 and 2006



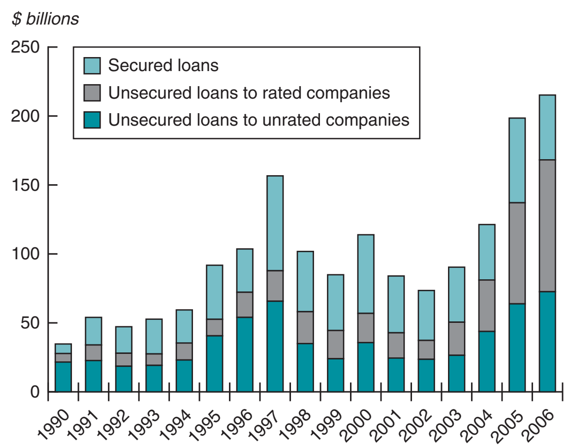
Source: World Bank staff estimates.

Figure 2.16 Bond issuance by developing countries by credit grade, 1996–2006



Source: World Bank staff estimates based on data from Dealogic Bondware.

Figure 2.17 Loan commitments to developing countries by credit grade, 1990–2006



Source: World Bank staff estimates based on data from Dealogic Loanware.

purchases increased in response to the removal of withholding taxes on foreign investors in February 2006. However, foreign investment in Brazil's local markets remains limited by the country's issuance of local currency bonds in international markets.

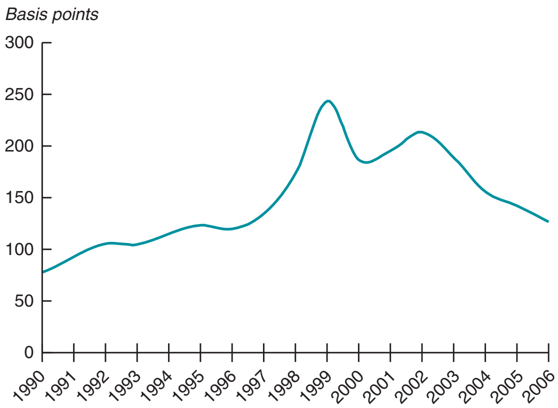
Despite their small share, foreign investors have played an important role in certain segments of domestic debt markets. Nonresidents held 84 percent of 20-year bonds during the early stage of their introduction in Mexico; more than 40 percent of 20-year bonds and at least 80 percent of inflation-indexed securities in Poland; and a substantial share of longer maturities in Brazil. The introduction of derivatives and structured products (such as credit-linked notes) by foreign investors has also reduced the interest rate risk borne by local financial intermediaries, contributing to the soundness of the domestic financial system. Nonresident investors have been active in providing domestic Brazilian institutions with derivative products to hedge interest rate risk.

Credit quality appears to have declined

As private debt flows swell, riskier borrowers may be taking a larger share of the market. The share of bonds issued by unrated (sovereign and corporate) borrowers rose from 10 percent in 2000 to 37 percent in 2006 (figure 2.16), and the share of unsecured loans in total bank lending rose from 50 percent in 2002 to almost 80 percent in 2006 (figure 2.17). While the profile of bank borrowers appeared to become more risky, average spreads across all loan commitments (measured relative to benchmark LIBOR interest rates) fell from more than 200 basis points in 2002 to 125 in 2006 (figure 2.18). Average loan maturities lengthened, even after taking into account shifts in sector, purpose, and country of borrower.

The shift to ostensibly more risky borrowers in the context of falling spreads and lengthening maturities may indicate that lenders are failing to price risk adequately. But other explanations are

Figure 2.18 Average spread across all loan commitments, 1990–2006



Source: World Bank staff estimates based on data from Dealogic Loanware.

also possible. The trend may reflect a significant improvement in the creditworthiness of corporate and sovereign borrowers. It may also reflect a broadening of the investor base as a result of the rapid growth of derivatives and the increasing participation of institutional investors (hedge funds, in particular). These developments have reduced the cost of intermediation for issuing bonds and equity, as well as the cost of capital to banks (thus reducing the price of risk). The extent to which the overall composition of private lending to developing countries has become riskier over the past few years is thus not clear.

Private equity market developments

Portfolio equity flows to developing countries reach record levels

Portfolio equity inflows to developing countries rose to $94 billion in 2006—15 times their 2002 level—led by strong gains in the East Asia and Pacific region (table 2.8). IPOs by two Chinese banks accounted for $21 billion of the total (table 2.9), increasing China's share from 30 percent to 35 percent. Although the number of IPOs declined, from 160 to 140, the value of IPO transactions reached a record $53 billion in 2006, accounting for some two-thirds of portfolio equity flows, up from $37 billion in 2005. Four of the 10 largest IPOs were by Chinese companies, accounting for almost two-thirds of total IPO value. Russian companies issued 3 of the 10 largest IPOs, accounting for 22 percent of the total.

The record volume of international equity issues over the past few years has been supported by growing demand on the part of institutional investors. Hedge funds have been playing an increasingly prominent role in the primary issuance market, to the point where their involvement often has a major bearing on the success of an IPO.

Emerging-market equities continue to perform well, despite turbulence

Equity prices in emerging markets outperformed those in mature markets in 2006, despite sharp declines in May–June 2006 and in February–March 2007 (figure 2.19). Net inflows to emerging-market

Table 2.8 Net portfolio equity flows to developing countries, 2000–06
$ billions

	2000	2001	2002	2003	2004	2005	2006e
Total	13.4	5.6	5.8	24.3	39.9	66.7	94.1
East Asia and Pacific	6.6	1.8	3.8	12.5	19.0	26.1	48.4
China	6.9	0.8	2.2	7.7	10.9	20.3	32.0
Thailand	0.9	0.4	0.5	1.8	1.3	5.7	5.4
Europe and Central Asia	0.6	−0.4	0.1	−0.6	5.3	6.3	10.5
Russian Federation	0.2	0.5	2.6	0.4	0.2	−0.2	9.2
Latin America and the Caribbean	−0.6	2.5	1.4	3.4	−0.6	12.4	11.1
Brazil	3.1	2.5	2.0	3.0	2.1	6.5	7.7
Mexico	0.4	0.2	−0.1	−0.1	−2.5	3.4	3.9
Middle East and North Africa	0.2	−0.1	−0.3	0.3	0.7	2.3	1.6
South Asia	2.4	2.7	1.0	8.0	8.8	12.2	10.0
India	2.3	2.9	1.0	8.2	9.1	12.2	8.7
Sub-Saharan Africa	4.2	−0.9	−0.4	0.7	6.7	7.4	12.5
South Africa	4.2	−1.0	−0.4	0.7	6.7	6.9	12.4

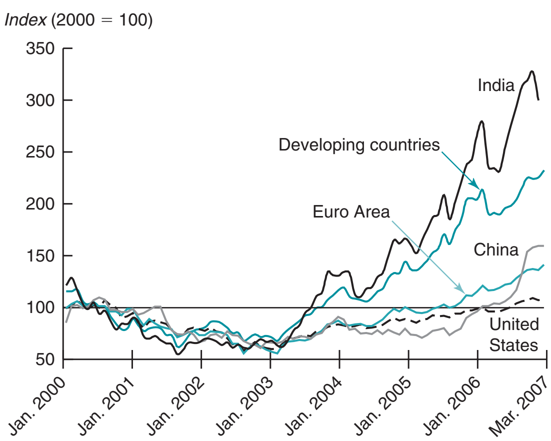
Sources: World Bank Debt Reporting System and staff estimates.
Note: e = estimate.

Table 2.9 Ten largest cross-border initial public offerings in 2006

Issuer	Country	Sector	Exchange	Value ($ billions)
Industrial and Commercial Bank of China	China	Banking	Hong Kong Stock Exchange	12.1
Bank of China Ltd	China	Banking	Hong Kong Stock Exchange	8.9
Rosneft	Russian Federation	Oil and gas	London Stock Exchange	5.5
KazMunaiGas Exploration and Production	Kazakhstan	Oil and gas	London Stock Exchange	2.3
TMK	Russian Federation	Materials	London Stock Exchange	1.1
Comstar UTS OAO	Russian Federation	Telecommunications	London Stock Exchange	1.1
Grupo Aeroportuario del Pacifico SA	Mexico	Transportation	New York Stock Exchange	1.0
Thai Beverage PCL	Thailand	Food and beverage	Stock Exchange of Singapore	1.0
Shui On Land Ltd	China	Real estate	Hong Kong Stock Exchange	0.9
Shimao Property Holdings Ltd	China	Real estate	Hong Kong Stock Exchange	0.6

Sources: Economist Intelligence Unit Country Reports; *Financial Times,* and other news media.

Figure 2.19 International equity prices, January 2000–March 2007



Sources: Standard & Poor's and International Finance Corporation composite indexes (S&P/IFCI).

Table 2.10 International equity prices, 2004–06

Percent change in equity price index (S&P/IFCI)

		Average rate of change[b]		Standard deviation[c]
	May–June, 2006[a]	2006	2004–06	2004–06
All developing countries	−18.9	32.6	33.3	4.6
United States	−7.1	22.4	21.5	2.2
Euro Area	−10.3	10.6	12.7	2.8
Developing countries with strongest gains in 2006				
Russian Federation	−26.7	92.0	60.0	8.9
Peru	−10.7	59.6	39.2	7.2
Brazil	−27.0	53.3	54.6	8.4
Colombia	−48.2	49.2	75.1	10.1
India	−27.8	46.5	45.0	9.5
China	−8.0	43.7	17.0	5.8
Argentina	−24.7	43.4	48.5	9.3
Mexico	−20.1	43.2	42.5	5.3
Indonesia	−23.4	42.5	39.5	7.2
Nigeria	9.7	41.9	35.0	7.9

Source: Standard & Poor's/International Finance Corporation composite indexes (S&P/IFCI).
a. Percent change between early May and mid-June 2006.
b. Year-end to year-end.
c. Standard deviation of monthly changes over the period 2004–06.

equity funds totaled $30 billion in the first four months of 2006, almost twice the total for the entire previous year. The S&P/IFCI Composite Index for emerging markets rose 16 percent in the same period.

Flows reversed abruptly in May–June, in the wake of turbulence that gripped international financial markets. The S&P/IFCI Composite Index fell 19 points between the beginning of May and mid-June, with most emerging equity markets suffering dramatic drops and emerging-market equity funds seeing a net outflow of about $17 billion (table 2.10). China was an important exception: equity prices there fell just 8 percent in May–June, and the Bank of China's $9 billion equity issue in May was oversubscribed. The markets recovered quickly, however, ending the year with an average gain of 32 percent, led by Russia (92 percent), Peru (60 percent), and Brazil (53 percent). Net inflows to emerging-market equity funds recovered over the balance of the year, more than offsetting the outflows in May–June.

Equities in several emerging-market economies outperformed those in mature markets by a wide margin over the past few years, while exhibiting much greater volatility. The S&P/IFCI Equity Price Index for Russia rose at an average annual rate of 60 percent over the past three years, well above the index for the United States (21.5 percent) or the countries in the euro area (12.7 percent). However, the standard deviation of monthly changes was four times that for the United States and three times that for the Euro Area countries.

There has been an ongoing shift in new equity listings away from exchanges in the United States toward exchanges in London and Hong Kong (China). Only 1 of the 10 largest cross-border IPOs in 2006 was issued in New York, while four were listed in Hong Kong and four in London. The value of new listings by emerging-market companies on U.S. exchanges declined about 7 percent, from $2.9 billion in 2004 to $2.7 billion in 2006.

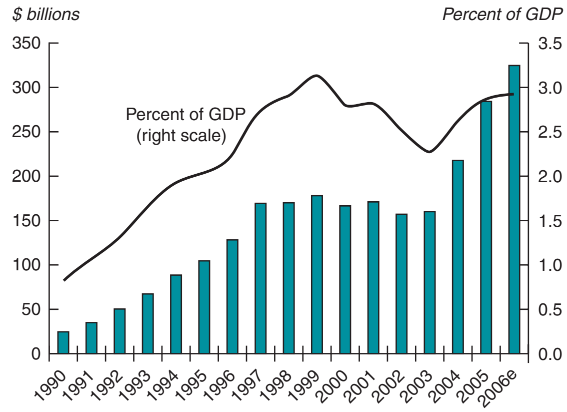
Meanwhile, the value of listings issued in London increased by a factor of 14 (from $0.7 billion to $9.6 billion) and the value of listings issued in Hong Kong (China) quadrupled (from $7.2 to $30.4 billion). The $20 billion raised by two Chinese banks through IPOs in Hong Kong represents a major breakthrough and perhaps, with the encouragement of the Chinese government, the beginning of a new era. By electing to list in Hong Kong, the two Chinese banks have defied the long-held belief that large corporations must list on a New York or London exchange to gain access to global capital. A steady stream of IPO transactions is expected in Hong Kong, as more state-owned enterprises in China are privatized.

FDI inflows continue to expand, keeping pace with strong growth

Foreign direct investment (FDI) inflows to developing countries reached a record $325 billion in 2006 (figure 2.20), up $44 billion from 2005. Virtually all of the gains occurred in Eastern Europe and Central Asia (table 2.11). FDI inflows stabilized at 2.9 percent of GDP in 2006, up from the low of 2.3 percent in 2003 but still below the peak of 3.1 percent reached in 1999.

As of 2004 (the most recent year for which data on the sectoral composition of FDI are available), half of the FDI stock in developing countries was in the services sector. Various indicators suggest that this trend has continued over the past two years, particularly in banking, telecommunications, and real estate. The trend has been supported by developing countries' improvements in policies designed to attract FDI, particularly in the services sector, where several countries have relaxed restrictions on foreign ownership and undertaken major privatizations.

Figure 2.20 Net FDI inflows to developing countries, 1990–2006



Sources: World Bank Debt Reporting System and staff estimates.
Note: e = estimate.

Most of the 10 largest privatizations, mergers, and acquisitions in 2006 (with a total value of $18 billion) occurred in the banking ($7.3 billion) and telecommunications ($5.6 billion) sectors (table 2.12). China was conspicuously active in this area, providing foreigners with greater access to investment opportunities in banking and insurance, in compliance with the membership requirements of the World Trade Organization. There has also been an increase in FDI in real estate over the past few years, notably in India, Turkey, and several countries in the Middle East and North Africa, driven by private equity firms and the recycling of petrodollars by the Gulf countries (notably Kuwait, Saudi Arabia, and the United Arab Emirates).

Global FDI flows reached a record $1.1 trillion in 2006, with mergers and acquisitions valued at a record $1.25 trillion worldwide. About a quarter of these transactions involved purchases of assets in developing countries, consistent with the historical average.

The continuing rise in FDI inflows to developing countries has been driven by a combination of external and domestic factors. Favorable global economic conditions boosted investor confidence. Along with strong global economic growth (4 percent in 2006), corporate profits as a share of GDP rose worldwide, reaching a 50-year high in the United States. Low long-term interest rates and rising stock market valuations make it easier for companies to finance investments.

Table 2.11 Net FDI flows to developing countries, 1998–2006

$ billions

	2000	2001	2002	2003	2004	2005	2006e
Total	166.5	171.0	157.1	160.0	217.8	280.8	324.7
East Asia and Pacific	45.1	47.7	57.0	53.5	65.8	96.4	88.3
China	38.4	44.2	49.3	53.5	54.9	79.1	76.0
Indonesia	−4.6	−3.0	0.1	−0.6	1.0	5.2	2.0
Malaysia	3.8	0.6	3.2	2.5	4.6	4.0	4.0
Philippines	1.3	1.0	1.8	0.3	0.5	1.1	0.9
Thailand	3.4	3.9	1.0	1.9	1.4	4.0	5.5
Vietnam	1.3	1.3	1.4	1.5	1.6	2.0	2.0
Europe and Central Asia	25.2	25.4	26.4	34.2	62.7	73.2	116.4
Bulgaria	1.0	0.8	0.9	2.1	2.0	2.6	5.0
Croatia	1.1	1.3	1.2	2.1	1.2	1.6	2.9
Hungary	2.8	3.9	3.0	2.2	4.6	6.4	9.0
Kazakhstan	1.3	2.8	2.6	2.1	4.1	1.7	5.0
Poland	9.3	5.7	4.1	4.6	12.9	9.6	12.6
Russian Federation	2.7	2.7	3.5	8.0	15.4	15.2	28.0
Romania	1.0	1.2	1.1	1.8	5.4	6.6	7.0
Slovak Republic	1.9	1.6	4.1	0.6	1.3	1.9	3.0
Ukraine	0.6	0.8	0.7	1.4	1.7	7.8	4.0
Turkey	1.0	3.3	1.1	1.8	2.7	9.7	19.0
Latin America and the Caribbean	79.8	70.6	51.0	43.0	62.5	70.0	69.4
Argentina	10.4	2.2	2.1	1.7	4.1	4.7	4.0
Brazil	32.8	22.5	16.6	10.1	18.2	15.2	18.8
Chile	4.9	4.2	2.6	4.4	7.6	6.7	8.5
Colombia	2.4	2.5	2.1	1.8	3.1	10.4	5.0
Mexico	17.1	27.7	15.5	12.3	17.4	18.1	18.9
Peru	0.8	1.1	2.2	1.3	1.8	2.5	3.5
Venezuela, R. B. de	4.7	3.7	0.8	2.7	1.5	3.0	−0.5
Middle East and North Africa	4.8	4.1	4.9	8.1	6.8	13.8	19.2
Algeria	0.4	1.2	1.1	0.6	0.9	1.1	1.1
Egypt, Arab Rep. of	1.2	0.5	0.6	0.2	1.3	5.4	6.3
Morocco	0.2	0.1	0.1	2.3	0.8	2.9	2.5
Tunusia	0.8	0.5	0.8	0.5	0.6	0.7	2.8
South Asia	4.4	6.1	6.7	5.6	7.3	9.9	12.9
India	3.6	5.5	5.6	4.6	5.3	6.6	8.0
Pakistan	0.3	0.4	0.8	0.5	1.1	2.2	3.5
Sub-Saharan Africa	3.5	12.1	5.3	9.1	7.1	13.8	12.5
Angola	0.9	2.1	1.7	3.5	1.4	0	1.5
Equatorial Guinea	0.1	0.9	0.3	1.4	1.7	1.9	2.0
Nigeria	1.1	1.2	1.9	2.0	1.9	3.4	4.0
South Africa	1.0	7.3	0.7	0.8	0.6	6.3	2.5
Sudan	0.4	0.6	0.7	1.3	1.5	2.3	2.5

Sources: World Bank Debt Reporting System and staff estimates.
Note: e = estimate.

Table 2.12 Major privatizations, mergers, and acquisitions in 2006

Seller	Country	Buyer	Country	Sector	Value ($ billions)
Akbank	Turkey	Citigroup	United States	Banking	3.1
Guangdong Development Bank	China	Citigroup-led consortium	United States	Banking	3.0
Vodacom	South Africa	Vodafone	United Kingdom	Telecommunications	2.4
Tunisie Télécom	Tunisia	TECOM-DIG	United Arab Emirates	Telecommunications	2.2
Kazakh Oil	Kazakhstan	CITIC	China	Oil and gas	1.9
MOL Foldgazellato	Hungary	E.ON Ruhrgas Int. AG	Germany	Oil and gas	1.3
Ukrsotsbank	Ukraine	Intesa Bank	Italy	Banking	1.2
Petrol Ofisi	Turkey	OMV	Austria	Oil and gas	1.1
Vee Networks Ltd	Nigeria	Celtel International BV	Netherlands	Telecommunications	1.0
Omimex de Colombia	Colombia	ONGC & Sinopec	China and India	Oil and gas	0.8

Source: World Bank staff estimates.

Box 2.1 Foreign direct investment in the oil and gas sector

Oil and gas was one of the first sectors in developing countries to become tightly integrated with other countries, through both trade and FDI. In 2005, 73 percent of production took place in developing countries, 55 percent of which was consumed by industrial countries (International Energy Agency 2006).

Oil exploration and production occur in developing countries. But downstream activities, notably refining and distribution, are concentrated in industrial countries, reflecting the importance of proximity to major markets and efficient infrastructure. The countries of the Organisation for Economic Co-operation and Development account for 54 percent of global refinery capacity but only 27 percent of global oil production. Industrial countries are net providers of FDI in exploration and production and net recipients of FDI in refining and distribution.

Developing countries receive about half of worldwide FDI flows into the oil and gas sector. The share fluctuates considerably from year to year, mainly because of large mergers and acquisitions. In 2006 FDI in the oil and gas sector was estimated at $25 billion, accounting for 7.5 percent of total FDI. In 1999 FDI in the sector reached a record $29.5 billion (about 16 percent of all FDI that year), when an Argentinean company (YPF) was acquired by a Spanish company (Repsol) for $13 billion.

Many oil-producing developing countries have liberalized regulations on FDI in the oil and gas sector as a way of modernizing technology and attracting equity capital from abroad. Foreign-owned companies operate under various arrangements, including direct ownership, joint ventures, and product-sharing agreements.

Some of these arrangements do not entail foreign ownership and hence are not included in conventional measures of FDI. (Because of this, official data on foreign participation in the oil and gas sector of developing countries are understated.) The nature of investment agreements can also influence the composition of FDI flows. For instance, when restrictions on foreign ownership are binding, foreign companies seek additional financing through intracompany loans. In Angola all FDI in the oil and gas sector takes this form.

State-owned enterprises play an important role in the oil and gas sector, because they hold exclusive access to nearly 90 percent of proven oil reserves in the developing world. High oil prices over the past few years have considerably increased the earnings of such enterprises. Many have expanded their operations abroad by investing in exploration and production activities in other countries in an effort to diversify their reserves. State-owned enterprises have also expanded their investments in refining, distribution, and petrochemicals. In addition, some countries—including Bolivia, Ecuador, and República Bolivariana de Venezuela—have passed legislation that gives state-owned enterprises majority ownership of all oil and gas operations, reducing foreign participation in the sector. Other developing countries (notably Kazakhstan and Russia), as well as the United Kingdom, the United States, and other developed countries, have revised tax policies to raise the governments' share of rents in the oil and gas sector.

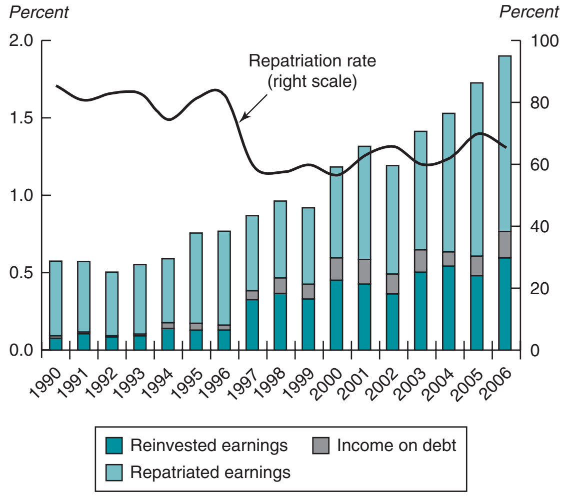
Although world oil prices declined over the second half of 2006, average prices for the year were 20 percent above 2005 prices (see figure 1.21). High prices continued to attract FDI in the oil and gas sector (box 2.1). Energy-related investments led a major increase in FDI inflows to Russia, from $15 billion in 2004–05 to $28 billion in 2006. FDI inflows to four major oil-producing countries in Sub-Saharan Africa (Angola, Equatorial Guinea, Nigeria, and Sudan) were estimated at $10 billion in 2006, half of all FDI to low-income countries.

The tremendous expansion in oil revenues in oil-exporting countries has altered the profile of FDI in developing countries. FDI inflows to the Middle East and North Africa increased by almost $10 billion in 2006, fueled mainly by foreign investments from oil-exporting Gulf countries (chiefly the Islamic Republic of Iran and the United Arab Emirates) in the energy, infrastructure, real estate, and tourism sectors. Private equity firms have also played a more prominent role as a source of FDI in developing countries. At the same time, FDI outflows from developing countries increased, from $63 billion in 2005 to an estimated $110 billion in 2006.[9] Part of the growth came as multinationals based in developing countries made major investments in developed countries, a growing phenomenon known as South–North FDI. Since 2004 FDI flows from India into the United Kingdom, for example, have exceeded flows from the United Kingdom to India.

FDI declined in a few countries, for various reasons. The drop in flows to Latin America and the Caribbean was concentrated in República Bolivariana de Venezuela, reflecting the deteriorating investment climate (notably the nationalization of oil and gas assets), and in Colombia, where FDI returned to normal levels after several large merger and acquisition and privatization transactions in 2005. The $3 billion decline in South Africa came on the heels of a $5 billion acquisition in 2005.

FDI continues to be concentrated in a few of the largest middle-income countries, although the degree of concentration has declined somewhat over the past few years. FDI to China declined slightly in 2006, but China still accounted for almost one-quarter of FDI inflows to developing countries, down from almost one-third in 2002. Almost half of FDI inflows went to the five top destinations in 2005–06, down from almost two-thirds in 2000 (figure 2.21).

Figure 2.22 FDI income relative to GDP, 1990–2006



Sources: World Bank Debt Reporting System and staff estimates.

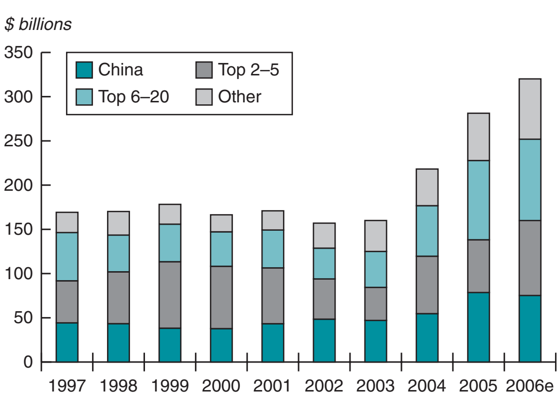
Income earned on FDI is rising

The income earned by multinationals on FDI has risen in tandem with the surge in flows. The value of multinationals' investments in developing countries reached an estimated $2.4 trillion in 2006. The income earned on that stock rose from $74 billion in 2002 to $210 billion in 2006. FDI income increased from less than 0.5 percent of GDP in developing countries in the early 1990s to almost 2 percent in 2006.

Not all of this income represents an outflow from developing countries' balance of payments. The portion of FDI earnings that is repatriated each year has been relatively stable over the past 10 years, averaging 62 percent, down from more than 80 percent in the early 1990s (figure 2.22). Repatriated earnings increased from $28 billion in 2000 to $125 billion in 2006, but they do not represent a significant burden on the balance of payments. Repatriated earnings have represented about 2 percent of developing countries' export revenues since 2000.

Several factors affect corporate decisions to reinvest or repatriate equity earnings. Corporations may seek to smooth dividend payments as a way of signaling that profitability can be sustained over the long term. Firms also have an incentive to repatriate earnings over time and across countries in a way that exploits differences in tax rates and regulations. For example, the Homeland Investment Act gave many U.S. corporations an incentive to repatriate earnings in 2005 to take advantage of lower tax treatment. As a consequence, repatriated earnings by U.S. multinationals surged to $260 billion in 2005, well above the annual average of $65 billion over the previous five years. A country's investment climate can also have a major effect: the portion of equity earnings that is repatriated tends to be lower (and thus the share of reinvested earnings higher) in countries with better investment climates. Sudden shifts in political risk and the imposition (or threat) of capital controls can lead

Figure 2.21 Concentration of net FDI inflows to developing countries, 1997–2006



Sources: World Bank Debt Reporting System and staff estimates.
Note: e = estimate.

Box 2.2 Remittance flows to developing countries

Recorded remittances sent home by migrants from developing countries reached $206 billion in 2006, up from $193 billion in 2005 and more than double the level in 2001 (see the table at right). Worldwide flows of remittances, including those to high-income countries, are estimated to have to grown to $276 billion in 2006. This amount, however, reflects only transfers through official channels. The true size of remittances, including unrecorded flows through formal and informal channels, is believed to be larger (World Bank 2005, chapter 4).

Regionally, Latin America and the Caribbean remains the largest recipient of recorded remittances. Due to a lack of data, remittance flows to Sub-Saharan Africa are grossly underestimated. Recorded remittance flows have grown robustly in virtually every region, although most quickly in Europe and Central Asia and in East Asia and Pacific. Growth of remittance flows appears to be slowing in Latin America and the Caribbean region, however, as a result of a slowdown in the housing sector in the United States. In contrast, remittances to other regions, especially South Asia, have been held up by the strong economy in the migrant-receiving countries in the Persian Gulf region and Europe.

The top recipients of remittances in nominal dollar terms are India, Mexico, China, and the Philippines. As a share of GDP, however, the top recipients are smaller countries such as Moldova, Tonga, Guyana, and Haiti, where remittances exceed 20 percent of GDP. Remittances as a share of GDP amounted to 3.5 percent of GDP in low-income countries in 2005 compared to 1.5 percent in middle-income countries.

Recorded remittances have more than doubled since 2001. First, remittance flows through informal channels are being subjected to greater scrutiny since the events of September 11, 2001. The discovery of the large size of these flows has prompted governments worldwide to improve the recording of these flows. Second, reduction in remittance costs and expansion of remittance networks have increased migrants' disposable incomes and their incentives to remit. Third, the depreciation of the U.S. dollar has raised the value of remittances from Europe and Japan. The appreciation of the Euro relative to the U.S. dollar may account for some 7 percent of the increase in remittance flows to developing countries during 2001–05 (Mohapatra and others 2006). Finally, growth in migrant stocks (due to falling travel costs and increased globalization) and an increase in migrant incomes have also contributed to higher remittances.

Global flows of international migrant remittances

$ billions

	2000	2001	2002	2003	2004	2005	2006e
Total	85	96	117	145	165	193	206
By region							
East Asia and Pacific	17	20	29	35	39	45	47
Europe and Central Asia	13	13	14	17	23	31	32
Latin America and the Caribbean	20	24	28	35	41	48	53
Middle East and North Africa	13	15	16	20	23	24	25
South Asia	17	19	24	31	31	36	41
Sub-Saharan Africa	5	5	5	6	8	9	9

Source: World Bank staff calculations based on IMF *Balance of Payments Statistics Yearbook 2007*. Remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers—see www.worldbank.org/prospects/migrationandremittances for the entire dataset.
Note: e = estimate.

to abrupt changes in repatriated earnings (World Bank 2004; Lehmann and Mody 2004; Desai, Foley, and Hines 2004). In the midst of Argentina's financial crisis in 2002, for example, repatriated earnings outstripped equity earnings by a factor of five, as corporations attempted to evade the introduction of controls on outflows and foreign exchange transactions.

Remittance flows to developing countries continue to rise, although at a slower pace

After FDI, remittances are the largest source of external financing for developing countries (box 2.2). In the 1990s, remittances were less volatile than other sources of foreign exchange earnings. Unlike private capital flows, remittances tend to rise when the recipient economy suffers an economic downturn following a financial crisis, natural disaster, or political conflict. Remittances provide a safety net to migrant households in times of hardship, and these flows typically do not suffer from the governance problems that may be associated with official aid flows. Remittances are person-to-person flows that are well targeted to the needs of the recipients, who are often poor.

Official development assistance

The many developing countries with little or no access to private capital markets depend heavily on grants and concessional loans from official sources to meet their financing needs.

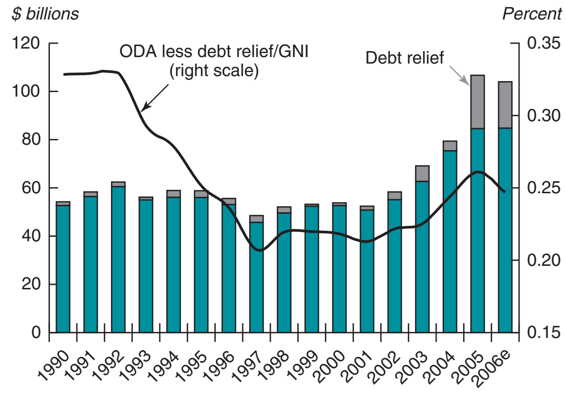
Little progress on official aid commitments

Participants at the UN Conference on Financing for Development in Monterrey in 2002 recognized that a substantial increase in foreign aid and other resources would be required if developing countries were to achieve internationally agreed development objectives, including the Millennium Development Goals (MDGs). Developed countries were urged to "make concrete efforts" to increase official development assistance (ODA) to the UN target of 0.7 percent of GNP. The Africa Action Plan announced at the 2002 G-8 Leaders Summit in Kananaskis, Canada, suggested that half or more of new development assistance should go to Africa. At the UN World Summit in 2005, countries reaffirmed the Monterrey Consensus, recognizing the importance of enhancing the aid effort, particularly in Africa, the only continent not on track to meet any of the MDGs by 2015. At the 2005 G-8 Summit in Gleneagles, Scotland, G-8 and other donors released a "Renewed Commitment to Africa" that included a pledge to increase the amount of ODA allocated to Sub-Saharan Africa by $25 billion a year by 2010, more than doubling aid to the region from the 2004 level.

Donors have made only modest progress toward fulfilling these commitments. Net ODA disbursements by the 22 member countries of the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD) declined by $3 billion in 2006, following a record $27 billion increase in 2005 (figure 2.23 and table 2.13). The decrease largely reflects the return of debt relief to more normal levels following extraordinary Paris Club agreements with two countries in 2005, under which Iraq and Nigeria received $19.4 billion in debt relief in 2005 and $14.1 billion in 2006.

Debt relief continues to play a critical role in the development agenda, especially for many of the poorest countries burdened by heavy debt service payments (see World Bank 2006, chapter 3). Debt

Figure 2.23 Net ODA disbursements by DAC donors, 1990–2006



Source: OECD Development Assistance Committee.
e = estimate.

Table 2.13 Net disbursements of official development assistance, 1990–2006
$ billions

Donor	1990	1995	2000	2001	2002	2003	2004	2005	2006e
DAC donors	54.3	58.8	53.7	52.4	58.3	69.1	79.4	106.8	103.9
G-7 countries	42.4	44.7	40.2	38.2	42.6	50.0	57.6	80.5	75.1
United States	11.4	7.4	10.0	11.4	13.3	16.3	19.7	27.6	22.7
Japan	9.1	14.5	13.5	9.8	9.3	8.9	8.9	13.1	11.6
United Kingdom	2.6	3.2	4.5	4.6	4.9	6.3	7.9	10.8	12.6
France	7.2	8.4	4.1	4.2	5.5	7.3	8.5	10.0	10.4
Germany	6.3	7.5	5.0	5.0	5.3	6.8	7.5	10.1	10.4
Canada	2.5	2.1	1.7	1.5	2.0	2.0	2.6	3.8	3.7
Italy	3.4	1.6	1.4	1.6	2.3	2.4	2.5	5.1	3.7
Non-DAC donors	0.1	1.0	1.1	1.2	3.2	3.4	3.8	4.2	—
Arab countries	—	0.6	0.6	0.7	2.7	2.7	2.1	1.7	—
Korea, Rep. of	0.1	0.1	0.2	0.3	0.3	0.4	0.4	0.8	—
Turkey	—	0.1	0.1	0.1	0.1	0.1	0.3	0.6	—
All donors	54.3	59.7	54.9	53.6	61.5	72.5	83.2	120.4	—
Memo items									
EU countries	28.3	31.2	25.3	26.4	30.0	37.1	42.9	55.7	58.9
Private NGOs	5.1	6.0	6.9	7.3	8.8	10.3	11.4	14.9	—

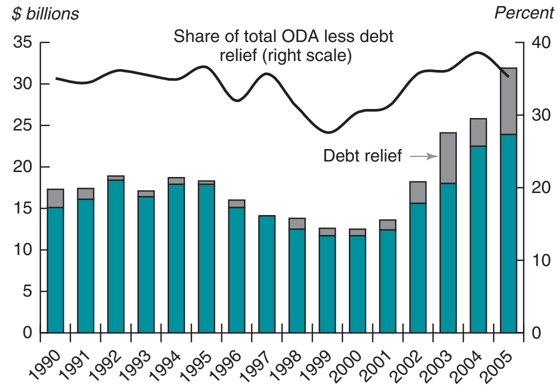
Source: OECD Development Assistance Committee.
Note: — = not available. e = estimate.

relief provided through the HIPC Initiative and the MDRI is estimated to have reduced the debt stocks of 29 countries that have reached the decision point by almost 90 percent.[10] Debt service paid by these countries has already declined by about 2 percent of GDP between 1999 and 2005, and is expected to decline further in the medium term, as a result of MDRI debt relief. Reductions in debt service payments enable countries to channel more resources to finance their development objectives, provided that debt relief does not displace other sources of development assistance. At the Monterrey conference, donors pledged that debt relief would be additional to their commitments to enrich ODA over time. Despite that commitment, ODA barely held its own in 2006, after growing at an average annual rate of 16 percent over the three previous years. ODA net of debt relief declined from 0.26 percent of gross national income in DAC donor countries in 2005 to 0.25 percent in 2006. This percentage is up from the low of 0.21 percent recorded in 2001 but well below the 0.33 percent level attained in the early 1990s and far short of the UN target of 0.7 percent.

Sub-Saharan Africa received less aid than expected

ODA allocated to Sub-Saharan Africa has increased significantly since the early part of the decade, rising from $12.5 billion in 2000 to $32 billion in 2005 (figure 2.24). Much of the increase has come in the form of debt relief, however. Excluding debt relief, Sub-Saharan Africa received 35 percent of total ODA in 2005, equal to its average share over the 1990–97 period. To meet their pledged increase in

Figure 2.24 Net ODA disbursements to Sub-Saharan Africa, 1990–2005



Source: OECD Development Assistance Committee.

ODA to Sub-Saharan Africa to $50 billion (in real terms) by 2010, donors would have to increase the flow of aid to the region by an average annual rate of 16 percent (in real terms) over the rest of the decade.

Donors are providing more assistance to countries affected by conflict

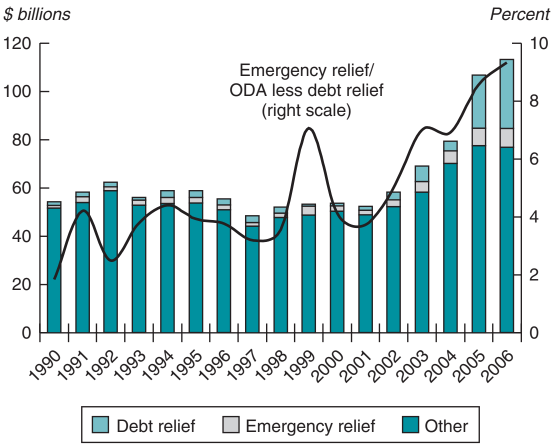
The allocation of aid to countries in or recovering from conflict has risen substantially over the past few years. The share of bilateral ODA disbursements to Iraq and Afghanistan increased from 8 percent in 2003 to 17.5 percent in 2005. Another 4.5 percent of bilateral ODA was allocated to Sudan and the Democratic Republic of Congo in 2005, bringing the total share allocated to these four countries to 22 percent (table 2.14). Emergency and disaster relief also became more

Table 2.14 Bilateral ODA disbursements to 10 largest recipient countries, 2003–05
$ billions

Country	2003	Country	2004	Country	2005
Iraq	2.1	Iraq	4.4	Iraq	7.5
Indonesia	1.6	Afghanistan	1.7	Indonesia	2.2
Afghanistan	1.2	China	1.6	Afghanistan	2.2
China	1.1	Vietnam	1.2	China	1.7
Jordan	1.1	Egypt, Arab. Rep. of	1.2	Sudan	1.5
Ethiopia	1.0	Congo, Dem. Rep. of	1.2	Vietnam	1.3
Russian Federation	1.0	Russian Fed.	1.1	Ethiopia	1.2
Vietnam	1.0	Tanzania	1.0	Congo, Dem. Rep. of	1.0
Tanzania	1.0	Ethiopia	1.0	Tanzania	0.9
Serbia and Montenegro	0.9	Angola	1.0	Sri Lanka	0.9

Source: OECD Development Assistance Committee.
Note: Excludes large debt-relief grants provided to Iraq ($13.9 billion) and Nigeria ($5.5 billion) in 2005 and to the Democratic Republic of Congo ($4.4 billion) in 2003.

Figure 2.25 Emergency relief provided by DAC donors, 1990–2006



Source: OECD Development Assistance Committee.

prominent, reaching 9 percent of ODA (excluding debt relief) in 2006, up from less than 4 percent in the 1990s (figure 2.25).

New donors have emerged . . .

ODA provided by the 22 member countries of the OECD's DAC provides only a partial perspective on aid activities, as other countries have emerged as new donors over the past few years. Some (notably Brazil, China, India, and Russia) are themselves developing countries, which are now both donors and recipients of development assistance. It is difficult to quantify the volume, allocation, and composition of aid provided by most new donor countries, because their activities are not reported in a comprehensive manner.

Fifteen donor countries that are not members of the OECD DAC report their aid activities to DAC. Net ODA disbursements provided by these donors increased from about $1 billion over the period 1995–2001 to $4.2 billion in 2005 (the most recent year for which data are available). The composition has shifted substantially over the past few years, as ODA provided by the Arab countries declined (from $2.7 billion in 2002–03 to $1.7 billion in 2005) while ODA provided by other non–DAC donors increased (from $0.5 billion to $2.5 billion in 2005). The increase was led by the Republic of Korea, which provided $0.75 billion in assistance in 2005, and Turkey, which provided $0.6 billion.

ODA provided by non–DAC donors increased over the past few years, but it rose by less than ODA from DAC members. In 2002 ODA by non–DAC donors totaled $3.2 billion, an amount equal to 5.5 percent of the ODA provided by DAC donors (5.9 percent excluding debt relief). In 2005 non–DAC donors provided $4.2 billion, equal to just 4 percent of the ODA provided by DAC donors (5 percent excluding debt relief).

China's "Africa Policy," introduced in January 2006, aims to support economic development in Africa—among other objectives—through a number of channels, including economic assistance and debt relief (Government of China, 2006). The Chinese government provides concessionary loans and grants to developing countries directly and indirectly through concessional lending by the Export-Import Bank of China. The total amount of concessional loans and grants provided by China is not reported in a comprehensive manner and estimates vary considerably.

In an effort to cast more light on the activities of new donors, the World Bank, in collaboration with the OECD DAC, the United Nations Development Programme (UNDP), and the United Nations Department of Economic and Social Affairs (UNDESA), conducted a survey of nine developing countries (Brazil, Chile, China, India, Malaysia, Russia, South Africa, Thailand, and República Bolivariana de Venezuela). Only three countries (Chile, Malaysia, and Thailand) have responded to the survey so far. The information provided by these countries indicates that almost all of their development assistance is provided to countries within their region, largely in the form of technical assistance. Their development assistance is often leveraged with funds provided by industrial countries (so-called "triangular cooperation"), notably Japan.

. . . and private organizations are playing a more prominent role

Nongovernmental organizations (NGOs) are providing a growing source of financial resources for developing countries. Governments' contributions to NGOs active in international development are already included in ODA tallies, but private contributions are not. Private sector aid contributions totaled $11 billion in 2006, an amount equal to 13 percent of the aid provided by DAC donors (excluding debt relief), up from 9 percent in the 1990s.

The amount of development assistance provided by NGOs is difficult to quantify. The measures reported to the OECD DAC are believed to be underestimated by a substantial margin. The reported figures are therefore likely to understate the growing contribution of NGOs to development.

Private philanthropic foundations attracted much attention over the past year, following Warren Buffet's $30 billion donation to the Bill & Melinda Gates Foundation. The Gates Foundation is the largest charitable foundation in the world, with an endowment valued at $33 billion at the end of 2006. Its goals are to enhance health care and reduce extreme poverty worldwide and to expand educational opportunities and access to information technology in the United States. The Gates Foundation is projected to disburse about $2.8 billion in 2007 (Brainard 2006), an amount equal to almost 3 percent of projected ODA disbursements by DAC donors. These projections imply that disbursements by the Gates Foundation will exceed those of about half of DAC member countries.

Data limitations make it very difficult to assess the overall contribution of private philanthropic foundations to development. There are no comprehensive measures of disbursements made by private foundations to poor countries for development purposes. The procedures used to collect data on the activities of private foundations differ greatly over time and across countries, making comparisons problematic. The more than 100,000 private foundations worldwide have a very diverse set of social, political, charitable, and religious objectives, which are often related to, but extend beyond, economic development.

Most private foundations begin by focusing on domestic initiatives, extending their operations abroad once they develop sufficient financial and human resources and acquire the expertise needed by developing countries. Private U.S. foundations are believed to be the most active internationally, because they tend to have greater financial resources and deeper experience than foundations in other countries.

The data provided by U.S. foundations are more comprehensive than data from foundations in most other countries. They reveal that the number of private philanthropic foundations in the United States grew from 30,000 in 1993 to 68,000 in 2005, while disbursements increased from $10 billion to $33 billion (Foundation Center 2006). About $3.8 billion (11.5 percent) of these disbursements went to international initiatives, most of which was channeled through international organizations (such as the Global Fund to Fight AIDS, Tuberculosis and Malaria); NGOs; and private-public partnerships (such as the Global Alliance for Vaccines and Immunization). U.S. private foundations provide relatively little development assistance directly to recipient countries, preferring to provide financial support to institutions with well-developed capabilities for delivering aid effectively in specific program areas.

Low-income countries' access to private debt markets

Major debt-relief initiatives have significantly reduced the debt burdens of many low-income countries, improving their creditworthiness and raising concerns among donors that some countries may seek financing from commercial sources on nonconcessional terms, compromising their hard-won gains in debt sustainability. To address this concern, donors have stressed the need to monitor borrowing by low-income countries closely and continuously and to assess the potential implications of their borrowing for debt sustainability (World Bank and IMF 2006).

How likely are low-income countries, particularly those with low debt burdens, to gain access to international debt markets? Two empirical studies suggest that debt relief is but one of several factors that affect a country's ability to attain financing from commercial sources. Grigorian (2003) examines 38 cases between 1980 and 2002 in which countries issued sovereign bonds for the first time. His findings suggest that several internal and external factors can help explain first-time bond issuance. Internal factors include the level and rate of growth of domestic GDP, per capita GDP, the current account balance, the fiscal balance, the ratio of external debt to exports, the ratio of foreign reserves to imports, and inflation. External factors include international interest rates and the rate of GDP growth in the United States. Gelos, Sahay, and Sandleris (2004) examine bond issuance by and syndicated bank lending to 144 developing countries between 1980 and 2000. Their results point to the importance of sound economic policies and institutions, as well as vulnerability to external shocks, in determining whether countries are able to gain access to private bond markets and bank loans.

Countries issuing sovereign bonds for the first time in the international market have had a wide range of debt burdens. In the early 1980s, the external debt to export ratio was less than 40 percent for three first-time issuers—Botswana (32 percent), China (33 percent), and Panama (37 percent)—and more than 300 percent for three others—Costa Rica (318 percent), the Philippines (302 percent), and Sudan (684 percent). These figures suggest that a country's debt burden has not been the dominant factor determining first-time access to the international bond market.

Most developing countries have accessed bank lending . . .

In 1980, 40 percent of developing countries (54 of 135 countries) had contracted at least one syndicated bank loan (figure 2.26). This number rose sharply in the early 1980s (with 31 countries gaining access between 1980 and 2004) and again in the early 1990s (with 13 countries gaining access between 1991 and 2003). By 2006 the proportion had increased to almost 90 percent, leaving just 13 of 135 developing countries never having contracted a syndicated bank loan.

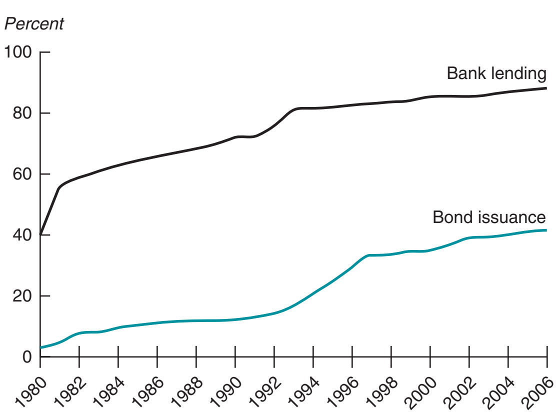
. . . but few have been able to gain access to the private bond market

Few developing countries issued external bonds before the late 1980s, when the introduction of Brady bonds gave rise to the emerging-market segment of the international bond market. Despite this development, by 1990 only 12 percent of developing countries (16 of 135 countries) had issued sovereign bonds in the external market (see figure 2.26). Thirty more countries gained access to the private bond market in the 1990s, but in the last four years only three new countries joined the pool, despite favorable economic and financial conditions and the strong surge in private bond flows to developing countries. This means that as of 2006, just 40 percent of developing countries (56 of 135 countries) had issued sovereign bonds at some point over the previous 27 years. Access to the private bond market could evolve significantly over the next few years, as four Sub-Saharan African countries—Ghana, Kenya, Nigeria, and Zambia—are expected to issue sovereign bonds in international markets for the first time.

Few countries access private debt markets on a frequent basis

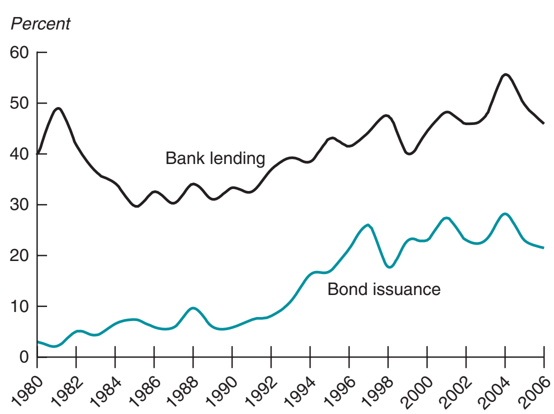
The number of countries that access either the external bond market or syndicated bank lending varies substantially from year to year, in response to the complex interaction of several supply and demand factors (figure 2.27). In 2006, 46 percent of developing countries contracted syndicated bank loans, down from the high of 55 percent in 2004 but above the 40 percent average level for 1980–2005. The number of developing countries that issued sovereign bonds in a given year rose

Figure 2.26 Proportion of developing countries that accessed private debt markets at least once, 1980–2006



Source: Dealogic Bankware and Loanware.

Figure 2.27 Proportion of developing countries that accessed private debt markets, 1980–2006



Source: Dealogic Bankware and Loanware.

substantially in the first half of the 1990s, averaging 23 percent since the mid-1990s. But annual bond issuance has been sporadic in most countries. Only 6 percent of developing countries issue external bonds on a frequent basis, compared with 38 percent for syndicated bank loans.[11]

Domestic debt has attracted foreign investment in some low-income countries

In countries with limited or no access to external debt markets, the domestic debt market is a potentially important source of financing for the public and corporate sectors, one in which nonresident investors have been known to participate.[12] Although domestic markets for sovereign bonds are much more advanced in large middle-income countries, there has been progress in developing such markets in some low-income countries. Most domestic debt issued by governments in low-income countries has traditionally been held by local commercial banks. Over the past few years, however, local institutional investors have begun to emerge as more prominent participants in some countries' markets—particularly countries in which private sector pension funds have evolved—raising demand for low-risk, medium- to long-dated maturities denominated in domestic currency. More recently, foreign investors (hedge funds and specialty investment funds in particular) have at times shown interest in some segments of so-called "frontier markets" for sovereign debt. However, local bond markets are still relatively undeveloped in most low-income countries. The acute lack of liquidity is a major obstacle to broadening the investor base, particularly for corporate bonds.

It is difficult to get accurate and comprehensive measures of foreign investors' participation in domestic debt markets in low-income countries. Data are not compiled or monitored on an ongoing basis in most countries; where they are compiled periodically, nonresident holdings are often greatly underreported and aggregated with other capital flows. The data that are available indicate that there has been a significant increase in nonresident purchases of sovereign bonds issued by Kenya, Nigeria, and Zambia. In Zambia the share of outstanding public debt held by nonresidents increased from a negligible amount in 2004 to 20 percent by May 2006, before declining to 13 percent by the end of 2006. Foreign investor interest waned in response to lower yields, which reflected stronger local investor demand, lower inflation rates, and a decline in the local currency's value in the wake of heightened uncertainty about the investment climate in the run-up to national elections in September 2006.

Foreign investors have been attracted to these fledgling bond markets by a combination of factors. Economic and financial fundamentals have improved significantly in many low-income countries, reducing investors' perceptions of risk. This is reflected in the decline in emerging-market bond spreads to record lows in early 2007, which has spurred investors to search for higher yields in frontier debt markets. Frontier markets provide investors with a wider range of options for attaining their desired risk/return trade-off and simultaneously broadening the scope for portfolio diversification.

At the same time, improved macroeconomic stability along with the adoption of more flexible exchange rate regimes in many low-income countries have enhanced investor confidence, making investors more willing to take on exchange rate and default risk. Dramatic increases in some commodity prices over the past few years (metals and minerals in particular, see figure 1.19) have led to sizable exchange rate appreciations in commodity-exporting countries (notably Nigeria and Zambia), making some foreign investors more willing to take on exchange rate risk with the expectation of upside gains. In addition, debt relief provided under the HIPC Initiative and the MDRI, along with additional debt relief provided by the Paris Club of creditors, has significantly reduced the debt burdens of qualifying countries considerably (World Bank 2006, p. 94). External debt declined below 10 percent of GDP (in net present value terms) in 10 of the 18 countries that qualified for debt relief under the HIPC Initiative and the MDRI.

Most low-income countries have gradually liberalized capital controls since the mid-1990s, to the extent that neither capital controls nor tax policies, as they appear on the books, remain major constraints to foreign participation in most local debt markets. In practice, however, varying interpretations of the regulations in some markets, particularly those regarding the remittance of interest proceeds, have impeded foreign investment. In some cases, capital controls or tax policies are employed to channel investment into longer-term securities. Withholding tax rates on interest earnings are lower than in many developed countries and do not distinguish between resident and nonresident investors.

Nonregulatory barriers—particularly information constraints—prevent many low-income countries from attracting more foreign participation. Most foreign investors lack the expertise and resources needed to monitor developments in frontier markets effectively. This is particularly true for the smallest and poorest economies, about which little reliable and timely information on economic and financial developments is available. For example, the lack of comprehensive data on the outstanding stock of domestic debt in most developing countries makes it difficult for foreign and domestic investors to assess debt sustainability and price the risk of debt default. Moreover, many low-income countries do not have sovereign credit ratings, which could help investors assess risks. Information constraints can explain why much of the existing foreign investment in domestic debt markets is channeled through hedge funds and investment funds that have developed specialized expertise in frontier markets.

Despite improvement in domestic macroeconomic stabilization policies, low-income countries are still believed to be subject to greater political and economic uncertainty than more developed economies. Many countries remain vulnerable to large terms-of-trade shocks, which have often led to large exchange rate depreciations or devaluations, which have substantially reduced rates of return. Local bond markets are not immune to sudden reversals in foreign investment at times of heightened political or economic uncertainty, even in relatively stable, well-performing economies. For example, in Botswana, an upper-middle-income economy with an investment-grade credit rating, nonresident holdings of local government bonds declined from 11 percent in early 2005 to virtually nothing by the end of 2005, following a sharp exchange rate devaluation. Maintaining a sound monetary and fiscal policy framework, and allowing the exchange rate to adjust to alleviate external imbalances, will be critical for preserving investor confidence in the face of adverse shocks.

Lack of liquidity is a major problem, particularly in secondary markets. Foreign investors often respond by opting for shorter maturities to reduce the risk of having to sell at a steep discount. Domestic bond markets in low-income countries are also characterized by a rather small pool of securities, particularly corporate issues from rated companies. If foreign investors came to dominate a segment of such a market, a sudden shift in sentiment could lead to large movements in interest rates and the exchange rate. This risk is amplified where foreign investors with short-term horizons (particularly hedge funds) play a prominent role in the market. The macroeconomic repercussions for the country could be severe. These concerns point to the need for developing countries to strive for a healthy balance between their local and foreign investor bases and to expand their base of local institutional investors as a means of deepening the demand for longer maturities.

Despite some risks, foreign participation in domestic debt markets could benefit low-income countries in several ways. Broadening the investor base to allow greater participation by foreign investors has the potential to raise demand for bond issues considerably and to diversify issuance across a broader spectrum of investors with differing risk profiles, potentially lowering financing costs and providing greater liquidity. Foreign participation may also play a catalytic role in stimulating financial innovation, which can reduce financing costs and improve liquidity. More important, foreign participation can strengthen incentives for countries to pursue policy reforms in key areas, including enhancing transparency; building sound financial regulatory and supervisory institutions; adopting modern, internationally recognized accounting standards; and strengthening the legal system to ensure enforcement of creditor claims in the event of arrears or default.

Because domestic debt is typically denominated in the domestic currency, it reduces a country's vulnerability to the large exchange rate depreciations and devaluations that have contributed to the severity of most financial crises in emerging markets over the past few decades. The development of a domestic market for government securities could help provide more flexibility in financing budget deficits, reducing incentives for governments to monetize fiscal deficits.

International financial institutions play a prominent role in helping developing countries define priorities and make progress on a reform agenda that aims to develop domestic debt markets, one of many related elements required for a sound domestic financial system. The World

Bank and the IMF, together with developing countries under the Financial Sector Assessment Program (FSAP), are working to identify vulnerabilities in financial systems and recommend reforms needed to build stronger and more diversified financial sectors, which often entails developing domestic debt markets. Moreover, initiatives are underway to improve the quality to the data on domestic debt so that borrowers and lenders can monitor developments in a more comprehensive and timely manner. The International Finance Corporation (IFC) provides technical assistance to help develop corporate debt markets. The development of domestic bond markets in developing countries plays a prominent role in the current G-8 policy agenda.[13]

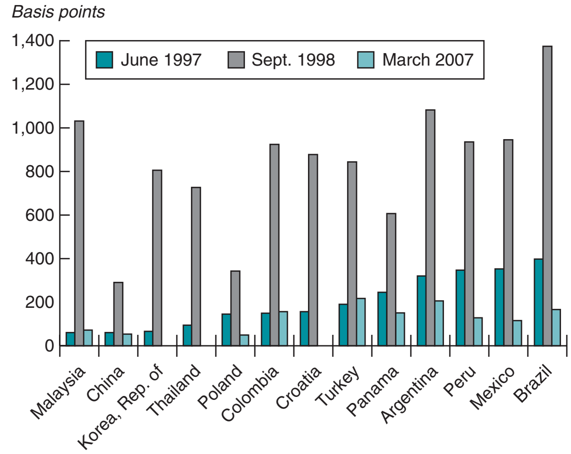
Prospects for capital flows

After four consecutive years of favorable external conditions supporting capital flows, there is a danger that debtors, creditors, and policy makers may become complacent in assessing future risks. The episodes of financial-market turbulence that occurred over the past year, although short-lived, were timely reminders of how sudden swings in investor sentiment can affect financial markets with little warning. The Mexican peso crisis and the Asian crisis are two extreme illustrations of this phenomenon. Spreads on sovereign bonds issued by Mexico shot up from 266 basis points in December 1993 to more than 1,800 in just 16 months. Spreads on Argentina's sovereign bonds increased from 350 to 1,800 basis points over a similar period. In June 1997 bond spreads in a number of emerging-market economies were below 200 basis points; by September 1998 spreads in some of those countries (namely, Colombia and Malaysia) approached 1,000 basis points (figure 2.28). Equity prices dropped sharply in many of these countries, in several cases by more than 50 percent (figure 2.29).

History has repeatedly shown that financial crises are difficult to predict. It would therefore be imprudent not to weigh the risks ahead of a crisis and consider how they might be managed most effectively. Capital flows to developing countries have leveled off. Global growth is expected to slow modestly over the next few years, and there is scope for long-term interest rates to rise. Under such conditions, capital flows as a share of GDP in recipient countries are likely to decline moderately. Although it is always difficult to pinpoint the precise timing and severity of a turning point in capital flows, it is nonetheless instructive to consider a range of possible outcomes.

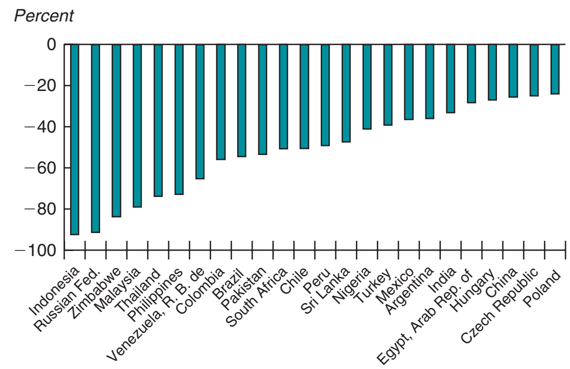
Under the "soft-landing" scenario, global growth declines from 4 percent in 2006 to 3.5 percent in 2009, consistent with the base-case projection reported in chapter 1 (see table 1.1). In the "hard-landing" scenario, global growth falls more abruptly, to 2.5 percent in 2009, as the result of a recession in the United States (see table 1.3). By 2009 capital flows are projected to decline from 5 percent of GDP in 2006 to 4.75 percent in the first scenario and 3.3 percent in the second. A more abrupt decline in global growth (under the

Figure 2.28 Emerging-market bond spreads in June 1997, September 1998, and March 2007



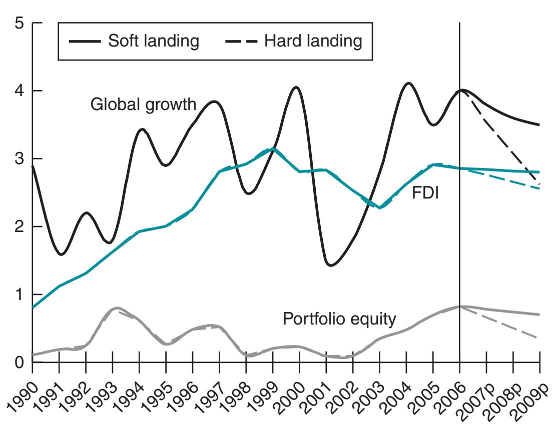
Source: JPMorgan Chase.

Figure 2.29 Change in emerging-market equity prices, June 1997–September 1998



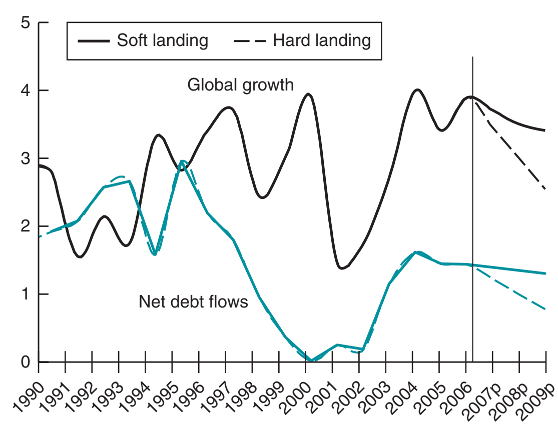
Sources: Standard & Poor's/International Finance Corporation composite indexes (S&P/IFCI).

Figure 2.30 World GDP growth and net equity flows as a percentage of GDP, 1990–2009



Source: World Bank staff estimates.
Note: p = projection.

Figure 2.31 World GDP growth and net debt flows as a percentage of GDP, 1990–2009



Source: World Bank staff estimates.
Note: p = projection.

"hard-landing" scenario) is projected to have a greater impact on net debt flows, which tend to be more volatile than net equity flows.

Between 2006 and 2009, net FDI inflows are projected to decline by less than 0.1 percentage point under the soft-landing scenario and by 0.3 percentage point under the hard-landing scenario (figure 2.30). The modest impact on projected FDI inflows of an abrupt decline in global growth reflects the fact that FDI flows do not have a strong cyclical element relative to GDP. (When global growth fell by 2.5 percentage points in 2000–01, for example, there was virtually no change in the ratio of FDI to GDP.) In nominal terms, FDI inflows are projected to continue increasing under both scenarios, rising from $325 billion in 2006 to $420 billion in 2009 in the first scenario and $377 billion in the second.

Portfolio equity flows have been more volatile than FDI inflows over the historical period considered here. This feature is reflected in the projections. The ratio of portfolio equity to GDP is projected to decline by a little more than 0.1 percentage point under the soft-landing scenario and by 0.5 percentage point under the hard-landing scenario. The impact is much greater in nominal terms than in the case of FDI inflows, with portfolio equity flows projected to increase from $90 billion in 2006 to $105 billion in 2009 in the first scenario and fall to $50 billion in the second.

Net debt flows have been much more volatile than net equity flows (figures 2.30 and 2.31). Net debt flows collapsed in the wake of the series of financial crises that rocked emerging markets in the 1990s, toppling from a peak of 2.8 percent of GDP in 1995 to almost zero in 2000. As a percentage of GDP, they have still not recovered to previous levels. Volatility in emerging-market bond spreads was even greater: the EMBI for Brady bonds rose from 400 basis points in early 1994 to more than 1,600 basis points in early 1995, returning to below 400 basis points in mid-1997 before abruptly increasing to more than 1,300 basis points in mid-1998.

Given the volatile nature of net debt flows and emerging-market bond spreads, a high degree of uncertainty surrounds any projections. Nonetheless, a projection exercise can be informative in illustrating the extent to which debt flows have been influenced by structural versus cyclical factors.

Under the soft-landing scenario, global growth should moderate to sustainable levels without major swings in interest rates or exchange rates. Net debt flows are projected to recede only slightly under such conditions—by a little more than 0.1 percentage point by 2009. In nominal terms they will rise from $152 billion in 2006 to $187 billion in 2009.

The impact of a more abrupt slowdown in global growth under the hard-landing scenario is even more difficult to assess, because there is a greater risk that major swings in interest rates or exchange rates could lead to a sudden swing in investor confidence in those emerging-market economies deemed to be most vulnerable. Such swings have often had a major effect on bond spreads in vulnerable economies. But fundamentals have improved significantly in many countries, and many of today's most active borrowers have low levels of external and public debt, ample foreign reserves, current account surpluses, flexible exchange rate regimes, a low and stable inflation environment, and a sound fiscal planning framework. Economies that have made the most progress along these lines are not immune to a sharp deterioration in international financial and economic conditions, but they are less likely to experience a sudden swing in investor sentiment.

Given the improved fundamentals in most emerging-market economies over the past few years, net debt flows are expected to be less volatile than in the past few decades. Even under the hard-landing scenario, the ratio of net debt flow to GDP is projected to decline by 0.5 percentage point by 2009, decreasing in nominal terms from $152 billion in 2006 to $130 billion in 2009.

Volatile periods in equity markets during the past year have focused investors' attention on the possibility that equity prices may be overpriced in certain emerging-market economies. Although recent declines have been relatively minor from a historical perspective, concerns persist that a more substantial correction could occur in some countries. Over the past four years, equity prices have risen by a factor of more than five in Argentina (525 percent), Brazil (520 percent), Colombia (517 percent), Egypt (760 percent), Peru (522 percent), and Russia (538 percent). A sharp correction in equity prices in these economies would be likely to curtail portfolio equity inflows considerably and possibly erode investor confidence.

A downturn in the credit cycle could have a major impact on low-income countries that are currently borrowing on nonconcessional terms. Countries that experience difficulties meeting their financing needs with available concessional loans and grants may resort to financing on less favorable terms. Because low-income countries, particularly those whose export revenues are dominated by just a few commodities, are the most vulnerable to external shocks, the danger of overborrowing is real. A slowdown in global growth is likely to have some impact on commodity prices elevated by several years of strong global demand. A marked slowdown in global demand could have a major impact on commodity prices, leading to severe repercussions for commodity exporters. Moreover, the institutional structures of financial markets in most low-income countries are still relatively undeveloped, particularly with respect to regulation and supervision, and there is an acute lack of liquidity in most segments of the domestic debt market. In countries where foreign investors play a prominent role in certain segments of this market, a sudden swing in investor sentiment could lead to major fluctuations in interest rates and exchange rates, possibly with severe macroeconomic repercussions. This is of particular concern for countries that have received significant debt relief. Imprudent borrowing could endanger debt sustainability over the long term in the event of adverse shocks, erasing the hard-won gains of debt relief.

Data limitations make it difficult to ascertain whether current borrowing activity runs a high probability of endangering debt sustainability over the long term. Filling this gap requires increasing the capacity of low-income countries to report their borrowing activities accurately and on a timely basis. A more modern monitoring framework is required to enable lenders, borrowers, and policy makers to assess underlying risks on an ongoing basis, so that preventive measures may be considered. Assessing the risks entailed by foreign participation in domestic debt markets is complicated by the lack of adequate monitoring systems for tracking cross-border portfolio investment flows. Nonresident purchases of bonds issued in the domestic market should be reported as external debt (consistent with the balance of payments convention) and included in assessments of debt sustainability.

Annex 1: Commercial Debt Restructuring

Developments between April 2006 and March 2007

Developing countries continued to manage their liabilities in a proactive way over the past year. In 2006, Brazil, Nigeria, Panama, the Philippines, and República Bolivariana de Venezuela retired about $12.8 billion in Brady bonds through buybacks and discounted swaps for unsecured bonds, almost completely extinguishing their remaining Brady debt. Peru also retired the bulk of its outstanding Brady debt in March 2007. Other parts of the bond market also saw major restructuring activities as a continuation of strategies to reduce debt service and improve yield curves. Some of these debt-management operations involved restructuring of stressed debt, such as Belize's $497 million swap transaction.

Debt restructuring in low-income countries

Nigeria. In November 2006, Nigeria bought back about $1.5 billion of Brady par bonds due in 2020 under the government's plan to clear the last of its London Club debt. Nigeria's London Club debt is in three parts: Brady par bonds, promissory notes, and oil warrants issued by the central bank in 1991 in connection with the country's Brady-style debt restructuring. Having retired the par bonds last year, the Nigerian government in March 2007 discharged $512 million worth of promissory note payments. It also retired about $0.37 million of oil warrants out of the total of $1.76 million outstanding, using a modified Dutch auction. The cost of the oil-warrant buyback is estimated at $82 million. Complete payoff of London Club creditors in 2007 would reduce Nigeria's external debt from 21 percent of GDP (in 2005) to an estimated 3 percent of GDP.

Buybacks and swaps in middle-income countries

Belize. In February 2007, the government of Belize successfully completed the restructuring of its external debt, concluding a swap launched in December. Belize renegotiated more than 98 percent of its foreign commercial debt with bondholders, affecting 50 percent of the country's total public debt. The government offered to exchange $497 million of foreign debt for new $546.8 million step-up bonds due in 2029. The new issue carries a coupon of 4.25 percent for the first three years, 6 percent for years four and five, and 8.5 percent thereafter. The new bonds will amortize in equal, semi-annual installments beginning in 2019.

Brazil. Brazil's government carried out three liability-management operations in 2006. In April, it exercised a call option at par value to retire all of its remaining $6.5 billion in Brady bonds, marking the end of a campaign to buy back $55 billion of original Brady debt. The operation was designed to improve Brazil's external debt profile and interest rate structure. In June, the government bought back about $1.1 billion of dollar- and euro-denominated global bonds due between 2007 and 2030. The deal fell far short of the target of $4 billion face value. The buyback involved 20 bonds of various types, including both short-maturity bonds and longer-dated off-the-run bonds. In August, Brazil reopened its 2037 bond in the amount of $500 million in exchange for five illiquid global bonds due between 2020 and 2030. The swapped amount was much lower than the expected $1.5 billion because investors were less receptive than the government had hoped.

Colombia. In September 2006, Colombia bought back $469.4 million of its global bonds due in 2020, 2027, and 2033, using part of the proceeds from the issuance of a new $1 billion global bond due in 2037. The new issue was priced to yield 250 basis points above the U.S. Treasury rate, with a 7.125 percent coupon. The transaction reflects the country's proactive liability-management and funding strategy. In February 2007, the Colombian government announced its plans to buy back both external and domestic bonds using excess tax revenues and privatization windfalls.

Mexico. Between August 2006 and March 2007, Mexico carried out three liability-management operations to restructure about $8.9 billion of its outstanding external debt. In August 2006, Mexico carried out a surprise buyback of $3.4 billion in global bonds due between 2007 and 2033 after raising more than expected in a domestic bond exchange. The buyback was part of the government's strategy to reshape its debt profile by moving from external to domestic debt. In January 2007, the government reopened its global 2034 bonds for an amount of $2.3 billion and paid $400 million in cash for $2.8 billion in shorter, higher-coupon, and less liquid bonds maturing between 2019 and 2033 (mostly in 2033). In March 2007, it launched another round of exchange warrants to swap about $2.7 billion of hard-currency bonds for local-currency debt later in the year.

Panama. In July 2006, Panama retired the last of its outstanding Brady debt (originally $3.23 billion) by exercising a call option for about $352 million in bonds. Eligible for the buyback were $9 million in par bonds, $13.2 million in discount bonds, $108.6 million in interest-rate-reduction bonds, and $220 million in past-due-interest bonds. Bonds were redeemed at par with accrued interest. The operation was financed by the government's excess liquidity and a $320 million credit facility from Barclays Capital. According to the government, the deal cut its total external debt stock by $30 million and reduced its debt service by about $19 million per year for the next 10 years.

Peru. In February 2007, the Peruvian government concluded a liability management operation to swap and buy back about $2.5 billion in outstanding Brady bonds (FLIRB, PDI, pars, and discounts) and global 2012 bonds for new securities and cash. The government bought back about $1 billion of global 2012 bonds with cash and in exchange for bonds due in 2016 and 2033. It also issued $1.2 billion in new global 2037 bonds in exchange for approximately $1.5 billion in Brady bonds. The new bond, which carries a coupon of 6.55 percent, will be the country's longest-maturity external bond. The sovereign also sold about $88 million of reopened local 2026 bonds to help finance the cash portion of the deal. This debt-management operation was part of the government's strategy to reduce its borrowing costs and extend the maturity of its debt.

The Philippines. In 2006, the Philippines undertook two buyback operations to retire about $575 million in Brady bonds. The sovereign also completed a debt-exchange operation to swap about $1.2 billion of expensive debt. In the first buyback, in June, the government exercised call options to redeem $410 million of interest-reduction bonds. The deal yielded a saving of about $32 million in interest payments and released underlying collateral of about $256 million. In December, the government also redeemed its outstanding floating-rate bonds and interest-reduction bonds, worth about $165.3 million. This operation was financed entirely from official government reserves. In September, the Philippines issued $764 million in new, amortizing bonds due in 2024 and reopened its 2031 bond in the amount of $435 million in exchange for $1.2 billion of global bonds due between 2007 and 2017. Some holders of 2024 and 2025 bonds were also invited to participate in the 2031 reopening. The new issue was priced to yield 7.38 percent at a spread of 200 basis points over the U.S. Treasury rate. In March 2007, the Philippines announced that it would redeem $126 million in outstanding Brady bonds during the second quarter of 2007, marking the end of the country's history with Brady bonds.

Turkey. In September 2006, Turkey carried out its first international liability management operation by swapping seven short-dated bonds due between 2007 and 2010 and $330 million in cash for new 10-year global bonds valued at $1.5 billion. The new issue carries a 7 percent coupon and was priced at 183 basis points over mid-swap, for a semi-annual yield of 7.12 percent. The exchange was intended to smooth out the country's redemption profile, extend the average maturity, and establish a more favorable yield curve. The country had previously made domestic bond exchanges. For example, in 2001 it swapped lira bonds valued at $8.4 billion for U.S. dollar–indexed bonds.

Uruguay. In November 2006, Uruguay bought back $1.14 billion in global bonds, including those it had restructured three years ago to avoid default. The government offered to swap up to $2.2 billion in global bonds maturing in 2019 or before, and one maturing in 2027. Investors were to be paid in cash (up to $400 million) or in longer-dated securities. In exchange for the old bonds, Uruguay will issue about $879 million of new bonds, including $602 million of 8 percent bonds due in 2022 and $277 million of 7.625 percent bonds due 2036. Earlier in the year the sovereign raised $800 million through peso- and dollar-denominated bonds, financing the exchange through a $500 million reopening of its 2036 bonds and the reopening of $300 million worth of existing inflation-linked 2018 peso bonds.

República Bolivariana de Venezuela. In 2006, the Venezuelan government carried out two straight buyback operations to retire an estimated $3.9 billion of outstanding Brady bonds, joining Brazil, Colombia, and Mexico in paying off the old obligations. In April, the sovereign bought back about $2.9 billion in Brady bonds, including Series A fixed-rate par bonds maturing in 2020 and Series A floating-rate discount bonds maturing in 2020. The buyback was mostly financed by reserves in various government funds. In May, the government repurchased all of its outstanding par and discount Brady bonds maturing in 2020 (Series B).

Annex 2: Debt Restructuring with Official Creditors

Restructuring of intergovernmental loans and officially guaranteed private export credits takes place under the aegis of the Paris Club. The agreements are concluded between the debtor government and representatives of creditor countries. The Paris Club treats each borrower individually, by consensus of all creditor countries. Most terms fall within one of the following categories, listed below in order of increasing concessionality:

- "Classic terms" signify the standard treatment (countries must have an appropriate program with the IMF showing the need for Paris Club debt relief).
- "Houston terms" are reserved for highly indebted lower-middle-income countries.
- "Naples terms" apply to highly indebted poor countries.
- "Cologne terms" are for countries eligible for the Heavily Indebted Poor Countries (HIPC) Initiative.

To make the terms effective, debtor countries must sign a bilateral implementing agreement with each creditor.

Moldova. Following the IMF's approval on May 12, 2006, of Moldova's arrangement under the Poverty Reduction and Growth Facility (PRGF), Paris Club creditors agreed to consolidate roughly $150 million due on debt contracted before December 2000, of which $68 million was in arrears and $82 million maturities falling due. The maturities are being restructured on Houston terms. The agreement is expected to reduce the country's debt service from $149.9 million to $60.8 million and to satisfy Moldova's financing requirements for 2006–08.

Grenada. On May 12, 2006, Paris Club creditors agreed to a restructuring of Grenada's external public debt, estimated at $17 million, following the IMF's approval in April of the country's arrangements under the PRGF. The agreement reschedules roughly $16 million in arrears and maturities falling due and reduces by more than 90 percent the debt service due to Paris Club creditors. The terms of the rescheduling were as follows: medium- and long-term claims are to be repaid progressively over 12 years, including 5 years of grace. Loans made as official development assistance will be rescheduled at a rate not higher than the interest rate of the original loan. Other loans are to be rescheduled at a market interest rate.

Cameroon. In April 2006, Cameroon reached the completion point under the Enhanced HIPC Initiative. To help restore the country's ability to sustain its debt, the Paris Club decided on June 17, 2006, to cancel debt valued at $921 million in nominal terms. Creditors also committed on a bilateral basis to grant additional debt relief so that the stock of debt owed to Paris Club creditors would be reduced by a further $2,554 million. As a result, the country's debts will be reduced from $3,502 million to $27 million.

Afghanistan. Following the IMF's approval of a PRGF arrangement on July 19, 2006, Paris Club creditors agreed to a significant reduction of Afghanistan's external debt under Naples terms. The stock of debt owed to Paris Club creditors was estimated at $411.3 billion. The agreement consolidates $2.4 billion, cancels $1.6 billion, and reschedules $0.8 billion. On an exceptional basis, this agreement also defers 100 percent of the moratorium interest due over the consolidation period, with repayments to be made after October 2011.

Malawi. In August 2006, Malawi reached the completion point under the Enhanced HIPC Initiative. As a means of restoring Malawi's debt sustainability, the Paris Club, on October 19, 2006, canceled debt worth $137 million in nominal terms. Most creditors also committed on a bilateral basis to grant additional debt relief of $217 million in nominal terms. As a result, Malawi's debt to Paris Club creditors will be reduced from $464 million to $9 million. Malawi agreed to allocate the resources freed up by debt relief to priority areas identified in the country's poverty reduction strategy.

Haiti. In November 2006, Haiti reached the decision point under the Enhanced HIPC Initiative. A Paris Club agreement concluded under Cologne terms on December 12, 2006, consolidated around $69 million in debt, of which $45 million consisted of arrears and late interest. An amount of $7.2 million was immediately canceled. On an exceptional basis, the agreement defers 100 percent of the moratorium interest due over the consolidation period, repayment of which is to begin in November 2010. Haiti's economic program is supported by a three-year arrangement under the PRGF approved by the IMF. Haiti's debt to Paris Club creditors was estimated to be $199 million in October 2006. Paris Club creditors have signaled their willingness to make further reductions in Haiti's debt as soon as the country reaches the completion point under the Enhanced HIPC Initiative.

Notes

1. Figure 2.3 shows foreign exchange reserves in each of the countries as a percent of GDP in all developing countries.

2. The London Club is an informal group of commercial banks that join together to negotiate their claims against sovereign debtors.

3. See annex 1 of this chapter for more detailed information on commercial debt restructuring activities in 2006.

4. Gross "bank lending" (table 2.4) reported by the World Bank's Debtor Reporting System (DRS) exceeded cross-border loan commitments (table 2.5) reported in Loanware by almost $100 billion in 2006. The large discrepancy, concentrated in Europe and Central Asia, grew substantially over the past five years. Much of the increase reflects the fact that "bank lending" as defined in the DRS includes interbank loans and trade credit, which are not included in the Loanware definition.

5. The figure for banks domiciled in high-income countries refers to syndicated loan transactions involving solely the participation of banks domiciled in these countries.

6. Data on bilateral loan commitments are not readily available.

7. World Bank staff estimates.

8. These figures are based on countries for which reliable data are available. For many developing countries, data on public debt are either unavailable or of dubious quality.

9. Cross-border merger and acquisition purchases by multinational companies located in developing countries are expected to reach about $100 billion in 2006.

10. World Bank and IMF (2006b). This calculation does not include Haiti, which reached the decision point in October 2006.

11. "Frequent basis" is defined as countries that issued bonds in more than 22 of the 27 years in the sample.

12. From the perspective of the balance of payments, international capital flows are defined with reference to the residency of the creditor, not the legal jurisdiction in which the bond is issued or the bank loan contracted. In contrast, the measure of external bonds examined here is defined with reference to the legal jurisdiction and hence does not take into account nonresident purchases of bonds issued in the domestic market.

13. In February 2007 the G-7 finance ministers met with their counterparts from Brazil, China, India, Mexico, Russia, and South Africa to discuss a proposal to promote the development of local and regional bond markets in low-income countries, with a focus on countries in Sub-Saharan Africa. A high-level conference was held on May 9–10, 2007, in Frankfurt to make recommendations.

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3

The Globalization of Corporate Finance in Developing Countries

CORPORATIONS BASED IN DEVELOPING countries are raising vast sums of capital on global markets on an unprecedented scale. Indeed, the growing profile of such companies, both public and private, in global investment and finance is a defining feature of the current cycle of capital flows to developing countries. Firms based in developing countries raised $156 billion through international offerings of corporate debt and equity in 2006; syndicated bank loans to such companies reached a record $245 billion; and cross-border mergers and acquisitions (M&A) involving companies from developing countries bidding for foreign targets amounted to $100 billion. The world's top Fortune 500 companies include 40 from the developing world, and the 394 developing-country firms traded on the world's major stock exchanges account for one-third of all global overseas cross-listings.

Developing countries stand to reap substantial benefits from the access their corporations have gained to the world's major financial centers, with their deep and liquid financial resources, broad investor bases, and modern trading platforms. The potential to redirect scarce domestic capital to high-priority purposes, such as rural development and small-scale business, without crowding out the corporate sector is a valuable solution to a trade-off that has bedeviled development for half a century.

Access to international capital markets is far from automatic. Companies qualify by complying with standards for financial accounting, disclosure, and corporate governance mandated by host-country exchanges and regulatory bodies. Most of the firms that have been able to access international capital markets are large, have high growth potential, and come from the banking, infrastructure, and mining industries. Others have established a global presence through trade, investment, or strategic M&A.

This chapter highlights the growing global importance of corporations based in developing countries and the implications of their ascent for development finance. It examines the factors that influence corporations' decisions to pursue external financing and how access to international capital markets affects the cost of capital and the returns on assets. The evidence and analysis presented are based on information gathered from firms about their external financing practices. The data cover nearly every company in the developing world that raised funds on global capital markets between 1990 and 2006 or listed shares on one of the world's major stock exchanges. The key messages are highlighted below.

- *Global borrowing by developing-country firms has surged in recent years and its pattern shifted,* with borrowers originating in emerging Europe and Central Asia now in the forefront. With ample global liquidity and rapid growth in developing countries underpinning growing demand among international investors for developing-country corporate assets, the markets have responded by offering a new generation of credit and equity products designed to finance corporate activity in emerging markets. Since 2002, 422 emerging-market companies have tapped international bond markets at least once, 537 contracted bank loans on the international syndicated market, and 360 raised capital on one of the global major overseas exchanges. Total foreign capital raised through these instruments reached $1.04 trillion, up from $300 billion in the previous three years.

The home bases of the major borrowers have changed as well. In the early 1990s, East Asian corporations were the major borrowers; from 1997 to 2001, Latin American firms led the way. Since then, firms from emerging Europe and Central Asia, particularly banks, have come to the fore and now account for 39 percent of total external borrowing by corporations in developing countries. Many are borrowing primarily to finance oil and gas and banking operations.

Transactions have also grown in size, with bond financing increasingly common. Large deals have brought greater liquidity to secondary markets and stimulated the development of a market for credit default swaps on emerging corporate debt.

- *The pace of corporate globalization in the developing world is likely to intensify in the medium term, subject to fluctuations in the business cycle and cyclical changes in global financial conditions.* Improved domestic policies and favorable international economic conditions have enhanced the ability of corporations based in developing countries to access international finance. Progressive trade and investment liberalization, competitive pressures, and rapid change in technology are pushing many to build a global presence through M&A, trade, and investment. Cross-border M&A by developing-country multinationals has been on the rise in recent years, increasing from $400 million in 1987 (when these countries accounted for less than 1 percent of global M&A transactions) to almost $100 billion in 2006 (almost 9 percent of global M&A transactions). Emerging-market corporate securities offer substantial opportunities for diversification and growth-related gains to international investors. Official and institutional investors from emerging economies are aware that they are among those who stand to gain; they have been adding corporate assets to their investment portfolios as a way of enhancing long-term financial returns. The state foreign investment corporation recently set up by the Chinese authorities has a broad investment mandate (encompassing energy and natural resources) that could stimulate demand for emerging corporate assets and securities.
- *Concerns are growing that corporate credit spreads may not fully reflect credit quality and that corporations may be underestimating global risk aversion.* With global financial markets operating in recent years with unprecedented liquidity, heightened risk appetite among investors, and a spectrum of new players and actors, the possibility of corporate credit spreads underestimating their long-term equilibrium levels is a real one. Favorable global financial conditions have reduced the cost of external financing to corporations based in developing countries not only directly, through lower international interest rates, but also indirectly, by enhancing their creditworthiness as the value of their collateralizable assets increases. Such factors could encourage excessive corporate borrowing, particularly in the context of weak corporate governance and poor supervision, engendering boom-and-bust cycles, with dire implications for growth and welfare. Excessive corporate borrowing can also limit the government's capacity to issue sovereign debt on international markets.
- *Managing these risks requires a comprehensive response, from the level of the firm to the macroeconomic level.* Credible commitment to capital market development, greater financial transparency, sound exchange rate systems (floating or under the European Monetary System [ERM II]), government regulation, and prudential oversight of banks' foreign currency borrowing can go a long way in most countries toward reducing the likelihood of excessive corporate borrowing and financial instability. For banks, strong monitoring and supervision, including prudential limits on foreign borrowing, are needed to ensure loan quality and the maintenance of adequate capital reserves. Where supervision is less than stringent, risks can be great—and they are rarely confined to the country in which the risky borrower is based. Several countries, particularly in emerging Europe and Central Asia, are now experiencing a credit boom, spearheaded by banks of untested financial health and stamina that have gained access to international credit markets partly because global liquidity is so great and competition in the

international banking industry so intense. Concerns are growing that some of these banks—particularly in Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Russia, and Ukraine—are increasing their foreign exchange exposure to levels that have the potential to jeopardize financial stability.

For nonfinancial corporations, policy makers must create an enabling framework in which businesses can manage risks while building a balanced capital structure that will embrace both local and foreign financing sources. As most firms tapping international debt markets tend to be large and relatively highly leveraged, they raise difficult public policy concerns in the event of an adverse turn in the global financial climate. While corporate decisions to raise capital on overseas markets should be left primarily to market forces, pubic policy has an important role to play in situations in which corporate financial distress could spill over to the banking sector, raising systemic risk. High levels of corporate debt also challenge policy makers and market participants to devise new tools to measure and assess credit risk, market risk, and operational risk within the macroeconomic and regulatory context of developing countries.

- *Good policies reduce the cost of capital.* International investors care about the macroeconomic, political, and institutional settings in which issuing companies operate. Such considerations define the entry and exit points for the cross-country allocation and management of investment portfolios. The econometric analysis conducted for this report finds that a 10 percent reduction in a country's perceived economic risk decreases corporate bond spreads by 52 basis points, while a 10 percent decline in perceived financial risk reduces spreads by 63 basis points—roughly equivalent to a credit-rating upgrade of two notches. The importance of sound macroeconomic management is particularly evident in the impact of higher growth and lower inflation on the spreads available to corporate borrowers. Investments in financial infrastructure to strengthen legal, regulatory, and supervisory institutions for local equity and debt markets also reduce spreads for emerging corporate borrowers.
- *Greater coherence is needed in international standards for cross-border listings and public offerings of securities.* In the years ahead, policy makers in both developed and developing countries will be called upon to simplify the complex international system for cross-border offering and listing of corporate securities. A simpler system would greatly enhance efficiency in the global allocation of capital. Currently, national accounting standards, disclosure rules, corporate governance structures, and enforcement systems associated with equity financing vary widely across countries. Complying with several sets of rules can be costly for firms, raising their cost of capital or deterring them from cross-listing. Market pressures and action by international regulators have brought some degree of convergence in certain areas, notably accounting standards (led by the International Accounting Standards Board). Mutual recognition of national regulations that meet a common minimum standard has also been used, within the European Union and, in certain areas, between the United States and Canada. But the need remains to strike a balance between regulations and market incentives in managing cross-border offerings and listings on major exchanges. The wave of consolidations, mergers, and strategic alliances that have swept the world's major stock exchanges make this need even more acute.

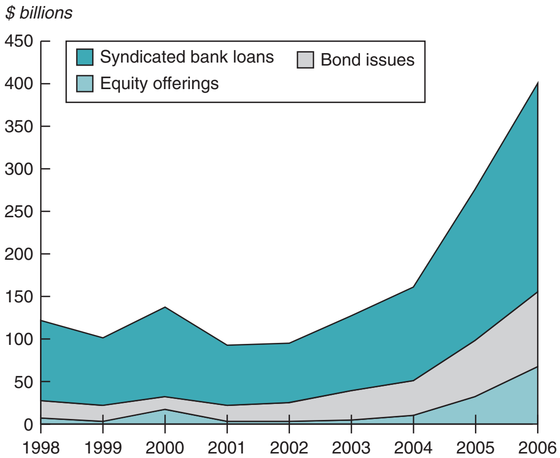
The rapidly evolving corporate sector in emerging economies

The internationalization of corporate finance has followed several distinctive patterns

Mirroring broader global trends, corporate finance in developing countries is taking on an increasingly transnational character. The twin forces of internationalization of business activity and integration of financial markets are pushing companies to minimize their cost of capital by diversifying their funding sources, building a long-term investor base, and increasing their international recognition.

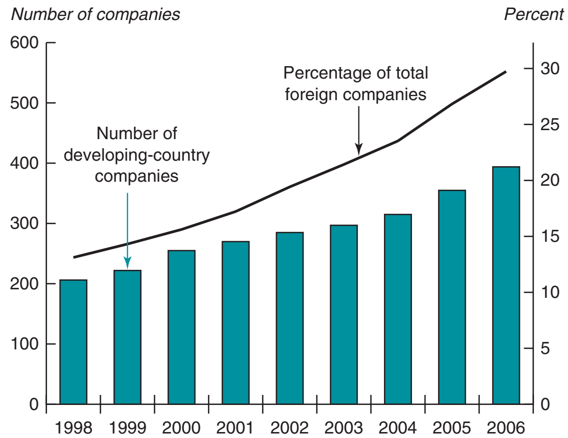
Firms are funding their investment spending, cross-border acquisitions, and operating needs through a mix of local and foreign financing. New capital raised through corporate securities offerings and loans from international bank syndicates

Figure 3.1 Foreign capital raised by developing-country corporations, 1998–2006



Source: World Bank staff estimates based on data from New York Stock Exchange (NYSE), NASDAQ, London Stock Exchange (LSE), Luxembourg Stock Exchange, and Dealogic.

Figure 3.2 Foreign companies listed on major global stock exchanges, 1998–2006



Source: World Bank staff estimates based on data from NYSE, NASDAQ, LSE, Luxembourg Stock Exchange, and the World Federation of Exchanges.

totaled $400 billion in 2006, a threefold increase from 2003 (figure 3.1). Since 2002, 422 companies from developing countries have issued bonds on international markets, 348 of them for the first time. Relatively easy financing conditions in banking markets have raised the number of international syndicated loans to 2,497 since 2002, swelled their volume, and spread loan activity more broadly across countries and regions.

Growing numbers of firms are opting to cross-list their shares on major stock exchanges around the world as a way of inducing foreign investors to trade in their shares, establish an international profile, and preserve their options for meeting future capital needs.[1] Of the 1,574 foreign companies listed on major global stock exchanges in 1998, only 206 (13.1 percent) were based in developing countries. By 2006 that percentage had more than doubled, with 394 (29.7 percent) of the 1,328 foreign companies listed based in the developing world. One-third of all companies now cross-listed on their own and foreign markets come from developing countries (figure 3.2).

Twenty middle-income countries account for most of the participation of developing-country firms in international capital markets, with Brazil, China, India, Mexico, and Russia most heavily represented. With an average per capita income in 2006 of $4,805, these countries accounted for 95 percent of total bond issuance, 85 percent of total bank borrowing, and 95 percent of total equity offerings by developing-country companies (table 3.1). These 20 countries—home to 67 percent of the developing world's population and the source of 78 percent of its GDP—are distinguished by their level of development, growth potential, openness to capital transactions, size and growth of their local equity markets, external financial position, and country risk status. Recent or potential members of the European Union within the group are also under pressure to catch up with their peers. The 20 countries have an aggregate stock market capitalization of $5.3 trillion, 88 percent of the total for the developing world and 10 percent of the total for the entire world. Their 12,557 publicly traded companies represent 95 percent of all those based in developing countries. Substantial foreign exchange reserves, rapid industrial growth, and relatively flexible exchange-rate regimes are other important characteristics that distinguish these countries from the rest of the developing world (table 3.2).

The macroeconomic stances and growth prospects of these 20 countries are largely positive. Nevertheless, several aspects of the participation of their corporations in global capital markets merit careful attention. First, the rapid growth in external debt contracted by firms over the past four years may represent a trend whose potential implications are not yet well understood. Second, as the pattern of corporate external borrowing has shifted

Table 3.1 Capital raised through equity issues, bond issues, and syndicated bank borrowing by firms in selected middle-income countries, 1998–2006

$ millions

Country	Equity issues	Bond issues	Syndicated bank borrowing	Total
Argentina	1,321	6,911	33,719	41,951
Brazil	8,798	56,051	100,226	165,076
Chile	453	11,537	43,749	55,739
China	71,997	14,168	80,304	166,469
Colombia	0	516	9,229	9,744
Egypt, Arab Rep. of	1,134	2,282	19,093	22,508
Hungary	252	7,247	17,817	25,316
India	13,398	8,140	49,441	70,978
Indonesia	4	7,635	18,402	26,041
Iran, Islamic Rep. of	0	0	18,775	18,775
Kazakhstan	902	15,773	19,643	36,319
Lebanon	896	1,645	344	2,885
Malaysia	28	16,633	38,259	54,920
Mexico	5,567	48,012	97,822	151,401
Philippines	134	7,841	20,836	28,811
Poland	1,655	5,684	30,186	37,524
Russian Federation	14,052	63,222	98,522	175,797
South Africa	1,663	14,248	32,396	48,307
Thailand	1,207	3,725	26,711	31,643
Turkey	1,589	9,049	72,432	83,069
Total	**125,051**	**300,318**	**827,905**	**1,253,273**
As percentage of all developing countries	**94.3**	**92.5**	**82.5**	**85.7**

Source: World Bank staff estimates based on data from Dealogic Bondware, Loanware, and Equityware; NYSE; NASDAQ; LSE; and Luxembourg Stock Exchange.

in recent years from East Asia and Latin America to Europe and Central Asia, with significant involvement by local commercial banks in borrowing and intermediation, the importance of regional factors (notably integration within the European Union) and bilateral lending have become prominent. Third, despite much recent improvement in the credit fundamentals of many developing countries, their access to the global corporate bond market remains vulnerable to sudden shifts in investor sentiment and to adverse turns in the global credit cycle. Each of these points is discussed below.

Substantial foreign capital has been raised in the form of debt

Private and state-owned corporations in developing countries have borrowed in international debt markets on an unprecedented scale in the past few years. In 2006 they raised $333 billion through syndicated bank loans and international bond issuance, up sharply from $88 billion in 2002 (table 3.3). Private sector companies accounted for more than 60 percent of total bank borrowing and 75 percent of new bond issuance during 2002–06; they also propelled much of the increase in borrowing. Regionally, firms from emerging Europe and Central Asia stand out, having contracted $135 billion in debt in 2006.

Financial corporations, particularly commercial banks from India, Kazakhstan, Russia, and Turkey, have been at the forefront of what appears to be a major foreign credit boom. Banks have tapped international debt markets to fund their growing domestic loan portfolios and to meet increasing capital adequacy requirements. Faced with competitive pressures and highly liquid markets, international banks have been eager to lend at narrower margins and on longer terms to a wider range of borrowers.

Foreign borrowing by companies in emerging markets has occurred in several distinct phases, mirroring the growth of industrial production in the countries from which companies have borrowed (figure 3.3). Companies from East Asia were the heaviest borrowers in the early 1990s. After the East Asian economic crisis, they were succeeded by companies from Latin America. Between 1997 and 2001, the share of Latin American companies in emerging-market corporate bank lending more than doubled, to an average of 46 percent, from an average of 22 percent between 1990

Table 3.2 Performance indicators of selected developing countries

Growth potential (annual %, 1990–2005)[a]		Local stock market growth (annual %, 2004–06)[b]		Country risk rating, 2000–06[c]		Foreign exchange reserves (change in % of GDP, 1997–2005)[d]	
China	9.7	Ukraine	87.7	Chile	78.6	Equatorial Guinea	64.1
Lebanon	7.6	Egypt, Arab Rep. of	84.3	Malaysia	77.9	Algeria	38.1
Vietnam	7.4	Colombia	65.0	Trinidad and Tobago	76.9	Malaysia	33.3
Myanmar	7.3	Romania	58.3	China	76.1	Yemen, Rep. of	27.3
Cambodia	7.1	Lebanon	51.7	Latvia	75.8	Bosnia and Herzegovina	24.8
Malaysia	6.5	Russian Federation	50.8	Poland	75.3	Solomon Islands	24.0
Maldives	6.5	Venezuela, R.B. de	48.5	Hungary	75.1	China	22.1
Mozambique	6.4	Jordan	45.6	Estonia	75.0	Trinidad and Tobago	20.1
Uganda	6.3	Argentina	43.5	Lithuania	74.7	Russian Federation	19.9
Lao PDR	6.3	Mexico	42.5	Slovak Republic	74.5	Morocco	19.1
Belize	6.0	Indonesia	40.6	Russian Federation	73.7	Ukraine	18.9
India	6.0	Hungary	40.5	Mexico	73.5	São Tomé and Principe	18.3
Chad	5.7	Bulgaria	40.4	Thailand	73.5	Slovak Republic	17.0
Chile	5.6	Estonia	38.8	Croatia	73.4	Honduras	16.7
Yemen, Rep. of	5.6	Peru	36.6	Morocco	73.4	Lebanon	15.2
Bhutan	5.5	Botswana	36.3	Tunisia	73.0	Macedonia, FYR	14.4
Botswana	5.3	Bangladesh	35.0	Costa Rica	73.0	Guinea-Bissau	13.8
Cape Verde	5.2	Ecuador	34.9	Kazakhstan	72.6	Kyrgyz Republic	13.6
Jordan	5.2	Jamaica	34.3	Panama	72.5	Jamaica	13.3
Sudan	5.2	Mauritius	33.4	Jordan	72.3	Cape Verde	13.2
Thailand	5.2	India	32.6	El Salvador	71.2	Congo, Rep. of	11.8
Bangladesh	5.0	South Africa	32.4	Bulgaria	70.9	Croatia	11.6
Panama	5.0	Morroco	31.2	South Africa	70.8	Thailand	11.6
Iran, Islamic Rep. of	5.0	Sri Lanka	30.8	Vietnam	70.3	Uruguay	11.2
Mauritius	4.9	Kenya	29.8	Peru	69.5	Rwanda	11.0
Eritrea	4.9	Latvia	29.3	Guatemala	69.3	India	10.7
Syrian Arab Republic	4.9	Pakistan	29.2	Syrian Arab Republic	69.3	Jordan	10.5
Tunisia	4.9	Côte d'Ivoire	29.0	Jamaica	69.2	Bulgaria	10.2
Sri Lanka	4.9	Brazil	28.6	Uruguay	69.1	Vietnam	9.9
Indonesia	4.8	Poland	27.4	Gabon	69.1	Romania	9.7
Costa Rica	4.7	China	26.8	Iran, Islamic Rep. of	69.0	Cambodia	9.3
Trinidad and Tobago	4.5	Philippines	26.8	Philippines	68.9	Ghana	9.0
Ghana	4.5	Turkey	26.5	Algeria	68.8	Tanzania	8.9
Benin	4.5	Oman	23.7	Ukraine	68.6	Sierra Leone	8.3
Tanzania	4.4	Tunisia	23.5	Azerbaijan	68.4	Barbados	7.9
Mali	4.4	Croatia	23.4	Egypt, Arab Rep. of	68.4	Dominica	7.8
Egypt, Arab Rep. of	4.4	Nigeria	22.9	India	68.1	Papua New Guinea	7.8
Mauritania	4.4	Lithuania	21.8	Romania	67.9	Nepal	7.7
Nepal	4.3	Bahamas	18.0	Dominican Republic	67.9	Nigeria	7.7
Turkey	4.3	Chile	17.7	Gambia, The	67.5	Philippines	7.4
Pakistan	4.3	Namibia	17.4	Bolivia	66.9	Pakistan	7.0
Dominican Republic	4.2	Malaysia	11.6	Brazil	66.8	Grenada	6.7
Burkina Faso	4.0	Trinidad and Tobago	9.3	Yemen, Rep. of	66.7	Paraguay	6.6
Oman	4.0	Ghana	4.4	Mongolia	66.2	Mongolia	6.3
Nigeria	3.9	Thailand	−2.9	Albania	66.2	Angola	6.2
El Salvador	3.9			Argentina	65.8	Sudan	6.0
St. Kitts and Nevis	3.8			Papua New Guinea	64.6	St. Vincent and the Grenadines	5.8
Angola	3.7			Senegal	64.6	Cameroon	5.6
Guinea	3.7			Belarus	64.5	Senegal	5.5
Senegal	3.6			Cameroon	64.3	Mongolia	6.3

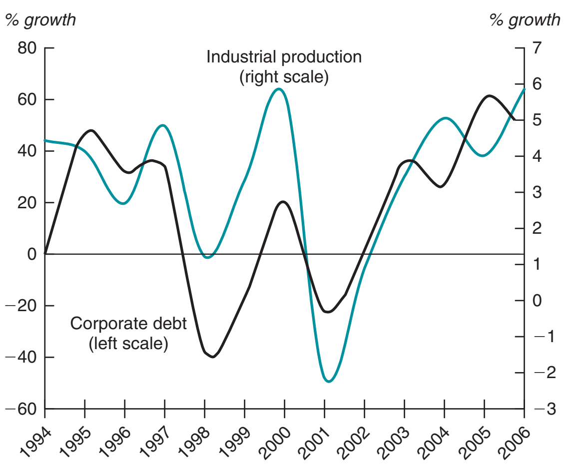
Sources: World Bank (various years) and World Bank staff estimates.
a. Average historical growth rate, 1990–2005, based on *WDI*.
b. Based on data from Bloomberg.
c. International Country Risk Guide (ICRG).
d. IMF *IFS*.

Table 3.3 Foreign debt contracted by developing-country corporations, 1999–2006
$ billions

	1999	2000	2001	2002	2003	2004	2005	2006
Total	91.86	110.29	86.83	87.54	117.58	147.96	237.59	332.92
By instrument								
Bond	19.20	14.78	19.03	21.67	35.95	41.38	65.93	87.70
Bank lending	72.66	95.51	67.80	65.87	81.63	106.58	171.66	245.22
By region								
Latin America and the Caribbean	46.17	54.23	46.87	25.89	36.58	43.45	54.16	86.07
East Asia and Pacific	15.85	20.87	11.38	28.76	31.15	24.80	47.34	47.36
Europe and Central Asia	14.31	22.25	16.10	20.83	28.71	50.55	92.43	134.92
Sub-Saharan Africa	5.52	5.41	6.38	5.13	11.14	9.78	13.69	24.71
Middle East and North Africa	3.42	3.51	2.68	1.92	3.91	7.70	14.54	10.71
South Asia	6.58	3.91	3.37	5.00	6.11	11.58	15.37	29.15
By ownership								
Public	24.73	29.56	25.14	33.21	44.81	50.34	66.35	71.76
Private	67.13	80.73	61.69	54.33	72.78	97.62	171.24	261.16
By sector								
Finance	17.09	23.15	19.94	15.55	20.03	40.99	64.11	102.31
Oil and gas	14.42	25.91	21.92	23.40	30.09	32.47	57.46	54.70
Telecommunications	17.39	17.93	11.38	8.85	9.19	15.33	19.22	31.93
Energy/utilities	16.57	16.66	9.66	11.05	19.52	11.37	14.89	15.92
Construction/building/metal and steel	4.18	5.70	5.08	3.51	6.60	11.73	22.37	35.71
Mining	2.58	2.70	2.88	1.78	2.38	7.04	7.11	7.67
Others	19.62	18.24	15.97	23.41	29.78	29.03	52.43	84.68

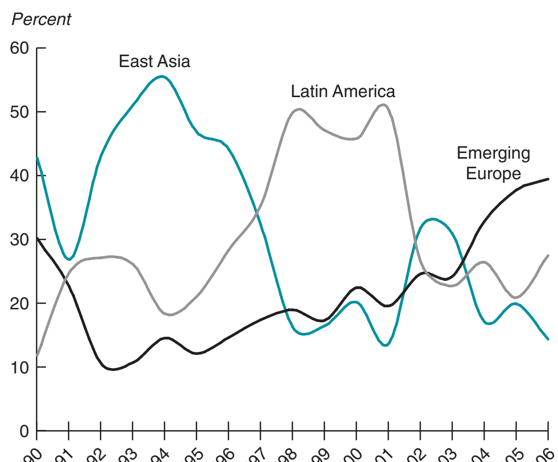
Source: World Bank staff estimates based on Dealogic Loanware and Bondware.

Figure 3.3 Trends in corporate debt and industrial production, 1994–2006



Source: World Bank staff estimates based on data from Dealogic Bondware and Loanware.

Figure 3.4 Foreign borrowing by companies from emerging-market countries, by region, 1990–2006



Source: World Bank staff estimates based on data from Dealogic.

and 1996 (figure 3.4). Most of the financing was in the telecommunication and power sectors. As economic and financial pressures grew in Latin America during 2002 and 2003, corporate borrowing in East Asia picked up, both in absolute terms and as a share of the developing-country total. Since 2003 borrowing has been dominated by companies from emerging Europe, which now account for 39 percent of total foreign borrowing by developing-country firms, up from 19 percent during 1996–2003. Oil and gas and banking were the major destinations of financing.

The financing trends depicted in figures 3.3 and 3.4 followed in part the waves of privatization

Table 3.4 International borrowing by banks in 10 middle-income countries, 2004–06

	Syndicated bank borrowing ($ millions)	Bond issuance ($ millions)	Total borrowing ($ millions)	% of total borrowing	Total borrowing as share of GDP (percent)	Number of banks
Russian Federation	17,029	13,932	30,961	26.3	0.9	51
Turkey	24,014	637	24,651	21.0	2.5	19
Kazakhstan	6,036	3,120	9,156	7.8	5.2	11
India	6,637	1,580	8,217	7.0	0.3	20
Brazil	4,106	3,718	7,824	6.7	0.4	27
Hungary	1,944	4,871	6,815	5.8	1.6	6
Malaysia	3,145	1,475	4,620	3.9	1.0	9
South Africa	3,435	0	3,435	2.9	0.3	6
Chile	2,396	200	2,596	2.2	1.0	8
Romania	1,441	585	2,027	1.7	1.1	4
Total	**70,184**	**30,119**	**100,301**	**85.3**	**0.9**	**161**
All middle-income countries	**83,539**	**34,110**	**117,649**	**100.0**	**0.4**	**295**

Source: World Bank staff calculations based on data from Dealogic Loanware and Bondware.
Note: Ratio of total borrowing to GDP is based on 2004 and 2005 data. It is calculated by dividing the sum of total borrowing in 2004 and 2005 by the sum of GDP in 2004 and 2005.

and private participation in infrastructure in the 1990s and the powerful impact of the European Union on the growth prospects, financing needs, and internationalization of the corporate sector in emerging Europe and Central Asia. Borrowing by banks in Russia and Turkey (which together accounted for just under half of external borrowing by developing-country banks in 2004–06) was more than five times greater than their external borrowing during the 1995–97 surge. As a share of GDP, external borrowing by Kazakhstan's banks was even greater, averaging more than 5 percent of GDP in 2004–06. By contrast, the substantial external borrowing by banks in Brazil and India did not reach 0.5 percent of GDP (table 3.4).

One important feature distinguish firms raising capital in overseas markets from their peers staying at home is firm size. Whether measured by asset size or sales volume, the companies tapping international bond and syndicated loan markets are local leaders. They tend to be larger than their peers by several orders of magnitude: ten times larger, on average, in assets, seven times larger in sales. The difference is statistically significant even after the effect of country size on company size is factored in (box 3.1).

Emerging-market corporations have become substantial bond issuers

The opening of the global corporate bond market to a growing number of private and public companies from Asia, emerging Europe, and Latin America epitomizes the structural change under way in emerging-market finance. By any measure—the volume of new issues, market size, liquidity, distribution, or appeal to a broad range of global investors—interest in bonds issued by firms from emerging-market countries has increased in recent years, embracing issuers with varied credit ratings from the financial, industrial, and infrastructure sectors in many different countries.

Having risen from a modest $2.3 billion in 1990 to $87.7 billion in 2006, corporate bond issuance from emerging economies now greatly exceeds sovereign issuance, in both volume and number of offerings (figures 3.5 and 3.6). The average size of issues rose from about $110 million in the early 1990s to $222 million in 2006. In recent years several companies have floated issues of a size once reserved for sovereign nationals, supranational agencies, and highly rated companies from industrial countries. Larger issues tend to be more liquid, which, in turn, facilitates trading and risk management, further increasing demand.

Bond features have also evolved. Subordinated debt (issued particularly by banks for capital adequacy reasons) is increasingly accepted. There is also less emphasis on negative-pledge clauses in bond covenants, more frequent inclusion of call or put provisions, and fewer third-party guarantees of the issuing company (by a parent company or the government, for example).

Narrower credit spreads are another sign of bond market maturation. Emerging-market

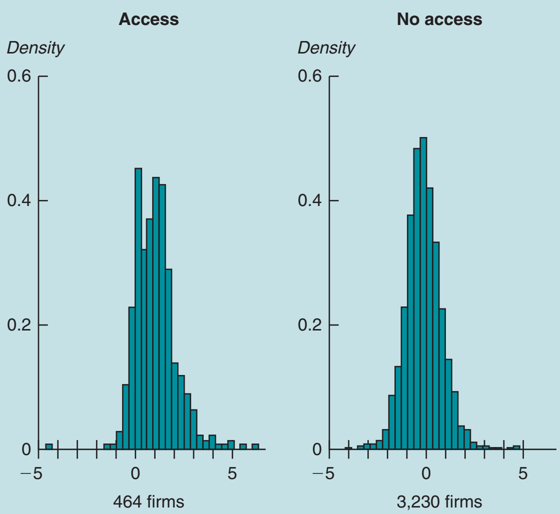
Box 3.1 A profile of developing-country companies that access global financial markets

Among firms based in developing countries, what distinguishes those that borrow in international debt markets? To assess the differences between the "access group" and the "no access group," several leading databases (Dealogic Bondware, Loanware, and Worldscope) were mined for information on their capital structure and borrowing characteristics. One distinguishing characteristic stands out as statistically significant: firm size.

Firms that borrow abroad are significantly larger than those that do not. The differences in total assets and sales are statistically significant according to t-tests for the equality of firm size (measured in millions of U.S. dollars for all firms in the sample). Plotting the frequency distributions of normalized logarithms of size, as shown in the figure below, confirms the finding.

The table below shows the median asset size of firms in 11 countries. The results confirm that firms that borrow abroad are significantly larger than those that raise all of their financing domestically.

Distribution of size of emerging-market corporations that have accessed international debt markets versus those that have not[a]



Source: World Bank staff estimates based on data from Dealogic Bondware, Loanware, and Worldscope.

a. Given the potential for heteroskedasticity, two subsamples were first normalized by subtracting from the natural logarithm of a firm's total assets the logarithm of its home-country mean and dividing the difference by the home country's standard deviation.

Asset size of emerging-market-based corporations based on access to international debt markets

$ millions

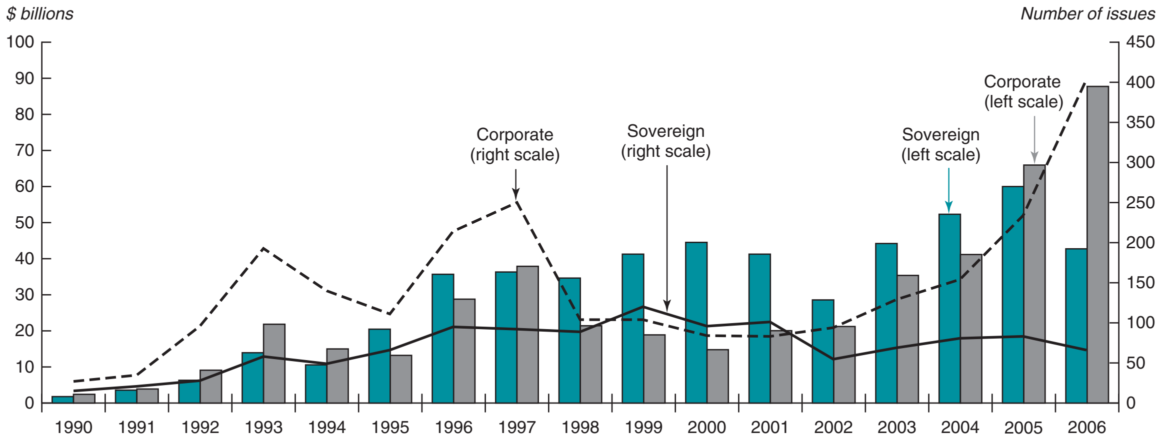
Country	No access	Access
Argentina	78	915
Brazil	466	2,407
Chile	118	1,341
China	180	1,712
India	147	3,143
Indonesia	86	467
Malaysia	54	586
Mexico	344	2,308
Philippines	35	924
Thailand	55	503
Turkey	171	3,102
Number of firms	**3,230**	**464**

Source: World Bank staff estimates based on data from Dealogic Bondware, Loanware, and Worldscope.

corporate bonds carried spreads over comparable U.S. Treasury securities of about 452 basis points in 1999. The average spread narrowed to about 349 basis points in 2006, despite a significant spike in 1997–98 during the East Asian and Russian financial crises (figure 3.7). The narrowing of spreads for investment-grade corporate borrowers (BBB and higher) has driven the overall drop. This effect does not reflect an increase in average credit quality, because the average rating has been consistently in the BB range on the Standard & Poor's scale (Ba2 on the Moody's scale). Spreads for the high-yield segment of the market remain relatively high. Access to international capital markets is more challenging for emerging-market corporate entities than for emerging-market sovereigns because of the higher information barriers and greater market constraints facing corporations (box 3.2).

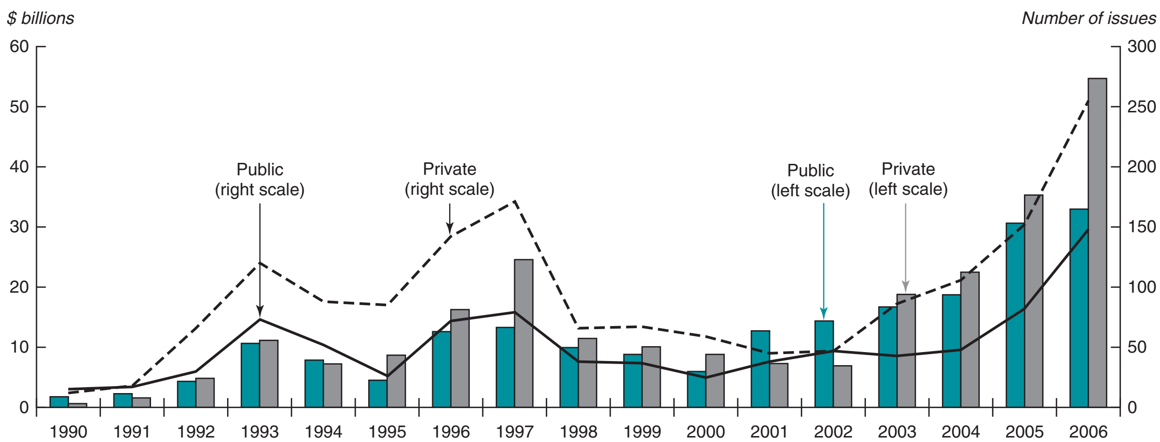
The segments of the global bond markets that best cater to the debt-financing needs of developing-country corporate issuers are the Eurobond market and the foreign U.S. dollar bond market, known as the Yankee 144A market. The

Figure 3.5 International bond issuance by sovereign governments and corporations, 1990–2006



Source: World Bank staff estimates based on data from Dealogic Bondware.

Figure 3.6 International bond issuance by public and private corporations, 1990–2006



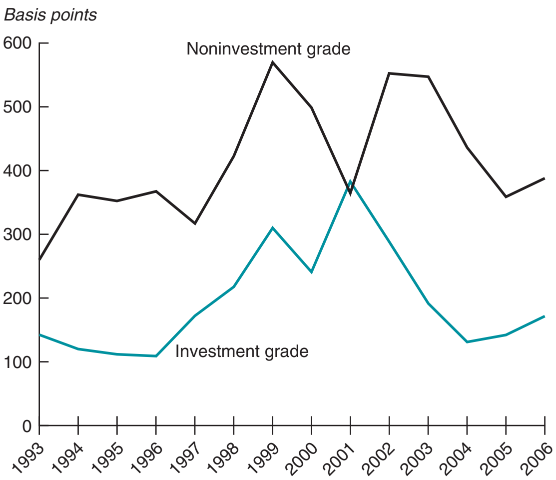
Source: World Bank staff estimates based on data from Dealogic Bondware.

yen-denominated Samurai market has been less appealing to developing-country issuers, except Hungarian and Polish companies, which have been regular issuers in recent years.

Many emerging-market firms have chosen to raise their capital in U.S. markets, where institutional investors (pension funds, insurance companies, and mutual funds) had $24.17 trillion under management at the end of 2004. Firms targeting the U.S. market have opted overwhelmingly to issue under Rule 144A, a federal rule defining a market in which securities are privately placed with qualified institutional investors. Introduced by the U.S. Securities and Exchange Commission in 1990, Rule 144A exempts foreign issuers from certain U.S. disclosure and distribution regulations, including SEC registration and liability under the 1993 Securities Act (Committee on Capital Markets Regulation 2006).

The Eurobond market's flexibility to accommodate both the issuer's choice of currency of denomination and of governing law (British or New York) has been an attractive feature of that market, as is the fact that Eurobonds are not taxed. Their flexibility is of particular relevance to emerging-market issuers domiciled in countries

Figure 3.7 Average spread of emerging-market corporate bonds against U.S. Treasury bonds, by grade, 1993–2006



Source: World Bank staff estimates based on data from Dealogic Bondware.

with different degrees of financial and trade linkages with the major economic poles of Asia, Europe, and the United States. International corporate bonds from emerging economies that have arrived on the market in recent years have increasingly been in the form of combined Eurobond and 144A issues floated in London and New York. Issuing simultaneously in both markets maximizes both investor demand and liquidity in secondary trading, because both tranches become fungible after three months. The significant regulatory differences between Eurobond and 144A markets imply different approaches to the primary distribution of debt securities in registration, disclosure, and possible listing on a major stock exchange.

Euro-denominated international bond issues by emerging-market firms took off in 1998, once the common European currency became a certainty and investors began to switch from other European currencies into the euro. Total issuance grew from $720 million in 1998 to about $15.3 billion in 2006. Euro-denominated issues tend to be somewhat larger on average than similar dollar-denominated bonds (about $250 million versus $200 million in recent years), with similar credit quality at issuance. These issues had been in the BB range but have lately risen to investment grade. The increase in credit quality reflects the preponderance of Eastern European issuers in this segment, whose ratings have risen with those of their countries of origin. As a result, spreads have been typically tighter in the euro segment (84 basis points in 2004 and 141 points in 2005) than in the dollar segment. Average maturities have been comparable.

Credit derivative instruments are finding new applications in connection with emerging-market corporate debt

The growth of emerging-market corporate debt has spawned new applications for credit default swaps (CDSs). As investor demand for emerging-market corporate credit has increased in recent years, trading in CDSs on selected emerging-market reference obligations—primarily well-established companies from Brazil, Mexico, Russia, and Turkey—has expanded, providing a mechanism for transferring risk from banks to capital markets. This new application of credit derivatives to emerging-market debt complements their growing role in the sovereign segment of the market, highlighted in *Global Development Finance 2006*.

As in the case of the sovereign CDS market, emerging-market corporate CDSs are marketed to global investors, particularly hedge funds and insurance companies, that wish to increase their exposure in emerging markets without having to invest directly in the underlying assets. Such investors function, in essence, as sellers of credit protection to other investors and to banks seeking to hedge their credit exposures against specific risks, such as default or a credit downgrade. The market operates on the basis of a contract between the seller and the buyer of protection. The understanding is that the seller will compensate the buyer for specified credit risks in return for periodic premium payments over the term of the contract. The price of a CDS, typically given as a basis point spread, is determined by the demand for and supply of protection against the credit risk of the underlying reference obligation. A widening of CDS spreads is a sign of the market's increasing concern about the reference company's credit quality; a tightening implies market participants' expectation that the company's credit status is improving.

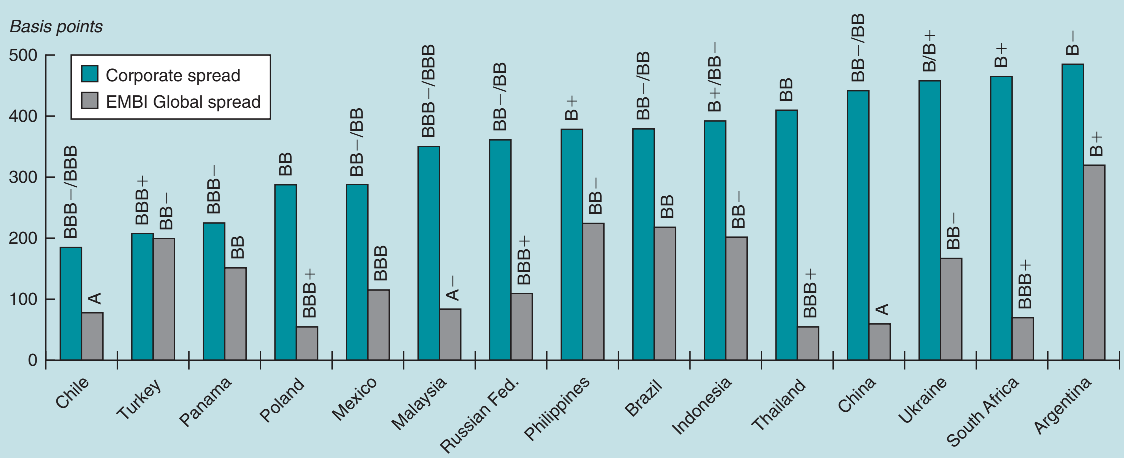
The fastest-growing segment of global derivatives, today's market for CDSs on corporate debt covers an estimated 3,000 firms worldwide. The market has expanded exponentially in recent years,

Box 3.2 The relationship between emerging-market sovereign and corporate bond spreads

Reflecting the influence of several factors, corporate bond spreads tend to be higher than sovereign spreads (see figure below). First, corporate entities face higher information barriers and greater market constraints than do sovereigns. Governments derive advantages from membership in multilateral financial institutions and from the state-centric nature of the international economic order. By contrast, developing-country firms, particularly private ones, stand or fall on their own financial performance, track record, and growth potential.

Second, even locally creditworthy firms may be constrained, for several reasons. Corporate ratings are often subject to sovereign ceilings. Corporate assets are not easily amenable to collateralization in international debt markets. Covenants written into corporate debt documents tend to be more confining than those that apply to sovereign debt. And swap markets for credit derivatives are better developed and more liquid for emerging sovereign names than for corporate names.

Corporate bond spreads vs. EMBI Global sovereign spreads for selected countries, 2006–07



Source: World Bank staff calculations based on Bondware and JPMorgan EMBI Global.
Note: Ratings shown above bars are those of Standard & Poor's.

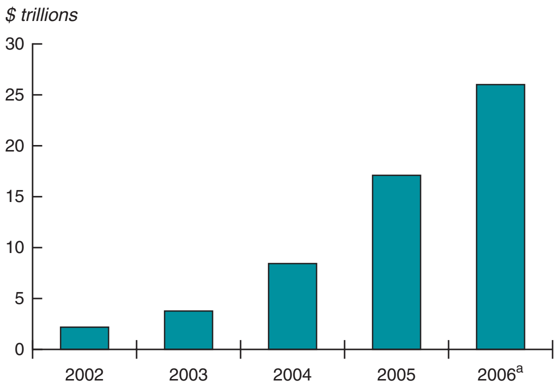
with the notional global value of traded CDSs increasing from $2.2 trillion in 2002 to $26 trillion in 2006 (figure 3.8).

The expansion of trade in CDSs supports the financing efforts of large companies in emerging markets by enabling banks to expand their offering of bilateral or syndicated loans while sharing their credit risk exposure with the rest of the market. CDS spreads provide useful information about the market's assessment of the credit risk of the reference obligations, often moving in tandem with cash bond spreads. And, like cash bond spreads, CDS spreads on blue chip emerging-market companies have been range bound over the past year. After spiking in May–June 2006, they have hovered around 40–60 basis points, closely paralleling spreads on highly rated U.S. companies (figures 3.9 and 3.10).

Factors shaping corporate access to international finance

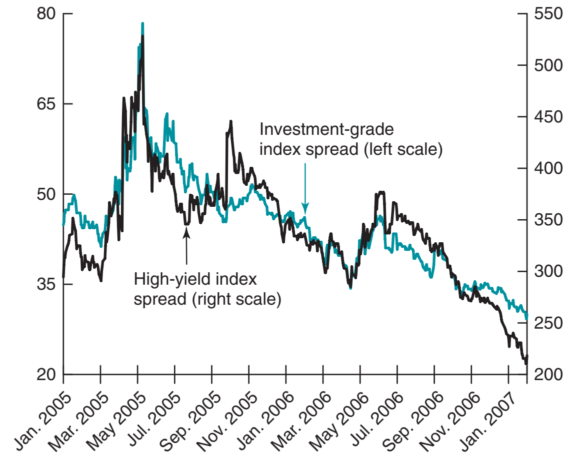
Firms do not enter the international capital markets by accident. They typically do so after a deliberate process of corporate remaking and long-term corporate financial planning. Once the choice is made, access to international capital markets helps the company diversify its source of funds,

Figure 3.8 Notional value of global credit default swaps, 2002–06



Source: International Swaps and Derivatives Association Market Survey, 1987–2006.
a. As of end-June 2006.

Figure 3.10 Spreads on U.S. credit derivative index, 2005–07

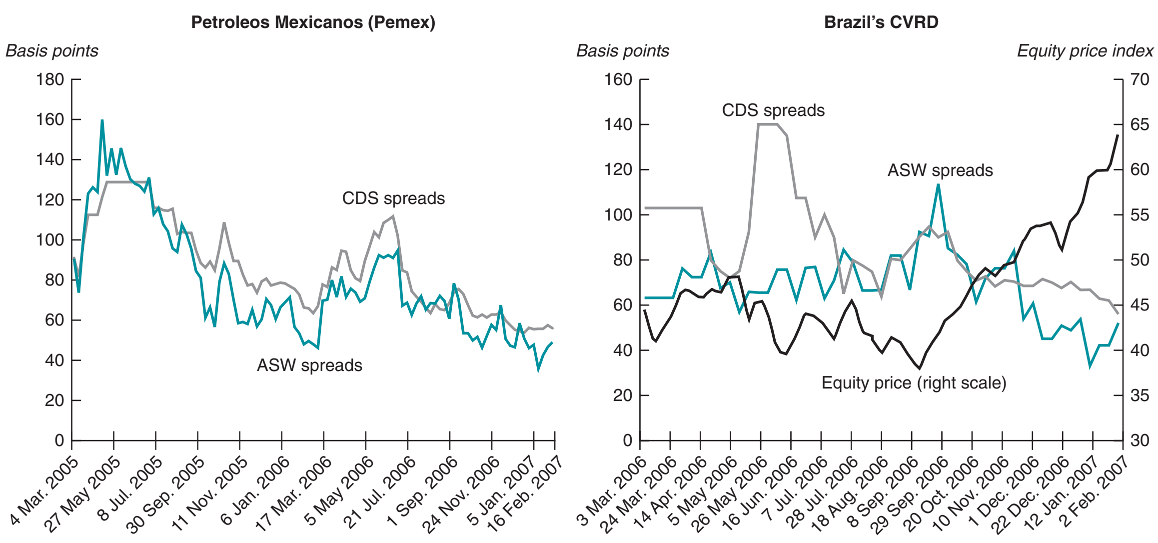


Source: World Bank staff estimates based on JPMorgan Chase.

improve risk management through more sophisticated financing instruments, borrow at longer maturities, gain international visibility, and possibly reduce the cost of capital. Accessing foreign capital markets helps firms reduce dependence on small local capital markets while exposing them to higher standards of accounting, reporting, disclosure, and corporate governance (Coffee 1999, 2002; Stulz 1999; Reese and Weisbach 2002).[2]

Among the developing-country firms that have entered the international capital markets are major global players that have amassed sufficient capital and know-how to contemplate expanding their presence in global markets through investment or M&A. Cemex, for example, is the leading cement company in Mexico; CVRD is Brazil's fourth-largest mining company. Tata Consultancy, Infosys Technologies, and Wipro are among the top Indian providers of business services. In the utilities sector, UES of Russia is ranked 13th. Other nonfinancial corporations in developing countries are major investors in certain countries or regions. Thailand's CP Group, for example, is

Figure 3.9 Five-year spreads on CDSs and ASWs



Source: World Bank (various years) and World Bank staff estimates.
Note: ASW = asset swap.

said to be the largest single foreign investor in China, and América Movil is the largest telecommunications company in Latin America.[3]

These firms increasingly invest in other countries to leverage their advantages and to acquire strategic assets, commonly through M&A. Multinational companies based in developing countries made more than 700 cross-border M&A purchases in 2006, up from just 11 such deals in 1987. These developments have put some of these companies on par with large companies from developed countries (box 3.3).

Box 3.3 Globalization and the growth of transnational companies in the developing world

The rise of developing countries' multinational corporations over the past decade reflects the impact of globalization, including the liberalization of trade and foreign investment flows, the falling cost of transportation and communication, and increased demand for product diversity. As many developing-country governments have eased their policies toward capital outflows, their companies have expanded their operations abroad. Developing countries now boast 15,000 multinational corporations. The foreign assets of the top 50 nonfinancial multinational corporations reached $200 billion in 2006, representing nearly a third of the total assets of all developing country–based multinationals (see table below). These companies employ almost 500,000 people, 16 percent of whom are based abroad. Foreign sales account for some 40 percent of total sales.

Globalization of production and sales may boost growth, as foreign markets provide additional sources of demand, enable firms to capture economies of scale, increase access to finance, and introduce firms to more-efficient technologies and management practices. Most companies in a survey of 200 outward investors from emerging Europe and Central Asia increased exports and improved their financial performance (Sevtlicic and Rojec 2003). In India outward investment enhanced the export performance of small and medium-size manufacturing enterprises compared with those that did not invest abroad (Pradhan 2005). A survey of Chinese multinational corporations indicates that their foreign operations tend to be more profitable than their domestic operations (Yao and He 2005). The 150 largest developing-country multinationals have achieved more rapid growth in assets and sales than domestic economies, although performance varies across countries (see figures on next page).

Firms may invest abroad by acquiring, often through M&A, technology, brands, and distribution networks—a

Industry position of selected southern transnational corporations, 2006

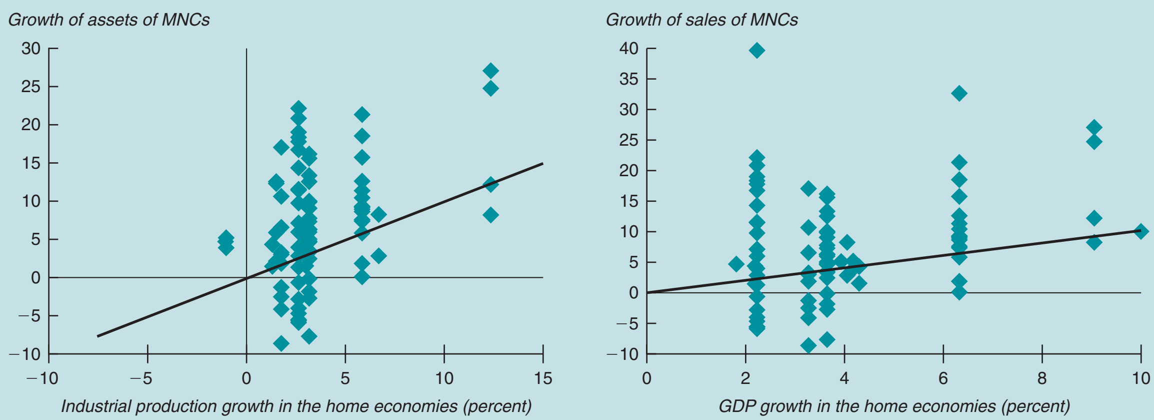
Company	Country	Industry	Rank in the industry	Sales ($ billions)	Profits ($ billions)	Assets ($ billions)	Market value ($ billions)
Embraer	Brazil	Aerospace and defense	14	3.85	0.47	5.23	7.26
ICBC	China	Banking	2	—	—	—	251.10
Tata Consultancy Services	India	Business services	5	2.23	0.45	1.21	18.34
Infosys Technologies	India	Business services	6	1.63	0.43	1.54	17.50
Wipro	India	Business services	9	1.87	0.37	1.64	16.66
Cemex	Mexico	Construction	1	15.33	2.11	26.44	23.82
Orascom Construction	Egypt, Arab Rep. of	Construction	23	1.41	0.18	2.10	8.11
Siam Cement	Thailand	Construction	27	4.95	0.94	6.63	7.42
CVRD	Brazil	Materials	4	10.37	2.43	15.97	53.22
China Shenhua Energy	China	Materials	5	4.74	1.08	13.18	27.51
Norilsk Nickel	Russian Fed.	Materials	17	7.29	1.90	13.63	17.81
Novolipetsk Steel	Russian Fed.	Materials	27	4.70	1.84	5.17	12.05
Gazprom	Russian Fed.	Oil and gas operations	4	36.47	7.24	104.56	184.37
PetroChina	China	Oil and gas operations	5	46.95	12.43	73.68	172.23
Petrobras-Petróleo Brasil	Brazil	Oil and gas operations	9	58.43	10.15	76.64	99.82
China Telecom	China	Telecommunications	15	19.47	3.39	48.53	29.73
América Telecom	Mexico	Telecommunications	22	17.17	1.11	22.85	20.13
UES of Russia	Russian Fed.	Utilities	13	24.52	1.15	40.45	28.00
+NTPC	India	Utilities	19	5.38	1.33	15.45	24.36

Source: Forbes Global 2000 list.
Note: — = not available.

Box 3.3 (*continued*)

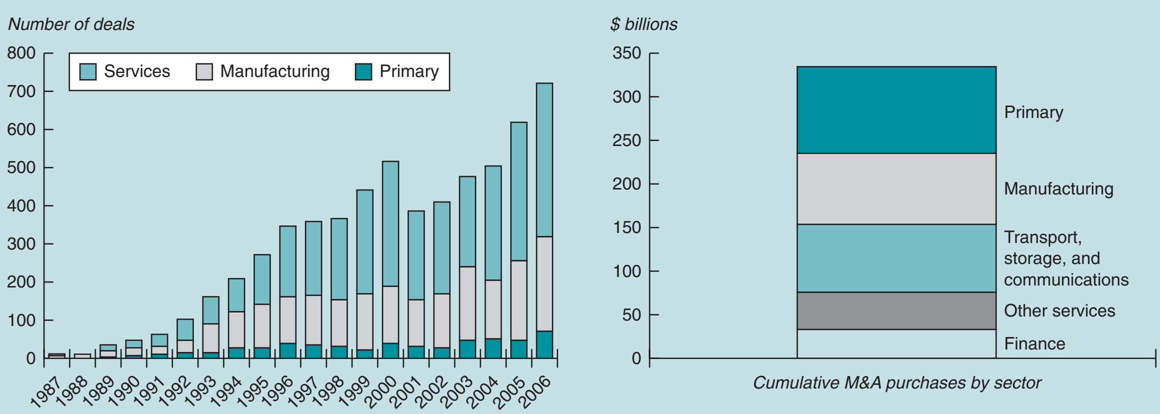
strategy known as *asset-augmentation*. As rapid advances in technology and globalization quickly erode comparative advantages, companies look to takeovers as a path to growth. Recent mega-deals by Cemex and CVRD, as well as the $1.75 billion purchase of IBM's personal computer division by China's Lenovo, are examples of asset-augmenting expansion. Cross-border M&A purchases by developing-country multinationals increased from $400 million in 1987 (when they made up less than 1 percent of global M&A transactions) to almost $100 billion in 2006 (almost 9 percent of global M&A transactions). The services sector accounted for almost half of the $350 billion in M&A purchases between 1987 and 2006 (see figures below).

Growth performance of southern MNCs vis-à-vis their home economies, 1995–2005



Source: World Bank staff calculations based on Worldscope and World Bank databases.

Cross-border mergers and acquisitions by developing-country firms, 1987–2006

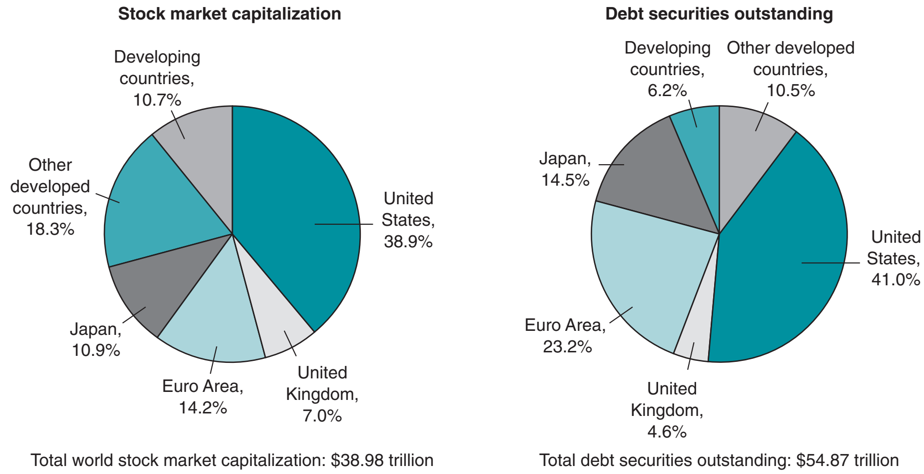


Source: UNCTAD data on cross-border M&As prepared for the World Bank.

The global financial environment consists of competing financial centers and jurisdictions that operate under different national regulatory regimes, accounting standards, and market practices. The United States is by far the largest capital market, accounting for about 40 percent of global equity and debt capital, followed by the euro area, the United Kingdom, and Japan (figure 3.11).

National (and regional) markets differ not only in the rules governing issuance of securities

Figure 3.11 Distribution of global debt and equity capital, 2005



Source: World Bank (various years) and World Bank staff estimates.

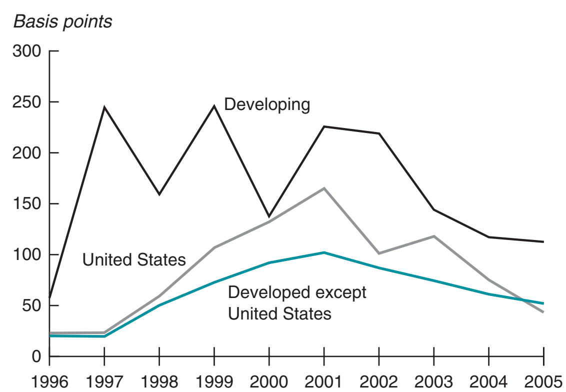
but also in their "home bias," which occurs when investors give too much weight to home securities in their investment choices. Despite significant progress in recent years in the transmission of information across global capital markets (Eun and Shim 1989; Kim 2003; Wongswan 2006), home bias remains an important phenomenon. Recent research suggests that Japan and Spain have the highest home bias in equity markets (88 percent in Japan, 80 percent in Spain), while Canada and the United States have the highest home bias in fixed-income markets (93 percent in Canada, 92 percent in the United States).

Emerging-market companies' engagement in international capital markets has been driven by two structural forces: (a) growing demand from investors seeking higher yields and investment diversification and (b) companies' increasing participation in international business transactions. But a variety of competitive disadvantages and institutional, informational, and economic obstacles continue to hamper emerging-market companies in their ability to access such markets. These include the following:

- high information barriers, which prevent market participants and analysts from developing well-informed views on a company's credit quality and growth potential;
- undeveloped or poorly defined standards of corporate governance, accounting standards, and transparency, which raise the agency costs of raising capital abroad;
- partially closed capital accounts and managed exchange rates, which introduce uncertainty about the flow of funds;
- the vulnerability of corporate earnings and valuations to the local business cycle and associated policy risks; and
- country risk, which may cause investors to require greater risk premiums from companies operating within the country's jurisdiction.

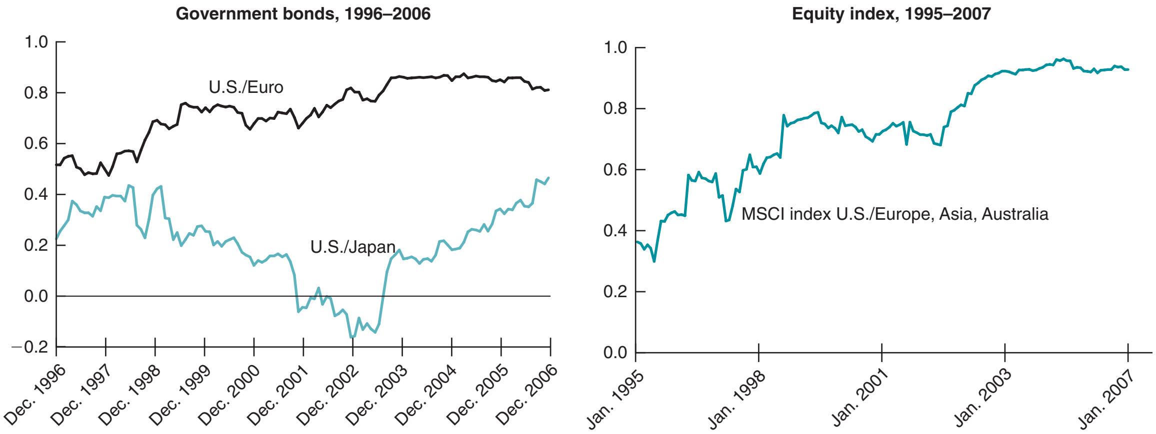
The practical result of these obstacles and disadvantages is an additional financing cost for emerging-market companies, one not borne by their competitors from developed countries (figure 3.12).

Figure 3.12 Spreads on investment-grade corporate bonds from developing and developed countries, 1996–2005



Source: World Bank staff calculations based on data from Dealogic Bondware.

Figure 3.13 Correlation in mature debt and equity markets



Source: World Bank staff calculations of 36-month rolling correlation based on Bloomberg and Morgan Stanley MSCI Barra.

Business cycles in the industrial countries have converged in recent years, and volatility has declined

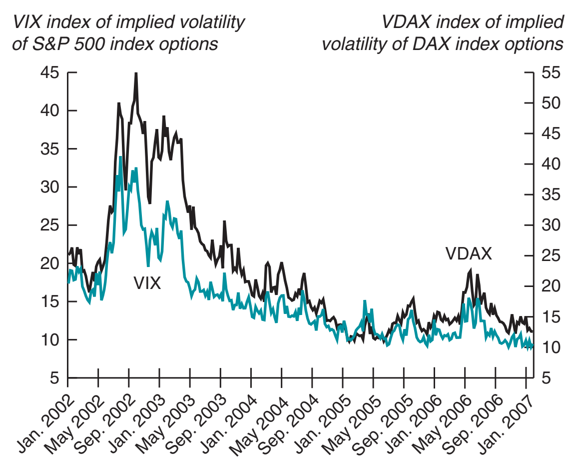
The benefits investors obtain by diversifying across assets and markets in the major developed countries have diminished in recent years, as business cycles have tended to converge, financial volatility has decreased, and rapid transmission of information across markets has consolidated market linkages and integration. The combined impact of these developments has been greater co-movement in national stock and bond markets (figure 3.13).

Along with a generalized moderation of volatility of economic activity, the secular trend toward convergence of business cycles in the G-7 countries has been a defining feature of the macroeconomic landscape in recent years. The "great moderation" of the U.S. economy, in particular, has received a great deal of academic and policy attention (Summers 2005; Kahn, McConnell, and Perez-Quiros 2002; Kim and Nelson 1999). Several factors appear to be at play, including the adoption by major central banks of a uniform approach to the conduct of monetary policy through inflation targeting and enhanced transparency and credibility; lower fiscal deficits in many countries; financial innovations, including risk-based loan pricing and securitization, which have made firms and households less sensitive to income fluctuations; and, in the case of Europe, the increased policy discipline associated with EU accession and the broader forces prompting regional integration.

The effect of convergence and moderation on the investment opportunities open to global investors is difficult to measure. It is possible to argue that the growth of the European Union has shrunk the set of investment opportunities in world equity markets, as intra–EU correlations of asset returns have declined. Improvements in monetary policy in major industrial countries have also played a role in advancing convergence in mature bond markets, as the greater predictability of central banks' policy intentions has stabilized inflation expectations and anchored national inflation rates around a narrow band of policy targets.

Financial volatility in mature markets has also declined in recent years (figure 3.14). Two of the key determinants of volatility—risk appetite among investors and macroeconomic stability—have

Figure 3.14 Volatility measures in mature equity markets, 2002–07



Source: JPMorgan Chase.

Table 3.5 Correlation of mature and developing stock market indexes
Monthly rate of return over 2000–06 period

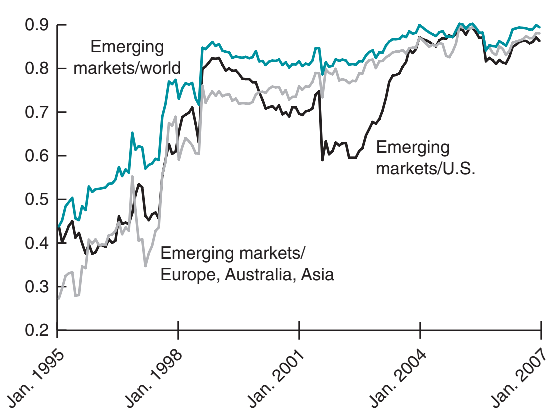
	United States	United Kingdom	Germany	Chile	Malaysia	China	India	Hungary	Russian Fed.	Mexico	Thailand	Brazil	South Africa
United States	1.00	0.85	0.75	0.37	0.22	0.02	0.39	0.39	0.33	0.55	0.41	0.58	0.52
United Kingdom		1.00	0.77	0.36	0.17	−0.06	0.46	0.45	0.38	0.58	0.37	0.55	0.57
Germany			1.00	0.35	0.37	0.17	0.42	0.43	0.29	0.56	0.22	0.54	0.50
Chile				1.00	0.43	0.02	0.33	0.40	0.21	0.28	0.40	0.39	0.35
Malaysia					1.00	0.13	0.32	0.36	0.23	0.34	0.22	0.27	0.22
China						1.00	0.05	0.03	0.18	0.04	−0.08	0.13	0.09
India							1.00	0.73	0.58	0.67	0.32	0.58	0.47
Hungary								1.00	0.61	0.66	0.29	0.63	0.44
Russian Fed.									1.00	0.67	0.33	0.60	0.41
Mexico										1.00	0.37	0.72	0.60
Thailand											1.00	0.49	0.62
Brazil												1.00	0.62
South Africa													1.00

Source: World Bank staff calculations based on data from Bloomberg.

improved with the sustained expansion of the world economy, growing global liquidity, better risk management techniques, and the expansion of markets in risk transfer.[4] Although correlation in stock market returns across mature markets is significantly higher than across emerging markets (table 3.5), correlation of equity returns between emerging and mature markets has increased in recent years (figure 3.15).

Significant recent advances in information and trading technology, the availability of high-frequency financial data, and greater technical capability for analyzing such data have increased the speed with which today's financial markets react to macroeconomic and political news. In the early 19th century, it took almost two months for changes in asset prices in New York, conveyed across the Atlantic in clipper ships, to have an impact in London. Today U.S. macroeconomic announcements are incorporated in German government bond yields and prices in a matter of minutes (Goldberg and Leonard 2003; Sylla, Wilson, and Wright 2005).

Figure 3.15 Correlation of equity returns in emerging markets and world markets, February 1992–January 2007



Source: World Bank staff estimates of 36-month rolling correlation of returns based on Morgan Stanley MSCI Barra.

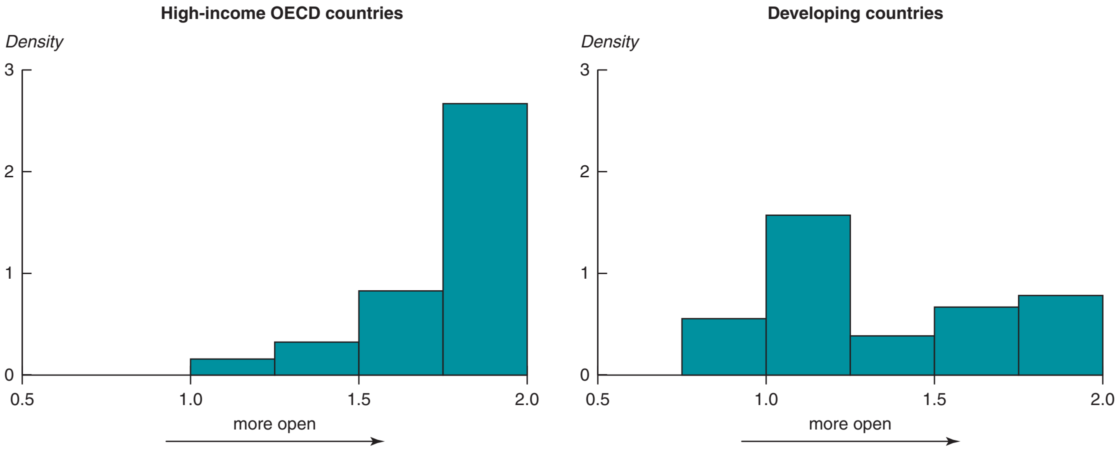
Corporate assets in emerging markets offer diversification and growth-potential gains

Business cycles in developing countries are weakly correlated with those of developed countries, and monetary policies are less weakly aligned across developing countries than across developed countries. There is thus considerable potential for gains from international diversification across developing-country corporate securities.

Despite a significant decline in inflation and a widespread acceleration of growth, developing-country macroeconomic conditions, business cycle dynamics, and growth prospects respond to global conditions in an amplified cyclical fashion. Their capital markets remain segmented, not only because of high informational barriers but also because of the official capital controls that remain in place in many developing countries, which restrict cross-border capital-account transactions (figure 3.16).

Economic, legal, and industrial structures often amplify diversification gains through the differential growth opportunities they offer local firms over the business cycle. As a result, and paradoxically, factors associated with market

Figure 3.16 Capital account openness in developed and developing countries



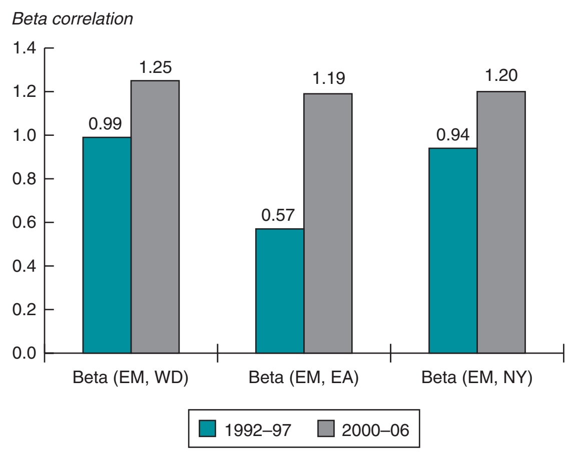
Source: World Bank staff calculations using methodology in Dailami (2000) and using data from IMF (various years).

segmentation may make emerging-market corporate bonds and equities more attractive to global investors. In recent years returns on emerging-market bonds and equities have been superior to comparable returns in mature markets; risks have also been higher. A comparison of the simple correlations between returns in selected developed and emerging equity markets over two periods confirms this observation (figure 3.17 and table 3.6). Repeating the same exercise for selected developed and emerging-market bond returns shows that market integration primarily affects developed-country bonds and that, in relative terms, emerging-market bonds still offer more opportunities for diversification.

Home-country growth prospects and institutional environment matter

Local economic and institutional factors in a firm's home country affect investors' perceptions through two channels. The first channel is corporate

Figure 3.17 Systematic movement of emerging-market equities with world markets



Source: World Bank staff estimates of beta based on returns from the Morgan Stanley MSCI Barra Index.

Note: EM = emerging markets MSCI; WD = MSCI world; EA = MSCI Europe-Australia-Asia; NY = NYSE composite.

Table 3.6 Segmentation of emerging-market equities from world markets

Correlation of selected market indexes, 1992–97 and 2000–06

	MSCI emerging markets		MSCI world		MSCI Europe-Asia-Australia		NYSE composite	
	1992–97	2000–06	1992–97	2000–06	1992–97	2000–06	1992–97	2000–06
MSCI emerging markets	1	1						
MSCI world	0.57	0.85	1	1				
MSCI Europe-Asia-Australia	0.43	0.84	0.92	0.96	1	1		
NYSE composite	0.48	0.75	0.76	0.94	0.46	0.86	1	1

Source: World Bank staff estimates based on data from Morgan Stanley MSCI Barra Index.

Box 3.4 Determinants of emerging corporate bond spreads

In pricing emerging-market corporate bonds, international investors take into account many factors, including the terms, structure, liquidity, origin, and credit risk and marketability of the issues. To analyze market risk perceptions and the importance of issue characteristics, Bank staff specified various linear models of the offerings' at-issue credit spread as a function of offering terms, rating, distribution, currency and jurisdiction, ownership, industry, and various economic, financial, and institutional control variables for each issuer's home country. The choice of specification follows the literature on reduced-form models of credit spreads (Elton and others 2001; Dailami and Hauswald 2003). The data consist of more than 1,200 corporate bonds (denominated in U.S. dollars or euros) issued by corporations from 34 emerging economies between 1990 and 2005. The importance of the various pricing factors and issue characteristics is gauged by their statistical significance. (The underlying methodology, econometric specification, and results are reported in the annex.)

This analysis yields several key findings:

- Because state-owned firms often carry an explicit or implicit government guarantee, their bonds are priced with lower spreads (about 45 basis points on average) than those of private companies from the same country. A third-party guarantee also decreases credit risk, lowering the at-issue spread by about 40 basis points.
- Pure Eurobonds offered only in London and Luxembourg tend to be price about 18–20 basis points higher than fully fungible global bond issues offered simultaneously in the United States, Europe, and Asia.
- Bonds with a U.S. tranche or pure 144A/Regulation S issues targeted at the U.S. institutional market tend to be priced 20–26 basis points higher than global bonds, making them about 2–6 basis points more expensive than comparable pure Eurobonds.
- Unrated bonds come to market at a price that is about 190 basis points higher than AAA–rated bonds. Each decrease in rating increases the at-issue spread of rated bonds by about 19 basis points. Unrated bonds are thus issued at prices that are about 10 notches below AAA.
- The country rating has a greater effect on investor perceptions than the issue rating. A one-notch decrease in the issuer's home-country rating increases the at-issue spread by about 28 basis points. In contrast, a similar decrease in the issue's own rating raises the cost of the issue by just 18 basis points.

Source: World Bank staff.

profitability and cash flow—and hence valuation. They are affected by local economic conditions, including both economywide and firm-specific factors. Systemic factors include the business cycle, aggregate growth performance, the tax regime, and interest rates. Important firm-specific factors include the firm's growth opportunities, the regulations to which it is subject, and the structure and quality of its management and governance. The second channel is the host country's legal, regulatory, and economic infrastructure, which affects the quality and reliability of a firm's disclosure and reporting policy, its transparency to local and foreign investors, and, more generally, the ability of shareholders and bondholders to exercise effective corporate oversight and contract enforcement. Foreign investors must incorporate all of these factors in their decisions.

Analysis of primary bond issuance by the emerging-market corporations that have tapped international capital markets since 1990 confirms the importance of local macroeconomic and institutional factors on corporate credit-risk premiums (box 3.4). Specific bond attributes and the jurisdiction in which bonds are issued and traded are also important factors.

The model results reported in the annex reveal that investors attach considerable importance to the prospects for economic growth in the home country of companies whose securities they are considering: a 1-percentage-point increase in real GDP growth reduces corporate bond spreads by about 7 basis points. But governments should not pursue growth policies at the price of inflation, which international investors clearly view in a negative light: inflation in the home country, which makes the issuer's domestic operations more risky, increases spreads by about five to six basis points.

Borrowers from countries with a well-developed stock market (one with high liquidity, as measured by the ratio of turnover to GDP) and banking system (as indicated by a high ratio of private credit to GDP) pay significantly less for their external debt. A 10-percentage-point increase in stock market turnover decreases at-issue spreads by 6–8 basis points, while a similar rise in private credit reduces spreads by 10–16 basis points. These results confirm anecdotal evidence and previous findings that local financial development significantly facilitates access to global capital markets for emerging-market firms (Caballero and Krishnamurthy 2003).

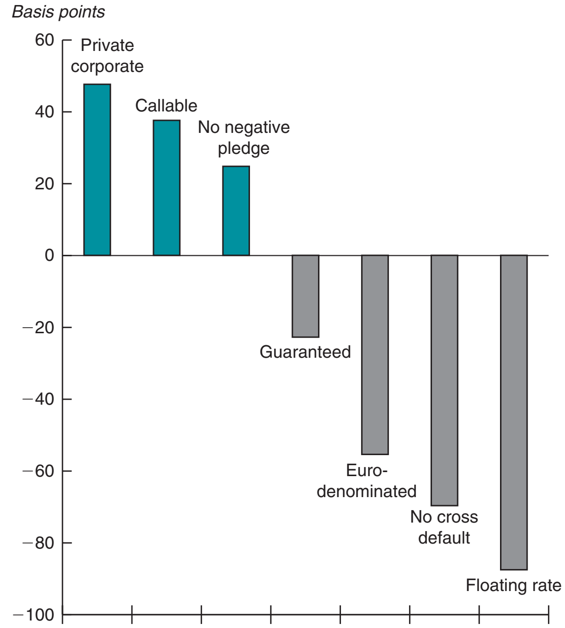
Using the indexes of the International Country Risk Guide to analyze the effect of the home country's economic, financial, and political institutions on the cost of borrowing reveals that a 10-percentage-point increase raises the home country's economic risk index by 52 basis points and its financial risk index by about 63 basis points. These findings add to the extensive empirical evidence suggesting that the quality of institutions is a crucial element underpinning economic and financial development.

Deal structure and security design can lower the cost of bond financing

Spreads on corporate bonds issued by companies based in the same country may show considerable variation. Such variations suggest ways to improve firms' terms of access to global capital markets. Larger offering sizes, for example, reduce the at-issue spread of emerging-market corporate bonds, because large deals offer greater liquidity in secondary trading. The corresponding reduction in spreads can be viewed as the premium investors are willing to pay for more-liquid issues.

Other attributes of issues also affect their cost (figure 3.18). By choosing variable-rate debt (float), issuers can reduce the spread by about 90 basis points, reflecting both the greater risk borne by the issuer and built-in reset provisions for the coupon triggered by covenant violations or rating downgrades. Such reset provisions partially compensate bondholders for increases in credit risk. Call provisions—that is, the ability of issuers to repay early, limiting their interest-rate exposure—increase credit spreads by about 35 basis points, the price of shifting interest-rate risk to bondholders. Euro-denominated issues are priced 55 basis points lower than comparable dollar-denominated issues.

Figure 3.18 Effect of selected characteristics of bond issues on at-issue spreads



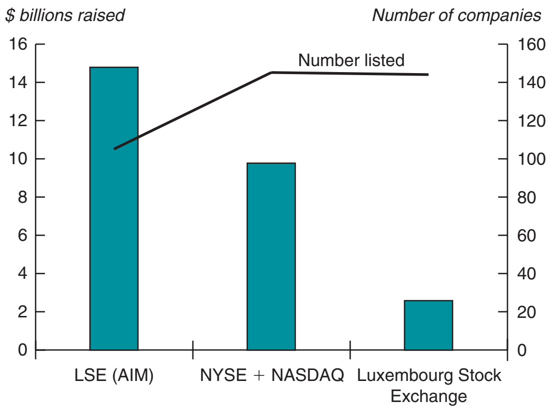
Source: World Bank staff estimates.

Covenant provisions also affect the price of a bond. The explicit exclusion of a negative pledge—a commitment not to grant future creditors better terms—that does not safeguard bondholders' standing in case of default increases a bond's riskiness, raising spreads by up to 25 basis points. The explicit exclusion of cross-default, so that default on another debt obligation does not trigger default on the bond in question, limits bondholders' credit exposure to one particular issue, for which borrowers are rewarded with a decrease in spreads of up to 70 basis points.

Corporate issuers have a choice of markets on which to offer their securities

The decision by emerging-market issuers to offer and sell securities in a particular jurisdiction involves balancing the associated transaction and agency costs with the benefits of liquidity, reputation, investor base, and longer-term business objectives. The main transaction costs are legal and investment banking fees, as well as the costs associated with complying with the jurisdiction's regulatory requirements and standards for disclosure, accounting, and reporting. Accounting standards and practices differ widely across countries, even across industrial countries.[5]

Figure 3.19 Number of listed companies and amount of equity raised on selected stock exchanges, 2006



Source: World Bank staff estimates based on NYSE, NASDAQ, and Luxembourg Stock Exchange data from the World Federation of Exchanges.

With the exception of Chinese corporations, most emerging-market companies have chosen the United States (NYSE and NASDAQ), London (LSE and AIM), or Luxembourg as their preferred destination for listing and offering their shares, raising $27.1 billion in equity capital on these markets in 2006 (figure 3.19). On the contrary, Chinese companies mostly preferred listing their issues on the Hong Kong (China) and Singapore stock exchanges. In 2006 they raised $38.4 billion on the Hong Kong exchange and $2.5 billion on the Singapore exchange, largely through mega-size initial pubic offerings (IPOs) placed by state-owned banks and companies. Proximity seems to have been a key factor in influencing firms' choice of location for listing and offering equity shares, with firms from Latin America migrating largely to the U.S. markets, Eastern European firms to London, and East Asian, particularly Chinese, firms to Hong Kong (China).

The choice of jurisdiction for a bond's underlying debt contract closely corresponds to the issue's type and location. Nearly all 144A offerings, and most issues including a 144A tranche, apply New York law. Issuers often specify a second local jurisdiction, either to satisfy domestic legal and regulatory requirements or because local courts are needed to enforce creditor rights over local assets pledged as security. Pure Eurobonds and some combined Euro-144A issues generally elect U.K. law and London courts. Although some bonds specify other jurisdictions, the preponderance of New York and U.K. law for international bonds stems as much from the substantive law offered by a given jurisdiction as the expertise of the courts that will interpret the debt contracts and the familiarity of lawyers with certain legal regimes.

More than 70 percent of bonds are listed, mainly on the Luxembourg stock exchange (77.1 percent of listed issues). Listing provides official prices for institutional investors, whose investment guidelines often require such marked-to-market valuation. Although Luxembourg has dominated all other markets as a listing location, the Swiss stock exchange has recently started to court international bond listings and cross-listings. However, almost all secondary trading in such issues takes place over the counter, because lead managers often provide liquidity services for up to 18 months (on average about 6 months) by keeping inventory. They act as de facto market makers in the issue.

Prospects and risks

For much of the postwar era, borrowing by governments has been the quintessential feature of financing for development. Having stood for decades at the center of national and international policy concerns, emerging-market sovereign finance has been the subject of a substantial stream of market practice, standards for credit-risk assessment, and international institutional arrangements for debt restructuring and dispute resolution.

The growing importance of cross-border borrowing on capital markets by emerging-market firms since the early years of this century has raised a new set of policy challenges for developing countries and the international economic community, including concerns about corporate foreign debt. Since the East Asian crisis, the majority of emerging-market economies developed more open capital accounts, improved their local capital markets, and significantly reduced their public external debt. Some, such as Argentina, Mexico, Brazil, and Russia, have abandoned fixed or crawling pegs and moved to flexible exchange rates, while new members of the European Union have pegged to the euro under the European Monetary System (ERM II) as part of their euro adoption plan. Such reforms have tended to shift the locus of currency and credit risk associated with external borrowing from the sovereign to the corporate sector, with important implications for the conduct of public policy.

The pace of globalization of corporations in the developing world is likely to intensify

Improved policies and favorable international economic conditions have allowed corporations based in developing countries to increase their engagement in global investment and finance, a process that is likely to continue over the medium term. The World Bank (2006b) projects that developing countries' share in global output will rise from about one-fifth to almost one-third by 2030 and that developing countries' exports will increase from less than 25 percent of their output to almost 35 percent. Rising incomes and higher export revenues will improve developing countries' creditworthiness, facilitating corporate access to international finance.

The growth of emerging-market multinationals will also support increased borrowing from capital markets. Greater participation by developing-country firms in overseas product markets is also likely to increase their ability to access overseas financial markets. Greater reliance on overseas markets for inputs and revenues will increase multinationals' incentives to diversify the currency composition of their balance sheets, which can be a more efficient approach to coping with exchange rate risk than purchasing derivatives.

Recent participation by emerging-market corporations in international capital markets may also help boost access by smaller corporate players. First-time borrowers can face high costs, because lenders must expend considerable resources in obtaining information. Once these initial expenses are absorbed, the marginal cost of making subsequent loans is lower, reducing financing costs for all borrowers.[6]

Other forces may also reduce firms' future borrowing on international capital markets. Rising incomes in developing countries are likely to be associated with more efficient domestic banking systems and capital markets, allowing firms to rely more on domestic sources of financing. In addition, demographic forces are set to increase savings rates in many developing countries while lowering those in industrial countries, possibly encouraging greater reliance on domestic finance (World Bank 2006b). The link between demographics and savings, and between savings and current-account balances, is uncertain, however. The recent surge in borrowing by developing countries, for example, has taken place in the context of a rising surplus in their current accounts.

The increasing access of developing-country firms to international capital markets over the medium term is likely to be interrupted from time to time, because the growing role of corporations in developing-country borrowing may increase the potential for sporadic crises. Corporations may, for example, borrow excessively, from the standpoint of the economy as a whole, because they do not take into consideration the overall indebtedness of their home country and its potential consequences for volatility in exchange rates and output. Meanwhile, governments have considerable difficulty monitoring corporate exposure, judging the degree of risk involved, and intervening effectively to resolve minor problems of corporate indebtedness before they become major ones. Thus while emerging-market corporations are likely to expand their reliance on international capital over the next few decades, the process could be subject to occasional sharp interruptions of a magnitude and duration that are impossible to predict.

Equally important in shaping the future course of globalization of corporate finance in emerging markets will be how the international community deals with and eventually accommodates internationally active firms. Policy and institutional responses to the East Asian financial crises of the late 1990s have highlighted the need for better risk management and transparency at both the corporate and national levels to avoid excessive corporate foreign borrowing and indebtedness. The market mechanisms, regulatory frameworks, institutional capabilities, and technical expertise needed to provide a safe and secure environment for overseas corporate securities offerings and listings are amply present in the world's major financial centers and jurisdictions. Untested is the ability of the international community to apply those mechanisms, frameworks, capabilities, and expertise in a manner that is well enough coordinated to provide stability to rapidly growing markets.

There is reason for optimism. The Yankee bond market (the foreign segment of the U.S. dollar bond market) came into existence in the early 1900s. The yen-denominated Samurai market was

Box 3.5 Foreign company listings on major financial centers continue to grow

The number of foreign companies listed on the world's major exchanges has increased over time, particularly since the 1980s. The trend reflects advances in trading technology, competition among exchanges, and companies' desire to list on major exchanges to boost international recognition and fund future M&A transactions.

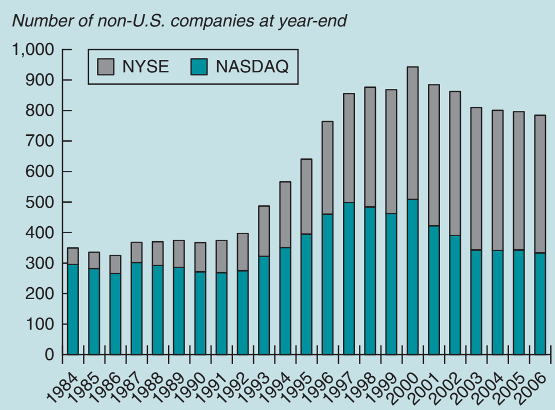
The number of foreign companies listed on the LSE increased from 387 in 1970 to 553 in December 1990 to 636 in December 2006 (figure below). The exchange's appeal and trading activity increased during the late 1980s, following the 1986 "Big Bang" deregulation, which abolished minimum commission charges for brokers and replaced the trading floor with a screen-based electronic trading system. In recent years, foreign firms have been drawn in particular to the LSE's Alternative Investment Market (AIM), a market for growing small-cap companies. Set up in 1995, AIM has less stringent regulatory and disclosure requirements than the main list. Transfers from the LSE main list have boosted the tally of listings on AIM.

Foreign companies listed on the LSE, 1966–2006

Source: LSE.

The number of foreign firms listed on the New York exchanges increased rapidly during the 1990s, before declining from 943 at the end of 2000 to 784 at the end of 2006 (figure at right). The recent decline largely reflects the impact of more demanding and stringent regulatory requirements and associated costs, as well as delistings of several Latin American firms and their return to home exchanges. The annual tally of foreign companies delisting American Depositary Receipts (ADRs) from the NYSE or the NASDAQ peaked for the 1990–2006 period at 53 in 2005, up from 38 in 2004. Nearly half (24) of the foreign companies delisting ADRs from these two exchanges in 2005 were of British origin; the largest number of delistings in this peak year by developing country-domiciled firms were of Mexican origin (7), followed by firms based in Chile (3).

Foreign companies listed on the NYSE and NASDAQ, 1984–2006



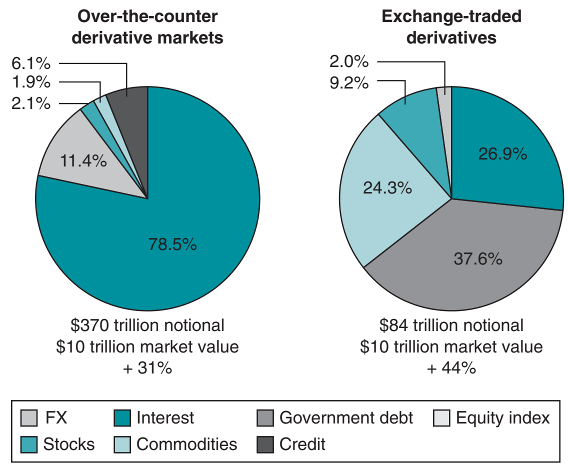
Source: NYSE.

created in the 1970s, as part of authorities' efforts to manage the large current account surpluses of the time. The Eurobond market has served as the world's most important source of bond capital to sovereign and corporate issuers from both developed and developing countries since 1963.[7] U.S. corporate securities were traded in the 1790s in markets on both sides of the Atlantic. And historically successive waves of privatization, liberalization, and growth spells in the world economy have kept a steady string of firms migrating to major financial centers to list their shares and raise capital (box 3.5).

With further domestic reform and the right degree of international cooperation, the outcome of the rapid globalization of corporate finance could be a positive-sum game capable of consolidating trade and growth linkages between developed and developing economies.

For international investors and their intermediaries contemplating investing in emerging-market corporate debt and equity, success will depend on sound risk management based on a nuanced appreciation of the interplay of risks (at the level of the firm, market, and country) in countries with partially open capital accounts, managed floating exchange rate regimes, imperfect capital markets, and standards and practices of corporate governance that may well be unique and still in flux. Shifting from sovereign to corporate debt demands greater attention to the transparency and quality of accounting standards, the credibility of financial reporting, the integrity of corporate governance, and the characteristics of the jurisdiction in which corporate securities are listed and offered.

Figure 3.20 Size of global derivative markets, June 2006



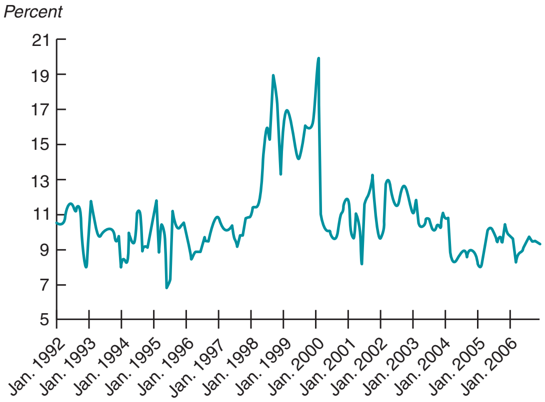
Source: Bank for International Settlements and World Federation of Exchanges.

Corporations in many developing countries need to improve their capacity for risk management

As corporations in emerging markets have increased in size and expanded their international operations, they have increased their exposure to risk. But they have also strengthened their risk management abilities. Many of these corporations have made efforts to hedge against the currency risk they face in financing and production. Like their counterparts in the industrial world, they are increasingly relying on derivatives to manage risks related to foreign exchange, interest rates, credit, and liquidity. More than 90 percent of the world's 500 largest corporations reportedly use derivatives, according to a survey conducted by the International Swaps and Derivatives Association (ISDA 2003). Over-the-counter derivatives are dominated by products designed to protect against fluctuations in interest rates; individual stocks and equity indexes provide the basis for most exchange-traded derivatives (figure 3.20).

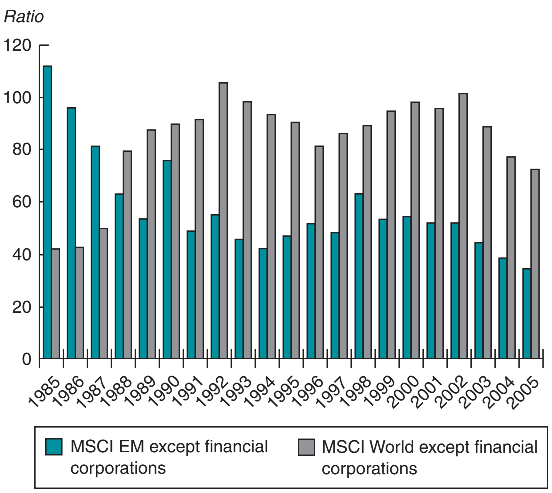
Since the East Asian crisis of 1997–98, emerging-market corporations have taken advantage of favorable international financial conditions to strengthen their ability to deal with unexpected shocks. The decline in corporate credit spreads (from an average of 452 basis points in 1999 to less than 349 basis points in 2006), coupled with low international interest rates, has enabled corporations to build a substantial liquidity cushion. As a result, corporate bond issuance has reached record levels, while the widespread use of interest-rate swaps has substantially reduced interest-rate risk. The average cost of equity declined from more than 18 percent during the East Asian crisis to about 9 percent in 2006 (figure 3.21), average debt-equity ratios in emerging-market corporations declined from more than 60 percent in 1997 to less than 40 percent in 2005 (figure 3.22), and average maturity of new corporate bond issues by nonfinancial companies increased from 6 years in 2000 to 10.3 years in 2006 (figure 3.23).

Figure 3.21 Implied cost of equity in emerging markets, 1992–2006



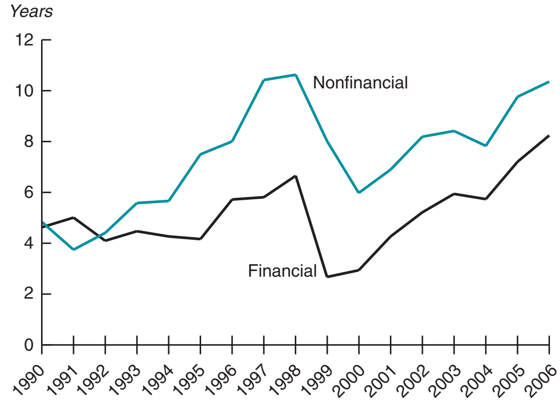
Source: MSCI, Worldscope, Morgan Stanley Research 2006.

Figure 3.22 Net debt-to-equity ratios for nonfinancial corporations in emerging markets, 1985–2005



Source: MSCI, Worldscope, Morgan Stanley Research 2006.

Figure 3.23 Average maturity of issues by financial and nonfinancial corporations, 1990–2006



Source: World Bank staff estimates based on data from Dealogic Bondware.

Despite these improvements, two areas of concern remain that are reminiscent of the position of emerging-market corporations immediately before the East Asian crisis. First, nonfinancial corporations based in emerging markets may have undertaken substantial liabilities denominated in Japanese yen, encouraged by very low interest rates on yen loans in recent years. Data from the Bank for International Settlements indicate that Japanese banks have cross-border claims totaling about $218 billion on foreign nonbank private sector companies (including those from industrial countries), part of which may be carry-trades and part of which may be corporate sector loans in Japanese yen (BIS 2006). Because even a modest appreciation of the yen could significantly weaken corporate balance sheets, debt-equity ratios and the cost of debt financing may be significantly underestimated unless foreign exchange risks have been hedged.

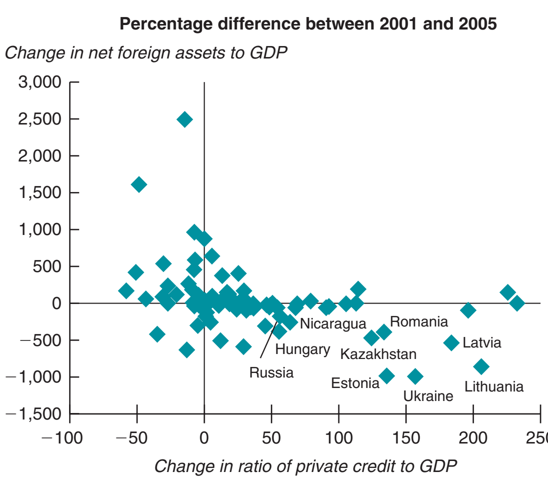
Second, market participants have raised concerns over weak credit-risk management in emerging-market corporations. Credit risk is often not integrated into an enterprisewide risk management framework, making it difficult to measure, aggregate, and hedge. Liabilities from corporate pension plans may be underestimated, not least because corporate pension managers appear to have taken on high-risk assets in their quest for higher yields and may not fully understand the risk exposure involved in popular credit derivatives. Moreover, credit risk may be substantially underestimated during the current peak of the credit cycle, and emerging-market corporations rarely analyze scenarios in which credit spreads might widen.

The banking sector's foreign exchange exposure may affect financial stability

The critical role played by banks in domestic monetary systems means that banks' exposure to foreign borrowing warrants special attention from policy makers. Sharp increases in external borrowing by commercial banks may be the result of a normal process of capital deepening in a rapidly growing developing country or transition economy. Moreover, these increases may be justified by the availability of profitable investments. If the underlying policy and regulatory frameworks promote healthy banking practices, sound credit allocation, and proper risk management, these developments pose little risk. By contrast, external borrowing can pose serious macroeconomic and financial stability risks if banks hold large currency mismatches in their portfolios, maturities are short, or large external inflows fuel a rapid expansion of bank credit to the private sector, particularly for consumer loan and housing finance, without sufficient prudential controls.

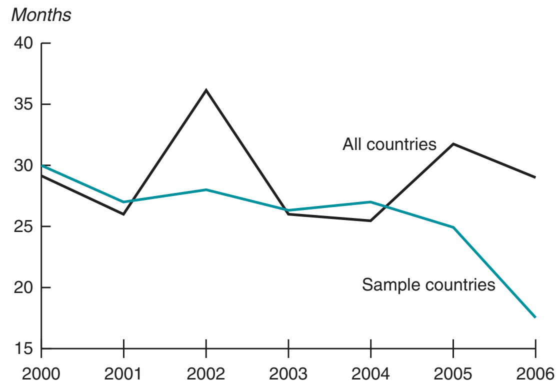
Several countries that have combined large inflows of external capital with a boom in bank lending to the private sector may be vulnerable to such risks.[8] Between 2001 and 2005, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Nicaragua, Romania, Russia, and Ukraine experienced strong growth in private credit accompanied by substantial external borrowing by banks. Both metrics rose by more than 50 percent, and banks' foreign liabilities now exceed their foreign assets (figure 3.24). Moreover, since 2005 the average maturity of the foreign loans contracted in these countries has been significantly shorter than the average across

Figure 3.24 Foreign borrowing by the banking sector and domestic private credit growth in developing countries, 2001–05



Source: IMF *IFS* and World Bank, *World Development Indicators*.
Note: The sample includes all developing countries except offshore banking centers and countries with fewer than five commercial banks. Net foreign assets equal foreign assets minus foreign liabilities of the banking sector as a whole.

Figure 3.25 Average foreign loan maturity contracted by commercial banks in select developing countries, 2000–06



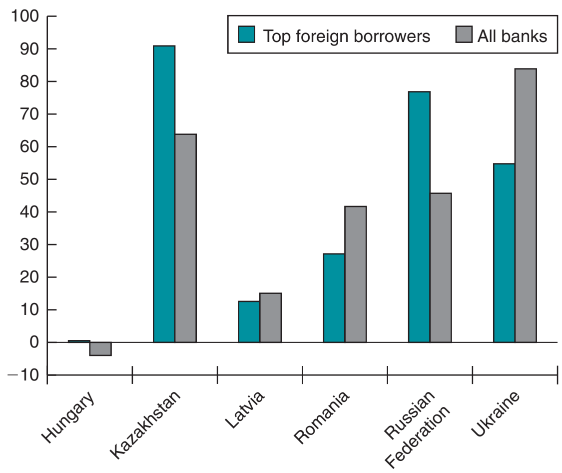
Source: World Bank staff calculations based on Dealogic Loanware.
Note: Sample countries are Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Romania, Russia, and Ukraine. Loans for trade financing are excluded.

developing countries, signaling potential liquidity problems when the credit cycle turns (figure 3.25). Evidence also indicates that in several countries, including Hungary, Russia, and Ukraine, bank loans to households, for consumer and mortgage loans, have increased considerably.

The extent of the risks to domestic financial stability posed by banks that borrow heavily abroad may be best assessed by focusing on the behavior of individual banks in relation to other banks in the same country and in relation to the home countries' overall macroeconomic and growth conditions With some exceptions, the top borrowers in most countries do not appear to be taking on excessive risks.

- Except in Kazakhstan and Russia, the assets of most of the top foreign borrowers did not grow much more rapidly than those of other banks in the country (figure 3.26).
- The asset quality of top foreign borrowers in all of these countries, as measured by the ratio of loan-loss reserves to gross loans, has improved in recent years, and indicators of efficiency and operational performance are in many cases better than those of other banks. However, in all countries except Hungary, the asset quality of the top borrowers is significantly worse than that of other banks (table 3.7).
- Loan growth of the top external borrowers is matched by increased deposits to a larger

Figure 3.26 Asset growth of largest foreign borrowers versus country asset growth, 2005



Source: World Bank staff calculations based on data from Bankscope.
Note: Country asset growth is the average of the growth rates of all commercial banks, savings banks, cooperative banks and medium and long-term credit banks located in the country and reported in Bankscope.

extent than is the case for other banks in the same country, possibly indicating that the top external borrowers are more established banks that inspire greater confidence in depositors.

- In almost all cases, the ratio of equity to total assets is lower for the top borrowers (see table 3.7), placing them in a relatively poor position to cope with a decline in global liquidity. In particular, major external borrowers in Russia score worse than other Russian banks on all vulnerability indicators, although most of the banks that perform poorly in this respect have a relatively low market share.

An agenda for strengthening the transparency of corporate governance

Devising rules to strengthen governance in emerging-market corporations is primarily the responsibility of developing-country governments. But the international community also has a role to play in ensuring the stability of the rapidly evolving international financial system. International financial institutions, international policy bodies, and standard setters in securities, accounting, and other fields are all well placed to promote better corporate governance in emerging markets through their work on the rules governing the issuance of corporate securities in major capital markets, on standards for accounting and reporting, and on regulatory and legal frameworks pertaining to corporate governance.

Globalization may help improve corporate governance, but more coherent capital market rules are needed as well

Developing-country corporations may well improve their governance to some degree simply by competing with corporations that are subject to industrial-country transparency requirements and complying with industrial-country standards to raise capital through overseas listings and IPOs. However, the degree to which industrial-country rules can be extended to improve corporate

Table 3.7 Performance and vulnerability of top foreign borrowers compared with other banks, selected aggregates, 2000–05

	Asset quality		Efficiency and operational				Vulnerability indicators			
	Loan loss reserves/ gross loans	Loan loss provision/ net interest revenue	Net interest margin	Return on average assets	Cost-to-income ratio	Net income/ total assets	Equity/total assets	Interbank ratio	Liquid assets/customer and short-term funding	Other operating income/average assets
Hungary					+		−			
Kazakhstan	−	−		−		−	−			
Latvia	−	−					−	−		+
Romania	−	−		+	+	+		+		
Russian Fed.		−		+	+	+	−	−	−	−
Ukraine	−						−	−		+

Source: World Bank staff calculations based on Bankscope.
Note: + = top borrowers perform significantly better at 10% level; − = top borrowers perform significantly worse.
Each indicator is calculated for each bank in each country (2000–05 averages) and then averaged for the banks included in the list of largest foreign borrowers and other banks in the respective country.

governance elsewhere is limited by the multiplicity of global financial "jurisdictions," each of which presents issuers and investors with a different array of trading rules, investor protections, disclosure and reporting requirements, and methods of complying with international accounting standards.

The U.S. and European capital-market regimes have been subject to separate waves of rule changes in recent years. Designed to strengthen governance, these changes have in some ways pushed the two systems farther apart. In the United States, the Sarbanes-Oxley Act of 2002 imposed a series of requirements aimed at ensuring the independence of boards of directors and assigning clear responsibility for the accuracy of financial statements.[9] In the European Union, national rules have had to be tightened recently to meet EU directives governing prospectuses for securities issuance, disclosure requirements for main-board listings on members' stock exchanges, and the detection and prevention of insider dealing and market manipulation.

A major difference between the two approaches is the wide extraterritorial reach of the U.S. regime. U.S. regulation of investor protection applies not only in the United States but also abroad. In contrast, the European approach sets minimum common standards while recognizing, where possible, the authority of home-market regulators (Coffee 1999).[10]

The European Union has adopted a "comply or explain" principle, under which companies deviating from any provision of the code must explain why they are not embracing best practice in corporate governance (see EU 2006; Arcot, Bruno, and Faure-Grimaud 2007). At the same time, it has sought to encourage convergence and coordination of the national codes of corporate governance of member states. Recognizing the advantages of the European approach, in 2006 the U.S. Committee on Capital Markets Regulation recommended a more principles-based approach to regulation to enhance shareholder rights while reducing overly burdensome regulations and litigation. This may signal progress toward the harmonization of capital-market regulation.[11]

The growth of international norms and standards has helped developing-country governments improve governance

A set of international financial standards and codes was developed in 1999, in response to the widespread weaknesses in financial supervision and corporate governance revealed by the East Asian financial crisis. A joint World Bank–IMF program assesses the observance of standards and codes by member countries; Corporate Governance Country Assessment reports for more than 40 countries are available to the public on the World Bank's Web site. A few countries, such as Pakistan, have adopted mandatory corporate governance guidelines. At least 35 countries have developed voluntary national corporate governance standards ("codes of best practice"). These codes have had a "major impact" on reform in many countries, according to one study (Berg 2007).

Many countries have improved their protection of shareholder rights (notably in procedures for shareholder meetings and recordkeeping) and made significant progress in strengthening the professionalism, independence, and accountability of corporate boards of directors. For example, more than 35 countries have established institutes to train directors or developed detailed guidelines for board members. Many countries are also adopting regulations to increase the transparency of changes in corporate control during takeovers and to provide fair treatment for existing shareholders.[12]

Many concerns nevertheless remain regarding the effectiveness of corporate governance rules in transition economies, developing countries, and many developed countries. When the general enforcement environment is weak, few of the traditional corporate governance mechanisms are effective (Berglof and Claessens 2004). Moreover, although many countries have adopted international financial reporting standards, very few have made progress toward meeting nonfinancial disclosure standards, particularly with regard to ownership, control, and related-party transactions. Much more needs to be done to instill commitment to sound corporate governance at the national and firm levels in many developing countries.

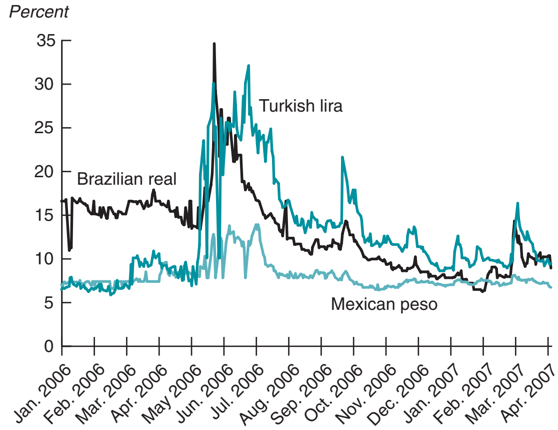
Challenging macroeconomic policy management tasks remain

Protecting the benefits of financial globalization for developing countries will require carefully crafted policies, both macroeconomic and regulatory, by governments in the developing world. Recognizing that the process of corporate globalization in developing countries is driven by long-term structural as well as short-term cyclical factors, governments must focus on managing short-term fluctuations and risks while continuing to play a steady, supportive, and catalytic role.

The key long-term requirement is to sustain, and in some cases extend, the structural changes and institution-building efforts that have made possible the growing involvement of developing-country corporations in global investment and finance. Under way in many countries since the early 1990s, those changes include progress toward a floating exchange rate regime (free or managed) or a peg arrangement (especially in the case of new European Union members), carefully phased easing of capital controls in combination with better governance and stronger domestic regulation, and privatization of public enterprises (World Bank 2006a). Far greater efforts are needed to spur the development of well-regulated and liquid local capital markets and to ensure prudential regulation of foreign borrowing by domestic banks and other regulated entities. Such structural improvements would greatly reduce the likelihood of corporate financial distress and vulnerability while promoting the growth of new market mechanisms and the regulatory capacity needed for effective macroeconomic management of the increasingly open economies of the developing world.

With almost half of developing countries now operating under a floating exchange rate regime, a key task facing policy makers is to find ways to reduce wide swings in local currency. Doing so requires a judicious mix of monetary policy and intervention in foreign exchange markets, tempered by recognition that the level and type of corporate indebtedness carry important monetary and exchange rate implications.[13] Success in stabilizing local-currency fluctuations has been the hallmark of macroeconomic management in several emerging-market countries, including Brazil, Mexico, and Turkey (figure 3.27). In these countries, currency volatility against the U.S. dollar—as measured by one-month implied options on such currencies—declined significantly over the course of 2006 and now compares well with the volatility of the British pound and Swiss franc. Lower currency volatility would help stimulate demand among foreign investors for corporate assets and give companies the confidence they need to commit capital to long-term investment and growth. Policy makers can reinforce that confidence-building effect by steering monetary policy toward price stability, a necessary condition for the smooth operation of market-determined interest rates aligned with international trends, and the adoption of inflation-targeting policies being pursued by a growing number of emerging-market economies.

Figure 3.27 Short-term volatility in emerging market currencies, January 2006–April 2007



Source: Bloomberg and World Bank staff calculations.
Note: Short-term volatility is defined as one-month implied volatility for options on the currency versus the U.S. dollar.

Annex: Econometric Methodology and Estimation of Corporate Bond Spreads

To analyze the determinants of at-issue yield spreads of international bonds offered by corporations located in emerging markets, Bank staff collected data from Bondware on 1,599 U.S. dollar- or euro-denominated offerings in 44 countries between 1990 and 2005. The sample represents a wide cross-section of issues in terms of maturity, amount, seniority, coupon, offering terms and legal provisions, listing, applicable law and jurisdiction, rating, industry, and market segment.

These data were matched against data from a variety of sources on the institutional, legal, financial, and economic development of each issuer's home country by month, quarter, or year. Variables from the World Bank's Financial Structure and Development database and the monthly International Consulting Resources Group (ICRG) country-risk indexes were used to gauge the degree of financial, legal, and institutional development of each issue's home country. Fifteen industry dummies were constructed on the basis of each issuer's two-digit Standard Industrial Classification (SIC) code to control for industry effects. Matching the various data sources leaves 1,206 observations for which full data were available.

The following linear model of emerging-market corporate bond spreads was then specified:

$$S_i = x_i^m \beta^m + x_i^b \beta^b + x_i^f \beta^f + z_i^{econ} \gamma^{econ} + z_i^{fin} \gamma^{fin} + z_i^{ins} \gamma^{ins} + u_i,$$

where S_i is the bond's at-issue credit spread over the yield of a maturity-matched U.S. Treasury security or, in the case of a euro issue, a comparable German Bundesobligation. The term x_i^m represents a set of variables relating to the issue's marketing choice, such as dummy variables for the market segment (Eurobond, 144A issue, global bond); the currency of denomination (U.S. dollars or euros); the applicable law and jurisdiction (New York, U.K., or other governing law); and the listing choice. The term x_i^b represents a set of control variables pertaining to the terms of the issue—namely, the coupon, log(amount), log(maturity), rating, seniority, call or put, common covenant provisions, and guarantees. The term x_i^f represents firm-specific variables, such as private versus public ownership and industry dummies. The model controls for the economic environment of the issuer's home country by including economic indicators (z_i^{econ}: [the log of] per-capita GDP, inflation, real growth); the home country's level of financial development (z_i^{fin}: stock-market capitalization or turnover as a percentage of GDP, private credit as percentage of GDP); and the quality of its legal, political, financial, and economic institutions (z_i^{ins}: the ICRG indexes of economic, financial, and political stability and its subindexes).

Various linear models of the offerings' credit spread at issue over comparable U.S. Treasury or German government debt securities are provided as a function of offering terms, rating, distribution, currency and jurisdiction, industry and ownership variables, and various economic, financial, and institutional control variables for each issuer's home country. All specifications are estimated using ordinary least squares (OLS) with country fixed-effects and clustered standard errors that are adjusted for heteroskedasticity across countries and correlation within countries. In the interest of parsimonious specifications, statistically insignificant control variables have been eliminated (table 3A.1).

Table 3A.1 Regression results of analysis of at-issue corporate bond spreads

Dependent variable	(1)	(2)	(3)	(4)
Bond attribute				
Floating rate note	−87.532	−90.065	−96.123	−90.255
	(0.000)***	(0.000)***	(0.000)***	(0.000)***
Euro-denominated	−55.465	−24.481	−23.689	−65.350
	(0.007)***	(0.250)	(0.176)	(0.000)***
Log (maturity)	−1.287	−6.397	−3.699	−2.354
	(0.800)	(0.328)	(0.586)	(0.710)
Log (amount)	−25.444	−23.564	−26.683	−29.634
	(0.002)***	(0.003)***	(0.000)***	(0.000)***
Nonrated issue	191.125	168.340	178.244	197.207
	(0.000)***	(0.000)***	(0.000)***	(0.000)***
Issue credit-rating index	19.361	16.852	17.531	18.324
	(0.000)***	(0.000)***	(0.000)***	(0.000)***
Private ownership	47.615	45.307	44.583	47.877
	(0.000)***	(0.000)***	(0.000)***	(0.000)***
Third-party guarantee	−22.748	−26.307	−24.630	−23.441
	(0.015)**	(0.014)**	(0.012)**	(0.009)***
No negative-pledge clause	24.785	21.779	24.566	6.935
	(0.001)***	(0.106)	(0.045)**	(0.784)
No cross-default clause	−69.673	−65.921	−63.247	−66.153
	(0.002)***	(0.003)***	(0.009)***	(0.062)*
U.S. (N.Y.) law	−15.861	−30.100	−27.652	−6.812
	(0.450)	(0.185)	(0.207)	(0.728)
U.K. law	−22.982	−33.162	−27.077	−15.299
	(0.352)	(0.192)	(0.257)	(0.469)
Eurobond	20.235	20.514	18.723	17.964
	(0.060)*	(0.077)*	(0.079)*	(0.025)**
144A only	−0.496	−4.049	−16.492	9.544
	(0.976)	(0.843)	(0.384)	(0.581)
Macroeconomic variable				
Log (GDP per capita)	212.774	75.806	−153.672	−56.602
	(0.054)*	(0.477)	(0.129)	(0.370)
GDP growth rate	−3.843	−7.256	−5.525	−3.904
	(0.015)**	(0.000)***	(0.002)***	(0.035)**
Log (1 + inflation)	96.637	103.637	104.160	104.100
	(0.000)***	(0.000)***	(0.000)***	(0.000)***
Home stock-market turnover/GDP	−79.722	−109.443	−98.186	
	(0.005)***	(0.004)***	(0.003)***	
Private credit/GDP	−97.267	−58.030	−182.505	
	(0.206)	(0.278)	(0.002)***	
Capital/trade flow restrictions			5.253	
			(0.001)***	
External debt as percentage of GDP			1.909	
			(0.090)*	
Institutional indicator				
Country credit-rating index		21.626		
		(0.005)***		
ICRG Composite Risk Index				9.262
				(0.000)***
ICRG Economic Risk Index	5.248			
	(0.000)***			
ICRG Financial Risk Index	6.316			
	(0.000)***			
ICRG Political Risk Index	1.314			
	(0.524)			
Sector				
Banking (SIC 60)	−28.001	−28.793	−33.740	−25.406
	(0.000)***	(0.001)***	(0.000)***	(0.002)***
Telecommunications (SIC 48)	13.483	20.642	28.958	8.123
	(0.217)	(0.077)*	(0.012)**	(0.569)
Chemicals (SIC 28)	60.832	78.341	75.118	65.070
	(0.006)***	(0.006)***	(0.009)***	(0.004)***
Railways (SIC 40)	198.479	186.036	179.946	176.296
	(0.000)***	(0.000)***	(0.000)***	(0.000)***

Table 3A.1 (*Continued*)

Dependent variable	(1)	(2)	(3)	(4)
Year dummy				
1998				65.847
				(0.000)***
1999				130.428
				(0.000)***
2000				61.385
				(0.033)**
2001				103.125
				(0.000)***
2002				165.231
				(0.000)***
2003				162.757
				(0.000)***
2004				94.013
				(0.003)***
2005				48.148
				(0.077)*
Constant	−1,776.928	−481.740	1,287.628	412.311
	(0.042)**	(0.592)	(0.122)	(0.402)
Number of observations	1,211	1,206	1,206	1,310
R-squared	0.629	0.591	0.596	0.662

Source: World Bank staff estimates.
Note: Fixed country effects are not reported; clustered *P*-values (standard errors adjusted for heteroskedasticity across countries and correlation within countries) are shown in parentheses.
* Significant at the 10 percent level.
** Significant at the 5 percent level.
*** Significant at the 1 percent level.

Notes

1. The universe of publicly traded companies is estimated at 41,246 firms in the world's major 50 stock exchanges (members of the World Federation of Exchanges), of which 2,789 are foreign-listed companies.

2. Recent theories have extended Merton's (1987) intuition by arguing that firms can attract investor interest in at least three ways: by improving disclosure practice, by making themselves more familiar, and by committing to good corporate governance.

3. América Movil took advantage of the liquidation of the emerging-market assets of U.S. operators such as AT&T, Bell South, and MCI, gaining more than 100 million subscribers by March 2006. Its Spanish-owned competitor, Telefónica Móviles, has 74 million subscribers.

4. A recent study by the Bank of Italy (2006) provides evidence of a significant reduction in the level of volatility between July 2004 and March 2006 relative to the historical average in both the stock and bond markets of France, Germany, Italy, Japan, Switzerland, the United Kingdom, and the United States.

5. From the perspective of international investors, the most important difference in accounting standards relates to the U.S. Generally Accepted Accounting Principles (GAAP) and the International Financial Reporting Standards (IFRS) adopted by the European Union for application to publicly traded companies as of January 2005. National adoption of IFRSs has been widespread across regions in recent years and the momentum continues. See, for example, Tweedie and Seidenstein (2005). In addition to moves toward an overall trend of convergence of national financial reporting standards, the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) have also launched an effort to harmonize differences between IFRSs and the U.S. GAAP. At their political summit meeting on April 30, 2007, European and U.S. leaders agreed to promote conditions for recognition of U.S. GAAP and IFRSs in both jurisdictions without need for reconciliation by 2009 (see the IASB Web site at http://www.iasb.org).

6. Empirical work confirms that developing countries' borrowing costs fall with greater participation in international capital markets. Spreads on sovereign loans fell with continued borrowing (Ozler 1992), and spreads on loans to both public and private borrowers fell with repeated loan commitments (Eichengreen and Mody 2000). However, repeat borrowing has little impact on bond markets, which rely largely on publicly available information (Eichengreen, Kletzer, and Mody 2005).

7. The first Eurobond issue is reported to have been the $15 million bond issuance by Italy's Autostrade in 1963.

8. Several papers examine the potential risks of rapid credit growth in Central and Eastern Europe. See, for example, Enoch and Otker-Robe (2007) and World Bank (2007).

9. These included requirements that the boards of companies listed on a U.S. exchange have a majority of independent directors; have wholly independent committees overseeing auditing, compensation, and nominations of directors; and require the company's chief executive and chief financial officer to sign a statement affirming the accuracy

of financial statements and the effectiveness of internal controls over financial reporting.

10. The EU Prospectus and Market Abuse Directives place greater emphasis on harmonization, however (Scott 2005).

11. The IASB, made up of accountancy bodies in more than 100 countries, publishes international financial reporting standards (IFRS, known until 2001 as "international accounting standards") that have been adopted by more than 90 countries. EU members, Switzerland, and Hong Kong (China), among others, use these standards. The 2005 EU decision to make IFRS binding for all publicly listed European firms is considered the first major standardization. China, India, Japan, and many other countries have begun to make strides toward adopting IFRSs, while the IASB and the U.S. FASB have launched an effort to harmonize differences between IFRS and the U.S. GAAP.

12. Studies have also shown the importance of corporate governance for developing countries' corporations. Higher corporate governance standards are associated with higher company valuation (Black, Jang, and Kim 2006) and growth (La Porta and others 2000; Djankov and others 2006). Moreover, better legal protection at the country level can be a substitute for poor governance at the company level (Klapper and Love 2004; Durnev and Kim 2005).

13. Foreign and local debt are often imperfectly substitutable on the corporate balance sheet, either because adequate currency hedging instruments are not available (or are not used) or because of differences in the degree of flexibility of the two types of financing (foreign debt is harder for firms to restructure than local debt). For these reasons, corporate foreign debt plays a role in the transmission of monetary policy (Bolton and Freixas 2000, 2006).

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Appendix: Regional Outlooks

East Asia and the Pacific[1]

Recent developments

The developing economies of the East Asia and Pacific region grew 9.5 percent in 2006, led by 10.7 percent growth in China (table A.1). For the region, this was the fastest growth in the last ten years, and the fourth year in a row that GDP in China expanded by more than 10 percent.

Industrial production slowed in the second half of the year in China (figure A.1) following the stagnation of U.S. import demand, a rise in domestic interest rates, and the imposition of administrative restrictions in some sectors. The latter caused investment volume growth to slow from a pace of more than 25 percent year-over-year in the first half of 2006 to 19 percent in the fourth quarter. This contributed to weaker real import growth and slowed the growth of exports among other economies in the region. High-frequency data suggest that industrial production recovered into 2007 and that Chinese export growth and monetary aggregates accelerated in early 2007 compared with the last quarter of 2006 (although seasonal factors linked to the Chinese New Year may also be at play).

Growth in the rest of the region was also robust, expanding by 5.7 percent. Notwithstanding a pronounced slump in high-tech demand in the second half of 2006 and a weakening in Chinese import demand, growth in most countries

Table A.1 East Asia and Pacific forecast summary

annual percent change unless indicated otherwise

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
GDP at market prices (2000 $)[b]	8.4	9.0	9.0	9.5	8.7	8.0	7.9
GDP per capita (units in $)	7.1	8.1	8.1	8.6	7.8	7.2	7.1
PPP GDP[c]	—	9.2	9.2	9.6	8.8	8.2	8.0
Private consumption	7.3	6.8	6.4	7.5	7.5	6.9	6.5
Public consumption	9.0	6.7	8.8	8.4	7.6	7.2	6.8
Fixed investment	10.3	11.5	8.0	7.9	8.1	6.3	6.0
Exports, GNFS[d]	11.7	22.6	18.4	18.4	15.5	15.8	13.2
Imports, GNFS[d]	11.3	20.6	11.2	14.8	14.8	13.1	11.1
Net exports, contribution to growth	1.2	6.5	9.9	12.2	13.2	15.3	17.0
Current account balance/GDP (%)	0.1	3.5	6.1	8.1	7.8	7.6	6.5
GDP deflator (median, LCU)	6.5	6.1	4.0	4.2	5.4	3.9	3.9
Fiscal balance/GDP (%)	−0.7	−1.5	−1.6	−0.7	−0.9	−1.0	−1.1
Memo items: GDP							
East Asia excluding China	4.8	6.1	5.4	5.7	5.7	5.9	6.0
China	10.4	10.1	10.2	10.7	9.6	8.7	8.5
Indonesia	4.2	5.1	5.7	5.5	6.3	6.5	6.4
Thailand	4.5	6.2	4.5	5.3	4.5	4.5	5.0

Source: World Bank.

Note: e = estimate; f = forecast; LCU = local currency units; — = not available.

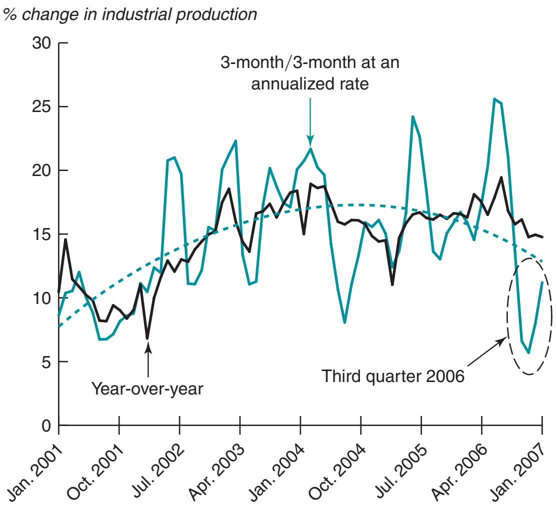
a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.

b. GDP measured in constant 2000 $.

c. GDP measured at PPP exchange rates.

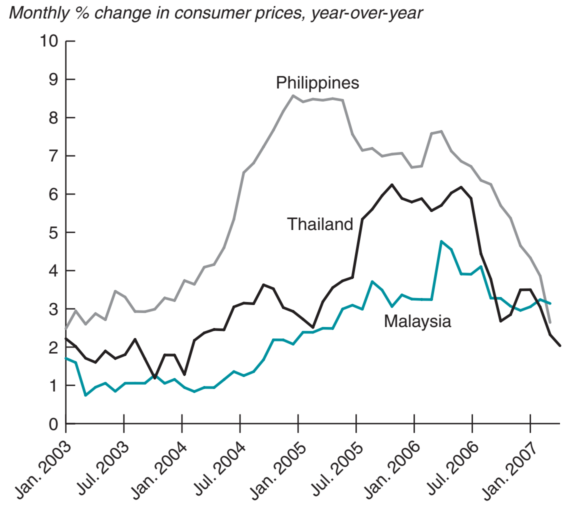
d. GNFS denotes goods and nonfactor services.

Figure A.1 Chinese industrial production



Sources: World Bank; Datastream.

Figure A.2 Inflation in Malaysia, the Philippines, and Thailand



Source: World Bank.

exceeded 5 percent. The expansion was particularly strong in Vietnam and Cambodia (GDP was up an estimated 8.2 and 10.5 percent, respectively), backed by across-the-board strength in exports, domestic consumption, and investment. In Indonesia, growth slowed in the first half of 2006, reflecting an earlier tightening of monetary policy and the withdrawal of fuel subsidies. Growth picked up subsequently, coming in at 5.5 percent for the year as a whole, spurred by a rebound in domestic consumption and investment. Growth also picked up in Malaysia, with GDP rising 5.9 percent, supported by strengthening exports and domestic demand. In the Philippines, output experienced a modest increase, with growth coming in at 5.4 percent for the year. Economic activity in Thailand expanded by 5.3 percent in 2006, an improvement over the 4.5 percent outturn in 2005, mainly on the back of strong export growth. Growth in 2005–06 was, however, more than 1 percentage point less than in the previous three years, mainly because of depressed business and consumer confidence due in part to high oil prices, increased political uncertainty, and recent policy changes affecting foreign investment.

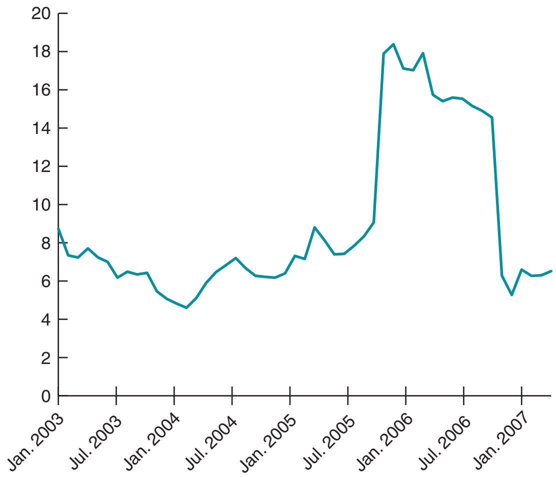
Trade continues to fuel the growth dynamic in the East Asia and Pacific region. The accession of Vietnam to the World Trade Organization (WTO) in January 2007 will provide another boost to trade flows. Apart from an average 4 percentage point reduction in import tariffs, the accession will strengthen regulations and financial management in Vietnam. Elsewhere in the region, the movement toward free trade persists. Since becoming a WTO member in 2001, China has launched a flurry of bilateral trade negotiations with more than 30 economies around the world. And in November 2006 the Asia Pacific Economic Cooperation forum (APEC) agreed to "seriously consider" negotiating a Free Trade Area of the Asia Pacific.

A generalized tightening of monetary policy in the region, following a pickup in consumer prices induced partly by high oil prices in 2005, has succeeded in lowering inflation in many economies (figure A.2). In Indonesia, the removal of energy subsidies has only temporarily raised inflation (figure A.3). The moderation of inflation has allowed Indonesia and Thailand to begin easing interest rates. Elsewhere, despite the downward trend in regional inflation, nominal interest rates have been stable or have declined less rapidly, leading, for example, to a tightening of monetary conditions in the Philippines. Given the continued robustness of growth, China increased interest rates and reserve requirements in the first quarter of 2007, the latest of several increases over the past year. Inflation there has been rising but was still fairly low at 3.3 percent in March 2007 (year over year).

Regional equity markets remain generally buoyant, although concern over valuations led to heightened volatility in February/March 2007,

Figure A.3 No permanent impact on inflation of a removal of energy subsidies in Indonesia

Monthly % change in consumer prices, year-over-year



Source: World Bank.

reminiscent of the more widespread correction observed in May/June 2006. More generally, this volatility serves to remind investors and policy makers of the riskiness of emerging markets, which are relatively thinly traded and therefore more sensitive to changes in market sentiment.

Notwithstanding acceleration in the renminbi's appreciation with respect to the dollar, economic pressures for the appreciation of currencies in developing Asia are likely to remain strong. Overall, the region's balance of payments is in significant surplus (8.1 percent of GDP, or 4.8 percent of GDP excluding China). In addition to reducing global imbalances, greater currency flexibility and exchange rate appreciation would help contain inflationary pressures, improve domestic macroeconomic management capabilities, steady asset markets, and, over time, improve living standards for local populations.

The strong current account position of East Asia and Pacific countries reflects large financial inflows, particularly in the form of FDI (table A.2).

Table A.2 Net capital flows to East Asia and Pacific

$ billions

	1998	1999	2000	2001	2002	2003	2004	2005	2006e
Current account balance	59.4	50.0	45.4	36.7	56.1	73.4	92.2	179.1	272.2
as % of GDP	4.2	3.3	2.7	2.0	2.8	3.3	3.5	6.1	8.1
Financial flows									
Net private and official flows	21.2	40.0	35.4	41.4	47.3	67.9	120.4	167.2	167.6
Net private flows (debt + equity)	6.5	27.5	28.8	38.2	55.2	75.1	125.7	169.7	179.9
Net equity flows	54.7	51.7	51.7	49.5	60.8	66.0	85.1	123.0	136.7
Net FDI inflows	57.8	50.4	45.1	47.7	57.0	53.5	66.1	96.9	88.3
Net portfolio equity inflows	−3.1	1.3	6.6	1.8	3.8	12.5	19.0	26.1	48.4
Net debt flows	−33.5	−11.7	−16.3	−8.1	−13.5	1.9	35.3	44.2	30.9
Official creditors	14.7	12.5	6.6	3.2	−7.9	−7.2	−5.3	−2.4	−12.3
World Bank	2.8	2.4	1.8	0.9	−1.7	−1.5	−1.9	−0.6	−1.0
IMF	7.0	1.9	1.2	−2.5	−2.7	−0.5	−1.6	−1.6	−8.4
Other official	4.8	8.2	3.5	4.8	−3.5	−5.2	−1.7	−0.2	−2.8
Private creditors	−48.2	−24.2	−22.9	−11.3	−5.6	9.1	40.6	46.7	43.2
Net medium- and long-term debt flows	−3.5	−10.9	−13.1	−13.0	−12.4	−9.4	8.0	7.2	11.4
Bonds	1.0	0.9	−0.7	0.4	0.1	2.1	9.7	9.9	7.1
Banks	−4.8	−12.0	−11.3	−11.8	−10.2	−8.4	0.2	−0.6	7.2
Other private	0.3	0.2	−1.0	−1.6	−2.3	−3.1	−1.9	−2.2	−2.9
Net short-term debt flows	−44.7	−13.3	−9.9	1.7	6.8	18.5	32.6	39.5	31.8
Balancing item[a]	−58.7	−62.0	−72.4	−29.7	−14.2	−4.0	24.0	−130.4	−150.1
Change in reserves (− = increase)	−21.9	−28.0	−8.4	−48.4	−89.2	−137.2	−236.6	−215.8	−289.6
Memo items									
Bilateral aid grants	5.2	5.2	5.3	4.9	5.0	5.9	6.4	7.9	5.6
of which									
Technical cooperation grants	2.7	2.7	2.8	2.7	2.8	3.4	3.6	3.9	3.5
Other	2.5	2.5	2.5	2.2	2.2	2.5	2.8	4.0	2.1
Net official flows (aid + debt)	19.9	17.7	11.9	8.1	−2.9	−1.3	1.1	5.5	−6.7
Workers' remittances	12.9	15.7	16.7	20.1	29.5	35.3	38.8	45.1	47.2
Repatriated FDI Income	7.1	5.9	6.4	13.0	11.6	13.0	23.0	29.5	—

Sources: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate; LCU = local currency units; — = not available.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

FDI has been increasing during the course of the expansion but eased to some $88 billion in 2006, with $67 billion going to China. The region has also attracted significant levels of bank lending and more volatile equity investments.

Net capital inflows to East Asia and Pacific totaled $167 billion in 2006, unchanged from 2005, marking a decrease in share of total flows to developing countries to 30 percent from 35 percent in 2005. The broad composition shifted from debt and FDI to portfolio equity. Higher equity inflows (up $22 billion to $48 billion) were offset by lower net (private and official) debt flows (down $13.3 billion to $30.9 billion) and lower net FDI inflows (down $8.5 billion to $88 billion). At $7 billion in 2006, net bank lending finally showed some activity after being negligible in 2004–05 and averaging net *outflows* of $10 billion in the six years following the Asian crisis in 1997. Repayments to official creditors outstripped lending by $10 billion in 2006, mostly due to an $8 billion prepayment by Indonesia to the IMF.

Net portfolio inflows to the region accounted for 53.5 percent of the total for all developing countries, up from an average of 47 percent over the previous five years. The increase reflected higher inflows to China (up $11 billion to $31 billion in 2006), mainly due to IPOs by the Industrial and Commercial Bank of China ($12.8 billion) and the Bank of China ($8.9 billion). Both transactions, launched on the Hong Kong exchange, were oversubscribed by a wide margin, defying the long-held belief that transactions of this magnitude needed to be listed in New York or London to gain access to a global pool of capital.

The estimated $8.5 billion decline in FDI inflows to the region in 2006 was concentrated in China and Indonesia. FDI to Indonesia declined by $3 billion following exceptional privatization and merger and acquisition activity in 2005 (totaling $5 billion). FDI inflows to China also declined by $3 billion, reducing its share from 28 to 23 percent of the total to all developing countries. FDI inflows to China have shifted from the manufacturing sector to the financial and real estate sectors, partly reflecting greater access by foreigners to investment in the banking and insurance sectors in compliance with WTO accession requirements.

Partly as a reaction to these strong inflows over the last 4–5 years, policy makers in the region have adopted increasingly flexible exchange rate regimes. Both China and Malaysia announced their intentions to replace the dollar as the reference for their exchange rate management schemes with a basket of currencies in 2005.

Medium-term outlook

Growth is projected to slow in 2007, although to a still-robust 8.7 percent, and continue moderating toward 7.9 percent by 2009. Somewhat weaker investment in China should be partially offset by stronger consumer demand, so that China's overall GDP is projected to expand about 9.6 percent in 2007 before slowing to 8.5 percent in 2009 (table A.3). Notwithstanding currency appreciation, China's current account surplus is projected to remain high at 7.8 percent of GDP in 2009. In contrast, growth in the remainder of the region is expected to pick up over the period, reaching 6 percent in 2009, up from 5.7 percent in 2006. Output in Indonesia is expected to accelerate to 6.3 percent in 2007 and remain strong at around 6.5 percent over the next couple of years due to continued buoyant domestic demand, and despite weaker Chinese imports. Growth in Thailand is projected to weaken further in 2007, to 4.5 percent, as policy changes and political turmoil continue to impact output, before picking up to 5 percent in 2009. Growth in Malaysia and the Philippines is also expected to remain robust on the back of continued gains in domestic demand, with a recovery of export growth toward the end of the forecast period.

Risks and uncertainties

This relatively rosy outlook is subject to a number of uncertainties. In particular, the projected slowdown in China is predicated on trend moderation in export growth, as the period of very rapid growth following the relaxation of trade barriers that accompanied its accession to the WTO gives way to increases more reflective of underlying differentials in productivity growth. Output in other countries in the region will be sensitive to this outturn, as China has become the major initial destination for most of their exports. Should China's export growth not slow as quickly as predicted, the expansion throughout the region could be stronger than projected, potentially placing additional pressures on prices and requiring a further tightening of macroeconomic policies.

Table A.3 East Asia and Pacific country forecasts
annual percent change unless indicated otherwise

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
Cambodia							
GDP at market prices (2000 $)[b]	—	10.0	13.4	10.5	9.0	6.8	6.5
Current account balance/GDP (%)	—	−3.7	−6.4	−7.9	−6.0	−5.8	−5.6
China							
GDP at market prices (2000 $)[b]	10.4	10.1	10.2	10.7	9.6	8.7	8.5
Current account balance/GDP (%)	1.5	3.6	7.4	9.3	9.2	9.1	7.8
Fiji							
GDP at market prices (2000 $)[b]	2.1	5.3	0.7	3.4	−2.5	2.0	2.5
Current account balance/GDP (%)	−3.1	−16.8	−16.3	−13.2	−9.0	−7.9	−8.4
Indonesia							
GDP at market prices (2000 $)[b]	4.2	5.1	5.7	5.5	6.3	6.5	6.4
Current account balance/GDP (%)	−0.4	0.6	0.3	2.8	2.3	1.3	0.7
Lao PDR							
GDP at market prices (2000 $)[b]	—	6.4	7.0	7.5	7.1	9.0	8.5
Current account balance/GDP (%)	—	−6.3	−24.6	−17.0	−26.6	−22.5	−18.8
Malaysia							
GDP at market prices (2000 $)[b]	7.1	7.2	5.2	5.9	5.6	5.8	5.7
Current account balance/GDP (%)	−0.4	12.6	15.2	14.6	12.9	13.9	13.1
Papua New Guinea							
GDP at market prices (2000 $)[b]	4.8	2.7	3.0	3.8	4.0	4.0	4.0
Current account balance/GDP (%)	2.2	−1.5	5.9	4.4	−2.0	−3.3	−3.5
Philippines							
GDP at market prices (2000 $)[b]	3.0	6.2	5.0	5.4	5.6	6.0	6.0
Current account balance/GDP (%)	−3.1	1.9	2.4	3.5	3.2	2.5	2.1
Thailand							
GDP at market prices (2000 $)[b]	4.5	6.2	4.5	5.3	4.5	4.5	5.0
Current account balance/GDP (%)	−1.2	4.2	−2.2	3.5	2.3	1.0	1.0
Vanuatu							
GDP at market prices (2000 $)[b]	4.1	4.0	2.8	3.0	2.4	2.4	2.5
Current account balance/GDP (%)	−8.2	−19.7	−4.3	−4.4	−4.7	−4.4	−4.4
Vietnam							
GDP at market prices (2000 $)[b]	7.6	7.7	8.5	8.2	8.0	8.0	7.8
Current account balance/GDP (%)	−5.1	−1.0	0.4	1.5	−0.5	−1.0	−1.0

Source: World Bank.
Note: Growth and current account figures presented here are World Bank projections and may differ from targets contained in other Bank documents. American Samoa, the Federated States of Micronesia, Kiribati, the Marshall Islands, Myanmar, Mongolia, Northern Mariana Islands, Palau, the Democratic People's Republic of Korea, the Solomon Islands, Timor-Leste, and Tonga are not forecast owing to data limitations. e = estimate; f = forecast; — = not available.
a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 2000 $.

Prospects in the region are also vulnerable to the possibility of a sharper-than-expected slowdown in the United States, a potential deterioration in global financial conditions, and an oil supply shock. While a substantial reduction in U.S. imports would certainly affect East Asian and Pacific exports, most of the region's export growth has reflected increased market share rather than very rapid import growth by the United States and other high-income countries. Moreover, direct trade links to the United States among the ASEAN countries, newly industrial economies, and Japan have diminished as a share of GDP. As a result, the projected impact of the slowdown in the United States is expected to be relatively minor (see IMF 2006).

The strong growth, large capital inflows into the private sector, and rising asset prices might seem strikingly similar to the situation 10 years ago, just before the 1997–98 crisis, when a reversal in investor sentiment resulted in a liquidity squeeze and a severe recession. However, it is unlikely that history will repeat. Contrary to the 1990s, most countries in the region now have large current account surpluses and have accumulated reserves well beyond what is needed to absorb sudden reversals in capital flows.

Reduced vulnerability to external financial shocks and the expansion of domestic debt and equity markets has shifted the balance of risks to domestic financial markets. Despite improvements in capitalization, governance, risk management, and operational efficiency in the banking sectors, there is still significant risk linked to limited availability of good information to price securities accurately. Therefore, improving corporate governance and the degree and quality of corporate financial disclosure remains a priority.

Europe and Central Asia

Recent developments

GDP in the Europe and Central Asia region is estimated to have increased 6.8 percent in 2006, up from 6.0 percent growth the year before (table A.4). An acceleration of growth in high-income Europe, still-low real interest rates, and further increases in incomes of regional oil exporters[2] helped to generate an acceleration in output among many countries in the region (notably in Bulgaria, Estonia, Latvia, Poland, Romania, Russia, and other oil exporters, the Slovak Republic, and Ukraine). Growth in Bulgaria and Romania was also bolstered by improved confidence and capital inflows tied to EU accession in January 2007. Strong capital inflows, including significant levels of FDI, into countries that recently joined or expect to join the EU,[3] coupled with extremely rapid domestic credit expansion and in some cases loose fiscal policy (such as Hungary and the Slovak Republic), are at the root of excess demand in several countries (including the Baltic countries, Bulgaria, Hungary, Romania, the Slovak Republic, and Turkey).

Among the region's larger economies, GDP in Russia increased 6.7 percent, boosted by rising oil revenues (oil prices were up 20 percent for the year as a whole) that fed into increased government spending, private consumption, and investment. In Poland, a welcome expansion in consumption, thanks to rising wages and employment and double-digit increases in investment volumes, helped to propel growth to 6.1 percent after a relatively modest and mainly export-led 3.5 percent expansion in 2005. In contrast, growth in Turkey declined from 7.4 to 6.0 percent between

Table A.4 Europe and Central Asia forecast summary

annual percent change unless indicated otherwise

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
GDP at market prices (2000 $)[b]	−0.9	7.2	6.0	6.8	6.0	5.7	5.8
GDP per capita (units in $)	−1.1	7.2	6.0	6.7	6.0	5.7	5.7
PPP GDP[c]	−0.8	7.4	6.0	6.9	6.1	5.8	5.9
Private consumption	0.5	8.3	7.4	8.2	6.9	6.4	6.3
Public consumption	0	2.0	2.9	3.6	3.6	3.5	3.3
Fixed investment	−6.1	13.1	11.5	13.8	10.2	10.4	9.6
Exports, GNFS[d]	1.4	13.4	7.9	9.5	9.0	9.0	9.4
Imports, GNFS[d]	−0.9	17.6	9.9	13.6	10.8	10.8	10.5
Net exports, contribution to growth	0.5	0.4	−0.5	−2.6	−3.6	−4.7	−5.6
Current account balance/GDP (%)	—	0.3	1.0	0.6	−0.8	−1.6	−1.8
GDP deflator (median, LCU)	104.7	6.1	6.1	3.9	6.0	5.5	5.3
Fiscal balance/GDP (%)	−5.8	−0.9	1.0	1.7	0.7	0.3	0.3
Memo items: GDP							
Transition countries	1.8	6.7	5.6	6.2	5.4	5.4	5.1
Central and Eastern Europe	1.0	5.6	4.6	6.2	5.9	5.3	5.0
Commonwealth of Independent States	−4.2	8.0	6.8	7.7	6.9	6.3	6.6
Russian Federation	−3.9	7.1	6.4	6.7	6.3	5.6	5.8
Turkey	3.6	8.9	7.4	6.0	4.5	5.5	5.4
Poland	3.8	5.3	3.5	6.1	6.5	5.7	5.0

Source: World Bank.

Note: e = estimate; f = forecast; LCU = local currency units; — = not available.

a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.

b. GDP measured in constant 2000 $.

c. GDP measured at PPP exchange rates.

d. GNFS denotes goods and nonfactor services.

2005 and 2006, as private investment and consumption growth slowed markedly in response to the tightening of monetary policy in the wake of the May 2006 currency crisis.

The European recovery, coupled with rapidly growing demand from large regional oil exporters, notably Russia, bolstered exports among oil importers, whose economies grew 6.3 percent. Moldova represented a notable exception to this strong regional performance. Growth there declined sharply from 7.1 to 4.0 percent between 2005 and 2006 due to higher gas import prices and Russia's imposition of trade restrictions on Moldovan exports (especially on wine, which generates 30 percent of Moldova's GDP). High oil prices and the coming on stream of oil projects and export capacity lifted the 2006 GDP growth among smaller oil exporters to 13.7 percent (notably Azerbaijan, where GDP rose by 34.5 percent, and Kazakhstan, where GDP rose by 10.6 percent).

Macroeconomic policy varies considerably across Europe and Central Asia. All but seven countries in the region have general government deficits of less than 3 percent of their GDP, with Albania, Croatia, the Czech Republic, Hungary, the Kyrgyz Republic, the Slovak Republic, and Tajikistan being the exceptions. Despite strong regional growth, fiscal positions deteriorated by nearly 1 percentage point or more of GDP in Azerbaijan (2.5 percentage point deterioration), FYR Macedonia (0.9), Hungary (3.0), Moldova (1.0), and Romania (0.9), which contributed to strong demand but also added to risks. Among oil importers, several have used strong revenue growth to reduce deficits. Government spending has increased rapidly among hydrocarbon exporters, although elevated energy sector revenues have kept balances in the black, and fiscal surpluses have actually risen as a share of GDP in Kazakhstan, Russia, Turkmenistan, and Uzbekistan.

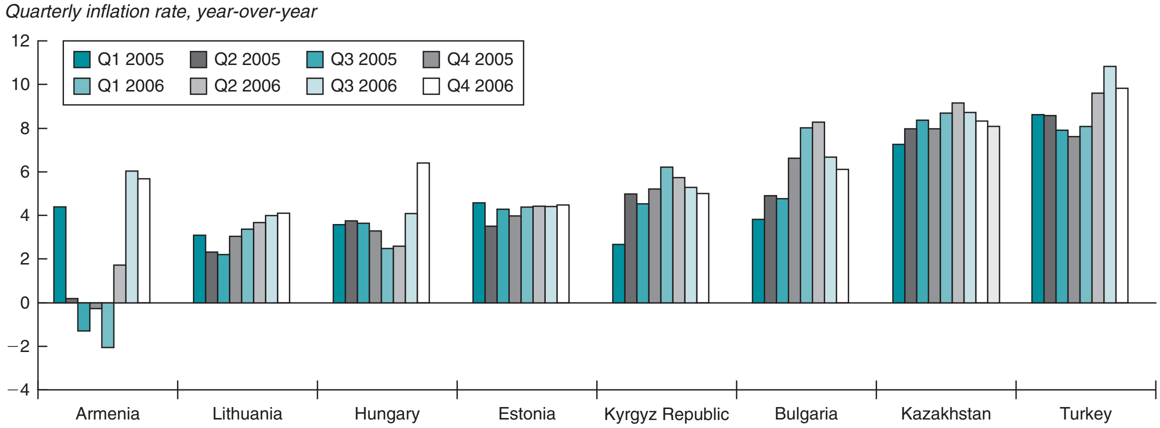
Several years of fast growth, a rapid expansion of credit (often fueled by capital inflows), and the rise in fuel prices have exacerbated inflationary pressures in a number of countries. Median consumer price inflation in the region accelerated to 6.6 percent in 2006, up from 5.8 percent in 2005—the highest rate since 2001. Inflation rose by 1 or more percentage points in several countries: Armenia, Bosnia and Herzegovina, Bulgaria, Kazakhstan, the Kyrgyz Republic, FYR Macedonia, the Slovak Republic, and Turkey (figure A.4). Many other countries had inflation rates in excess of 5 percent: Bosnia and Herzegovina, Bulgaria, Latvia, Romania, Turkey, and all countries in the Commonwealth of Independent States except Armenia.

Tighter monetary policy helped Belarus, Romania, Russia, Serbia and Montenegro, and Ukraine to lower inflation by 2 percentage points or more. Ukraine brought its inflation rate down significantly in 2006, to 9.1 percent, from 13.5 in 2005. For some EU member countries, achieving inflation rates in line with the Maastricht criteria (2.8 percent in 2006) remains a challenge, especially for those seeking to adopt the euro at an early date.

The very strong domestic demand and capital flows that underlie the rise in regional inflation have also generated a substantial increase in

Figure A.4 Building inflationary pressure in Europe and Central Asia

Quarterly inflation rate, year-over-year



Sources: World Bank; Datastream.

external imbalances among regional oil importers, whose current account deficits deteriorated sharply from 4.7 percent of GDP in 2005 to 6.3 percent of GDP in 2006. Current account positions deteriorated precipitously, by 4 percent of GDP or more, in a number of oil-importing countries: Belarus, Bulgaria, Estonia, Georgia, the Kyrgyz Republic, Lithuania, and Ukraine. In the Kyrgyz Republic, an exceptionally sharp deterioration of over 15 percent of GDP reflected a surge in imports and a fall-off in gold production, which represents roughly one-third of total exports. Current account deficits in excess of 10 percent of GDP were posted in Bosnia and Herzegovina, Bulgaria, the Baltic countries, Kyrgyz Republic, Montenegro, Romania, and Serbia.

Net capital inflows to the region surged by $71 billion in 2006, reaching a record $241 billion and accounting for 42.6 percent of total flows to all developing countries, up from 35.5 percent in 2005 (table A.5). Private capital flows have expanded tremendously over the past five years, rising from a low of $27 billion (2.8 percent of regional GDP) in 2001 to $271 billion in 2006 (11 percent of regional GDP). In contrast, repayments to official creditors continued to outstrip lending by a wide margin ($30 billion in 2006), as plentiful oil revenues enabled Russia to finish paying off its Soviet-era debt with a $22 billion prepayment to Paris Club creditors, following a $15 billion prepayment in 2005. Multinational companies with headquarters located in the region contracted $135 billion in foreign debt in 2006, accounting for 40 percent of cross-border borrowing by companies in developing countries, with most of the funds financing the oil and gas sectors.

FDI inflows increased from $62.8 billion (3.6 percent of GDP) in 2004 to $116 billion (4.6 percent of GDP) in 2006, accounting for over one-third of the total to all developing countries, with most of the flows concentrated in Russia ($28 billion), Turkey ($19 billion), Poland

Table A.5 Net capital flows to Europe and Central Asia

$ billions

	1998	1999	2000	2001	2002	2003	2004	2005	2006e
Current account balance	−24.7	−1.1	16.7	17.7	6.0	−0.1	4.8	22.6	13.8
as % of GDP	−2.1	−0.1	1.8	1.8	0.5	0	0.3	1.0	0.6
Financial flows									
Net private and official flows	68.3	44.2	47.9	29.3	52.9	88.7	148.6	170.7	241.4
Net private flows (debt + equity)	59.8	44.6	47.8	27.2	50.3	95.7	158.7	206.9	271.4
Net equity flows	26.6	25.2	26.0	26.8	26.5	33.6	68.1	80.0	126.9
Net FDI inflows	23.7	23.4	25.4	27.2	26.4	34.2	62.8	73.7	116.4
Net portfolio equity inflows	2.9	1.8	0.6	−0.4	0.1	−0.6	5.3	6.3	10.5
Net debt flows	41.7	19.0	21.9	2.5	26.4	55.1	80.5	90.7	114.5
Official creditors	8.5	−0.4	0.1	2.1	2.6	−7.0	−10.1	−36.2	−30.0
World Bank	1.5	1.9	2.1	2.1	1.0	−0.6	0.4	−0.7	0.3
IMF	5.3	−3.1	−0.7	6.1	4.6	−2.0	−5.9	−9.8	−5.6
Other official	1.6	0.8	−1.3	−6.1	−3.0	−4.4	−4.6	−25.6	−24.6
Private creditors	33.2	19.4	21.8	0.4	23.8	62.1	90.6	126.9	144.5
Net medium- and long-term debt flows	27.1	18.9	13.4	6.3	19.1	31.1	70.7	103.9	114.4
Bonds	14.4	7.8	5.6	1.2	3.7	9.5	23.3	28.4	48.3
Banks	13.7	11.9	9.3	7.2	17.0	21.7	48.7	76.7	66.9
Other private	−1.0	−0.7	−1.5	−2.2	−1.6	−0.2	−1.3	−1.2	−0.8
Net short-term debt flows	6.1	0.5	8.4	−5.9	4.7	31.0	19.9	23.0	30.1
Balancing item[a]	−38.8	−36.9	−46.0	−36.4	−14.9	−27.7	−74.9	−99.9	−80.2
Change in reserves (− = increase)	−4.8	−6.2	−18.6	−10.5	−43.9	−60.9	−78.6	−93.4	−175.0
Memo items									
Bilateral aid grants	9.5	12.5	11.4	10.5	13.1	12.7	14.4	6.6	13.0
of which									
Technical cooperation grants	4.2	4.4	2.9	3.5	4.7	4.3	4.3	2.6	1.9
Other	5.3	8.1	8.5	7.0	8.4	8.4	10.1	4.0	11.1
Net official flows (aid + debt)	18.0	12.1	11.5	12.6	15.7	5.7	4.3	−29.6	−17.0
Workers' remittances	14.4	12.2	13.4	13.0	14.4	17.3	22.7	31.4	31.7
Repatriated FDI Income	2.5	2.4	2.9	4.2	7.1	12.2	16.4	27.8	—

Sources: World Bank Debtor Reporting System and staff estimates.

Note: e = estimate; — = not available.

a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

($12 billion), and Hungary ($9 billion). Major privatizations and mergers and acquisitions in several countries, notably Turkey, Kazakhstan, Hungary, and Ukraine, contributed to the strong gains in FDI inflows to the region. In Turkey, despite the recent deterioration in external balance, quality of financing has improved as the share of short-term flows dropped to 18 percent in 2006 from 41 percent in 2005. FDI inflows reached a historic high of $19.2 billion (4.8 percent of GNP) in 2006, up from $8.7 billion (2.4 percent of GNP) in 2005.

Private debt flows to the region increased from $0.4 billion in 2001 to $144 billion in 2006, accounting for almost two-thirds of the total to all developing countries. Substantial external borrowing by banks in several countries in the region (notably Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Russia, and Ukraine) has financed a surge in credit growth, accompanied by mounting inflationary pressures (in Estonia, Latvia, Kazakhstan, and Ukraine). There are also growing concerns about exchange rate exposures in the banking sector in countries such as Hungary, Romania, Ukraine, and the Baltics, where half of the total value of loans is denominated in foreign currency, as well as concerns about interest rate risk in the banking sector in the Baltics, Ukraine, Kazakhstan, and Russia, where short-term bank lending is prevalent.

Foreign exchange reserves increased strongly, by $175 billion, during 2006, nearly double the $93 billion level of reserve accumulation recorded in 2005. This primarily reflects increases posted in the region's oil-exporting countries, with foreign reserves rising $120 billion in Russia and $12 billion in Kazakhstan. Worker remittances are projected to have been sustained at the 2005 level of over $31 billion, falling somewhat as a share of GDP to 1.3 percent in 2006 from 1.5 percent in 2005, although still above the average of 1.2 percent recorded during 2000–04.

Medium-term outlook

Output in the region is expected to decelerate to 6.0 percent in 2007 and to remain close to that more sustainable level until 2009 (table A.6). Among oil exporters, lower oil prices and a moderation in the pace at which new productive capacity comes online is projected to lower the pace of growth from 7.7 percent in 2006 to about 6.8 percent in 2009. For oil importers, growth should also ease from 6.3 percent in 2006 to 5.2 percent in 2009 due to tighter policy conditions and less robust demand from regional oil exporters. An expected tightening of monetary policy in high-income Europe will likely contribute to the slowdown by raising the opportunity cost of investment in emerging markets, resulting in an expected slowdown in FDI and other financial inflows.

Table A.6 Europe and Central Asia country forecasts
annual percent change unless indicated otherwise

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
Albania							
GDP at market prices (2000 $)[b]	1.4	5.9	5.5	5.0	6.0	6.0	6.2
Current account balance/GDP (%)	−5.6	−4.8	−7.8	−7.2	−7.5	−7.3	−7.2
Armenia							
GDP at market prices (2000 $)[b]	−3.8	10.5	14.0	13.4	9.0	7.0	6.7
Current account balance/GDP (%)	−12.0	−4.5	−3.9	−4.0	−4.5	−4.8	−4.8
Azerbaijan							
GDP at market prices (2000 $)[b]	−5.2	10.2	26.2	34.5	27.0	21.0	25.0
Current account balance/GDP (%)	−15.8	−29.8	1.3	17.7	22.0	24.0	26.8
Belarus							
GDP at market prices (2000 $)[b]	−1.2	11.4	9.2	9.3	6.3	5.2	4.8
Current account balance/GDP (%)	—	−5.2	1.5	−3.1	−5.5	−5.3	−4.1
Bulgaria							
GDP at market prices (2000 $)[b]	−1.7	5.7	5.5	6.3	6.0	5.2	5.4
Current account balance/GDP (%)	−2.3	−6.0	−11.2	−15.8	−13.0	−11.6	−10.6
Croatia							
GDP at market prices (2000 $)[b]	−1.5	3.8	4.3	4.8	4.5	4.2	4.3
Current account balance/GDP (%)	1.1	−5.2	−6.6	−7.4	−7.0	−6.0	−5.8

(*Continues*)

Table A.6 (*Continued*)

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
Czech Republic							
GDP at market prices (2000 $)[b]	0.3	4.2	6.1	5.9	4.9	4.6	4.3
Current account balance/GDP (%)	−2.5	−6.0	−2.0	−4.4	−4.1	−3.3	−3.2
Estonia							
GDP at market prices (2000 $)[b]	−0.8	7.8	9.8	11.4	9.2	7.9	7.0
Current account balance/GDP (%)	−4.5	−13.0	−10.5	−14.8	−14.8	−13.9	−12.4
Georgia							
GDP at market prices (2000 $)[b]	−9.3	5.9	9.3	9.0	7.5	7.0	6.7
Current account balance/GDP (%)	—	−8.3	−5.4	−9.5	−13.0	−8.6	−7.9
Hungary							
GDP at market prices (2000 $)[b]	0.8	5.2	4.1	3.9	2.4	2.8	4.0
Current account balance/GDP (%)	−5.4	−8.5	−7.3	−6.8	−5.5	−4.9	−3.5
Kazakhstan							
GDP at market prices (2000 $)[b]	−3.6	9.6	9.7	10.6	9.0	8.8	9.4
Current account balance/GDP (%)	−1.8	0.8	−1.8	−2.3	−7.0	−6.5	−6.0
Kyrgyz Republic							
GDP at market prices (2000 $)[b]	−4.0	7.0	−0.2	2.7	5.5	5.0	4.8
Current account balance/GDP (%)	−10.6	−3.4	−8.3	−23.6	−11.0	−10.9	−10.8
Latvia							
GDP at market prices (2000 $)[b]	−2.8	8.6	10.2	11.9	10.0	7.5	6.5
Current account balance/GDP (%)	−1.6	−12.9	−12.7	−16.5	−17.8	−16.7	−15.6
Lithuania							
GDP at market prices (2000 $)[b]	−3.3	7.0	7.6	7.4	6.5	6.3	6.1
Current account balance/GDP (%)	−5.9	−7.7	−7.2	−11.5	−10.5	−10.4	−10.2
Macedonia, FYR							
GDP at market prices (2000 $)[b]	−0.9	4.1	3.8	3.1	4.5	4.0	4.3
Current account balance/GDP (%)	—	−8.0	−1.4	−0.4	−3.2	−3.8	−4.3
Moldova							
GDP at market prices (2000 $)[b]	−9.8	7.4	7.1	4.0	5.0	5.0	5.2
Current account balance/GDP (%)	—	−2.0	−9.1	−9.4	−6.7	−5.7	−4.5
Poland							
GDP at market prices (2000 $)[b]	3.8	5.3	3.5	6.1	6.5	5.7	5.0
Current account balance/GDP (%)	−3.5	−4.2	−1.7	−2.3	−2.9	−3.0	−3.1
Romania							
GDP at market prices (2000 $)[b]	−1.7	8.4	4.1	7.5	6.2	6.0	5.8
Current account balance/GDP (%)	−4.8	−8.5	−8.7	−10.5	−10.8	−10.0	−9.3
Russian Federation							
GDP at market prices (2000 $)[b]	−3.9	7.1	6.4	6.7	6.3	5.6	5.8
Current account balance/GDP (%)	—	10.0	10.9	10.2	6.4	3.6	2.1
Slovak Republic							
GDP at market prices (2000 $)[b]	0.3	5.5	6.0	8.3	8.5	6.2	5.7
Current account balance/GDP (%)	—	−3.1	−8.6	−7.8	−4.8	−3.8	−3.5
Turkey							
GDP at market prices (2000 $)[b]	3.6	8.9	7.4	6.0	4.5	5.5	5.4
Current account balance/GDP (%)	−1.1	−5.2	−6.5	−8.2	−6.9	−6.4	−5.7
Ukraine							
GDP at market prices (2000 $)[b]	−8.0	12.1	2.6	6.8	5.3	5.8	5.7
Current account balance/GDP (%)	—	10.7	3.2	−1.7	−5.1	−5.2	−5.1
Uzbekistan							
GDP at market prices (2000 $)[b]	−0.2	7.7	7.0	7.3	5.0	5.0	5.0
Current account balance/GDP (%)	—	10.1	13.6	18.4	15.3	15.1	13.8

Source: World Bank.

Note: Growth and current account figures presented here are World Bank projections and may differ from targets contained in other Bank documents. Bosnia and Herzegovina, Tajikistan, Turkmenistan, and the former Yugoslavia (Serbia and Montenegro) are not forecast owing to data limitations. e = estimate; f = forecast; — = not available.

a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.

b. GDP measured in constant 2000 $.

In Russia, the region's largest economy, GDP growth rate is projected to decline from 6.7 percent in 2006 to 5.8 percent by 2009, reflecting weaker oil revenues, capacity constraints in the oil and other sectors, and a deceleration in investment as implementation of much needed structural reforms is slow. The still-robust domestic demand, exacerbated by an expected appreciation in the ruble, is projected to yield a marked reduction in the current account surplus from about 10 percent of GDP in 2006 to about 2 percent in 2009.

In Turkey, growth is expected to decelerate further to 4.5 percent in 2007 due to sustained higher interest rates, which have already led to a dampening of growth. Inflation at just below 10 percent remains well above the central bank's target and therefore policy is expected to remain tight in an effort to break inflationary expectations. These efforts and sustained fiscal restraint (Turkey has a primary government surplus of 7.0 percent of GDP in 2006) are expected to help gradually restore internal and external balance, allowing policy to relax somewhat toward the end of 2007 or in 2008. As a result, growth is projected to pick up to around 5.5 percent in 2008 and 2009.

In Poland, growth is projected to accelerate further to 6.5 percent in 2007 from 6.1 percent in 2006 due to strong private consumption—supported by accelerated lending and improvements in the labor market—and by double-digit investment growth, which will be bolstered by high corporate profits, rising FDI, and improving absorption of EU structural funds. Assuming that more restrictive fiscal policy is instituted, growth is projected to decelerate in 2008 and 2009, coming in at a sustainable 5.0 percent in 2009. Growth in Hungary is expected to weaken further, to around 2.4 percent in 2007, under the weight of substantial fiscal and monetary policy tightening (interest rates were increased 425 basis points in 2006). However, growth should begin to pick up toward the end of the forecast period as the initial impact of these measures wears off. In the Czech Republic, an anticipated tightening of monetary policy, a deterioration in business and consumer confidence tied to political wrangling within the coalition government, and delays in structural reforms are expected to cause growth to slow to below 5.0 percent in 2007 and toward a more sustainable 4.3 percent pace by 2009.

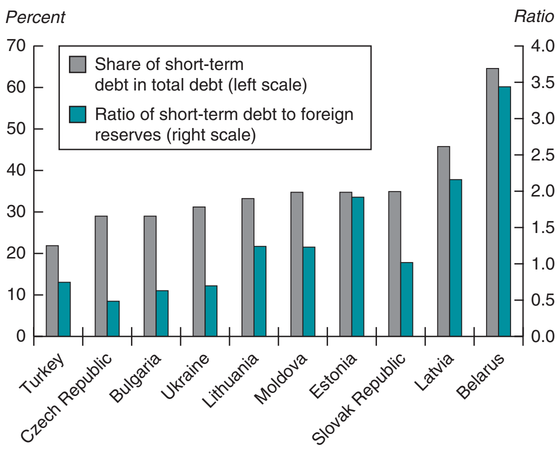
Growth among the region's small hydrocarbon exporters is projected to slow as the expansion in production and export capacity that have underpinned recent strong growth wind down and energy prices fall. Azerbaijan and Kazakhstan are expected to receive a boost to growth in 2009 as new oil capacity comes on stream. The projected deceleration of growth in Russia and other oil exporters, along with a general deceleration in the pace of world trade volumes, should contribute to slower growth in many countries in the Commonwealth of Independent States. Growth in Central Europe is also projected to ease. In addition to weaker demand for the region's exports, growth among the first round of accession countries is expected to slow due to tighter monetary conditions and a reduced growth impetus from EU integration.

Risks and uncertainties

The combination of rising inflation and elevated current account deficits poses a persistent challenge for policy makers in the region. To the extent that the contractionary influence of higher interest rates continues to be offset by capital inflows, further fiscal tightening may be unavoidable—even if it means pushing government balances into surplus in some countries.

While the baseline forecast assumes policy makers are able to manage soft landings, the risks involved with a bumpier adjustment process remain significant for countries that have become dependent on large capital inflows, even if inflows were in the form of less volatile FDI. Capital inflows are expected to remain strong, motivated by investment opportunities associated with EU integration. However, the real-side disequilibrium they have provoked (domestic demand in excess of supply and unsustainably large current account deficits) makes these countries sensitive to a change in investor sentiment, as was the case for Turkey in May 2006. If private capital inflows drop sharply, adjustment in countries with relatively inflexible exchange rate regimes, such as Bulgaria, Croatia, Estonia, and Lithuania, could be particularly challenging. Absorbing the impact of a sudden drop in capital inflows would also pose difficulties to countries with large current account deficits, such as Turkey, given the large financing requirement. Countries with strong reliance on short-term capital inflows are especially vulnerable (figure A.5).

Figure A.5 Short-term debt in selected countries of Europe and Central Asia, Q3 2006



Source: World Bank.

An upside risk derives from the timing of Russia's accession to the WTO. While the boost to Russian exports is expected to be modest, this is nevertheless an important step binding the country more firmly into the system of world trade rules and could provide a significant boost to investor confidence and have a positive effect on medium-term growth.

On the other hand, declining populations, evident in Russia and many other European and Central Asian economies, will pose a significant challenge that may dampen medium-term growth prospects. The declines stem from both dynamics of more deaths than births (high mortality and low fertility) and emigration in countries including Bulgaria, Latvia, Lithuania, Moldova, Poland, Romania, and Ukraine. For other countries, including Belarus, Russia, and the Central European countries that are new EU members, declining populations are the result of natural population declines not being fully offset by immigration.

Latin America and the Caribbean

Recent developments

Economic growth in Latin America and the Caribbean strengthened to 5.6 percent in 2006, up from 4.7 percent in 2005 (table A.7). This marks the third year of solid growth for the region. Over the past three years, regional GDP has increased more than twice as quickly as during

Table A.7 Latin America and the Caribbean forecast summary

annual percent change unless indicated otherwise

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
GDP at market prices (2000 $)[b]	3.4	6.2	4.7	5.6	4.8	4.3	3.9
GDP per capita (units in $)	1.6	4.7	3.2	4.2	3.5	3.0	2.6
PPP GDP[c]	4.3	5.9	4.5	5.5	4.8	4.3	3.9
Private consumption	3.4	5.4	6.8	6.1	5.1	4.4	3.8
Public consumption	1.5	3.3	3.1	3.7	3.2	2.5	2.5
Fixed investment	4.7	12.5	11.0	12.5	9.1	7.1	6.1
Exports, GNFS[d]	8.1	12.0	8.0	6.9	5.2	5.9	5.9
Imports, GNFS[d]	10.7	15.3	12.2	12.7	8.4	7.5	6.8
Net exports, contribution to growth	−0.3	1.0	0	−1.4	−2.2	−2.6	−2.9
Current account balance/GDP (%)	−2.8	1.0	1.6	1.8	0.7	0.1	−0.2
GDP deflator (median, LCU)	10.8	7.4	6.2	7.2	5.3	4.6	4.2
Fiscal balance/GDP (%)	—	0	0.4	0.8	0.3	0.2	0.1
Memo items: GDP							
LAC excluding Argentina	3.2	5.8	4.0	5.1	4.4	4.0	3.9
Central America	3.6	4.1	3.0	4.9	3.6	3.7	3.7
Caribbean	3.6	2.6	6.5	8.7	5.3	4.9	4.6
Brazil	2.7	5.7	2.9	3.7	4.2	4.1	3.9
Mexico	3.5	4.1	2.8	4.8	3.5	3.7	3.6
Argentina	4.5	9.0	9.2	8.5	7.5	5.6	3.8

Source: World Bank.
Note: e = estimate; f = forecast; LCU = local currency units; — = not available.
a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 2000 $.
c. GDP measured at PPP exchange rates.
d. GNFS denotes goods and nonfactor services.

Box A.1 New GDP estimates for Brazil

On March 21, 2007, the Brazilian Institute of Geography and Statistics published a revision of the nominal and real values of Brazil's GDP between 1995 and 2005. The headline news is that the country's economy in 2005 was 10.9 percent larger than previously thought and its growth rate since 2000 has increased from an annual average rate of 2.6 percent to 3.0 percent.

The revisions rely more than previously on annual surveys which sample economic activities of firms and households. As a result of these better measurements, two major changes emerged: a) in the new 2000 base year, services' value added as a share of total value added increased by 10 percentage points (from 56 percent to 66 percent); b) on the demand side, household private consumption increased from 60.9 percent to 63 percent of total GDP. The contribution of investment to GDP declined from 19.3 to 16.8 percent due to a change in structure, as machinery and equipment were previously undervalued and construction was overvalued.

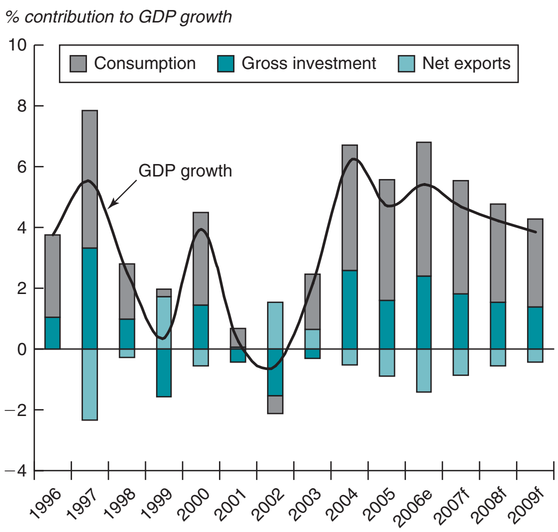
the preceding six years. Growth slowed in only six countries and accelerated in the rest. In 2006, output expanded by 3.5 percent or more in 22 of the 27 economies of the region. Many countries have benefited from increasing commodity prices, which boosted export revenues and contributed to higher incomes and domestic and import spending. Fixed investment, which grew at double-digit rates, and rapid growth of private consumption were the dominant factors in the acceleration of output (figure A.6).

Following a slow start in 2006, GDP in Brazil accelerated in the second half of the year in response to an easing of monetary policy and increased fiscal stimulus. Using the National Statistical Office's revised methodology (see box A.1), GDP increased by 3.7 percent, faster than the 2.9 percent growth recorded in 2005, with the acceleration concentrated in industrial and mining activities. Real interest rates are declining and are currently below 9 percent. This still-elevated level provoked an appreciation of the real and contributed to a decline in inflation from 5.7 percent in 2005 to 3.1 percent in 2006, the lowest rate since the adoption of the inflation targeting regime in 1999. Monthly inflation picked up toward the end of the year and into the first quarter of 2007, partly reflecting an increase in regulated prices, although most analysts concur that inflation will continue its recent downward trend in the near future.

GDP in Mexico accelerated sharply to 4.8 percent in 2006 from 2.8 percent in 2005 as lower interest rates boosted domestic demand and construction activity. Stronger sales of cars to the United States and oil exports also contributed to the pickup in growth. While growth in Argentina eased somewhat, domestic demand remains very strong, and GDP expanded by 8.5 percent—significantly above potential. Inflation in Argentina, which had reached 12.3 percent toward the end of 2005, dropped to 9.1 percent in March 2007 with the help of administrative price measures.

Growth elsewhere in Latin America continues to be supported by very strong commodity prices. GDP in República Bolivariana de Venezuela expanded by an unsustainable 10.3 percent in 2006, fueled by rising government transfers. Despite price controls, inflation accelerated further to 18.5 percent in March 2007. Falling oil production and

Figure A.6 Contribution of consumption, investment, and exports to GDP growth in Latin America and the Caribbean



Sources: World Bank; Datastream.
Note: e = estimate; f = forecast.

weak investment growth, which has been discouraged by high taxes and royalties and antibusiness policies, meant that despite strong demand, industrial production declined 4.9 percent in the 12 months ending February 2007. Domestic demand in Colombia is also growing fast and inflation picked up to 5.8 percent in March 2007. As a result, the central bank has increased interest rates twice in the first few months of the year, bringing its benchmark rate to 8 percent. In Chile, mining stoppages, a waning investment boom, and higher imports contributed more than 2 percentage points to the slowing of the economy despite booming copper prices. The authorities have responded to the weakening of growth by lowering interest rates for the first time in three years and there are some signs of a strengthening in domestic demand and activity.

Growth accelerated in most Central American and Caribbean countries in 2006, boosted by robust private consumption and investment. The construction sector has been an important driver of activity as the region continues to recover from the damage caused by Tropical Storm Stan. In contrast to most of the region, growth in Nicaragua has been weak due to poor rainfalls that have held back the agricultural sector and reduced external receipts. Despite the expectation of accelerating growth following the implementation of the Dominican Republic-Central America Free Trade Agreement (DR-CAFTA), big gains are unlikely in the near future. Members who have ratified the agreement (congressional debate on the agreement continues in Costa Rica) are still losing market share of their maquila exports to China, while Guatemala and El Salvador are experiencing increased competition from low-wage regional exporters such as Honduras and Nicaragua. Despite healthy revenues from tourism and mining, export volume growth in the Dominican Republic and Jamaica have been disappointing. Elsewhere, robust remittances have offset the deterioration in the trade balance. While some countries, most notably Guatemala, have adopted a more relaxed fiscal and monetary stance, others, such as Costa Rica, have taken advantage of strong private sector growth to increase tax receipts and significantly reduce the size of the fiscal deficit.

Although the currencies of a number of countries were affected by the financial turbulence in May 2006, the adjustments were either welcome corrections or short-lived. Stock markets also underwent a major correction. The resilience of countries in the region to this shock, and to the smaller one of February 2007, reflects improved fiscal and monetary policies and reduced indebtedness. Indeed, with a few notable exceptions, inflation is on a downward trend in the region despite the cyclical upturn and fiscal policy has been less expansionary during the upswing and recent elections than in the past.

Net capital inflows to the region increased slightly to $68 billion in 2006, up from $65 billion in 2005, but were well below the $110 billion level attained in 1998. As a percentage of GDP, net capital inflows declined from 2.8 to 2.5 percent and represented less than half the 5.5 percent of GDP level observed during the late 1990s (table A.8). Net private (debt and equity) inflows declined by $3.4 billion in 2006, with net equity inflows of $80.5 billion were substantially higher than net private debt inflows of $12.3 billion. The pace at which countries in the region repaid existing debt to official creditors declined and, as a result, net capital outflows from the region fell from $31.2 billion in 2005 to $24.6 billion in 2006. In 2006, the outflows were mainly due to large voluntary prepayments by Argentina ($9.6 billion) and Uruguay ($2.5 billion) to the IMF, and by Mexico ($2.5 billion) to the Inter-American Development Bank and the World Bank.

Net FDI inflows were unchanged at $70 billion in 2006, declining from 3.0 to 2.5 percent of GDP. Net bank lending surged from zero in 2005 to $17.4 billion in 2006, due entirely to a record $17.6 billion bridge loan contracted by the Brazilian mining company Compania Vale do Rio Doce (CVRD), to acquire the Canadian mining company Inco.

The large buybacks of sovereign debt by Brazil ($15 billion), Mexico ($5.4 billion), República Bolivariana de Venezuela ($4.6 billion), and Colombia ($4.3 billion) in 2006 reduced the average cost of capital of these countries and significantly improved their debt-servicing profiles. With less than $6 billion outstanding, Brady bonds, once the mainstay of the emerging-market asset class, have been almost completely retired. Despite these improvements in the external debt statistics, dependence on foreign capital has likely declined to a lesser extent because sales of bonds issued on domestic debt markets purchased by foreigners are not recorded in these statistics. Two other developments are worth mentioning: the

Table A.8 Net capital flows to Latin America and the Caribbean
$ billions

	1998	1999	2000	2001	2002	2003	2004	2005	2006e
Current account balance	−89.6	−55.8	−47.4	−52.8	−15.6	8.5	21.1	37.1	51.1
as % of GDP	−4.5	−3.2	−2.4	−2.8	−0.9	0.5	1.0	1.6	1.8
Financial flows									
Net private and official flows	109.8	101.2	75.4	95.2	50.4	63.8	58.0	65.0	68.2
Net private flows (debt + equity)	98.7	99.6	86.5	74.9	37.7	59.1	68.3	96.2	92.8
Net equity flows	71.9	85.0	79.4	73.1	53.2	47.4	61.9	82.4	80.5
Net FDI inflows	74.1	88.6	80.0	70.6	51.8	44.0	62.5	70.0	69.4
Net portfolio equity inflows	−2.2	−3.6	−0.6	2.5	1.4	3.4	−0.6	12.4	11.1
Net debt flows	37.9	16.2	−4.0	22.1	−2.8	16.4	−3.9	−17.4	−12.3
Official creditors	11.1	1.6	−11.1	20.4	12.7	4.7	−10.3	−31.2	−24.6
World Bank	2.4	2.1	2.0	1.3	−0.3	−0.4	−1.0	−0.8	−4.4
IMF	2.5	−0.9	−10.7	15.6	11.9	5.6	−6.3	−27.6	−10.9
Other official	6.2	0.4	−2.4	3.5	1.1	−0.4	−3.0	−2.9	−9.3
Private creditors	26.8	14.6	7.1	1.8	−15.5	11.7	6.4	13.8	12.3
Net medium- and long-term debt flows	55.1	19.5	8.0	16.4	−5.0	9.0	−0.9	16.6	10.2
Bonds	17.7	20.1	8.4	2.9	−0.4	11.0	−1.8	16.6	−7.1
Banks	39.1	−1.4	0.4	15.2	−2.6	−1.0	0.9	0.1	17.4
Other private	−1.7	0.8	−0.8	−1.6	−1.9	−0.9	0	−0.1	0
Net short-term debt flows	−28.3	−4.9	−0.9	−14.6	−10.5	2.6	7.3	−2.8	2.1
Balancing item[a]	−29.2	−52.7	−25.3	−40.5	−32.9	−37.7	−54.1	−67.3	−64.0
Change in reserves (− = increase)	9.0	7.3	−2.7	−1.9	−1.9	−34.6	−25.0	−34.8	−55.3
Memo items									
Bilateral aid grants	5.5	5.2	5.2	6.1	5.7	6.6	8.7	8.0	6.6
of which									
Technical cooperation grants	2.3	2.3	2.7	2.9	2.9	3.6	3.8	3.2	2.9
Other	3.2	2.9	2.5	3.2	2.8	3.0	4.9	4.8	3.7
Net official flows (aid + debt)	16.6	6.8	−5.9	26.5	18.4	11.3	−1.6	−23.2	−18.0
Workers' remittances	15.9	17.7	20.1	24.4	28.1	35.0	41.4	48.2	52.5
Repatriated FDI Income	13.8	12.6	14.0	14.6	12.7	14.7	18.8	29.7	—

Sources: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate; — = not available.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

accumulation of reserves and the rapid expansion of remittance inflows. The latter supported import spending, especially in Central American and Caribbean countries.

Medium-term outlook

Regional GDP growth is expected to moderate from 5.6 percent in 2006 to 4.8 percent in 2007 and ease further to 3.9 percent in 2009 (table A.9). However, this slowdown in regional growth mainly reflects a return toward more sustainable growth rates in Argentina and República Bolivariana de Venezuela, following a postcrisis rebound in growth. Excluding these two countries, expansion in the rest of the region is projected to remain relatively steady at 4.1 percent during the forecast period, down only 0.6 percentage points from 2006.

Prospects for individual countries reflect a number of offsetting influences. The projected slowdown in global activity should moderate demand for commodities, resulting in a modest decline in their prices and slower volume growth. As a result, growth among commodity exporters will moderate, although their export revenues will remain elevated in historical perspective. GDP growth for exporters of agricultural commodities is expected to decelerate from 7.7 percent in 2006 to 5.2 percent in 2008. Despite softening metal prices, growth among exporters of these commodities should pick up due mainly to expansionary monetary policies in Chile and Brazil. Notwithstanding lower projected oil prices, growth of small oil importers (excluding Brazil and Chile) is projected to slow from 7.1 percent in 2006 to 4.5 percent in 2009 due to weaker demand in the United States and slower investment growth in Central American and Caribbean countries.

The positive trends recently observed in Brazil—decreasing unemployment, creation of formal jobs, recovery of real earnings, and

Table A.9 Latin America and the Caribbean country forecasts

annual percent change unless indicated otherwise

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
Argentina							
GDP at market prices (2000 $)[b]	4.5	9.0	9.2	8.5	7.5	5.6	3.8
Current account balance/GDP (%)	−3.1	2.1	2.8	3.1	2.3	1.6	1.2
Antigua and Barbuda							
GDP at market prices (2000 $)[b]	3.3	4.3	5.2	5.6	5.8	5.7	5.6
Current account balance/GDP (%)	−6.0	−11.9	−11.4	−12.0	−12.3	−12.3	−11.7
Belize							
GDP at market prices (2000 $)[b]	5.9	4.6	3.1	4.0	2.8	3.3	3.4
Current account balance/GDP (%)	−7.3	−14.4	−12.0	−8.7	−6.3	−6.1	−6.0
Bolivia							
GDP at market prices (2000 $)[b]	3.8	3.9	4.1	4.5	4.6	4.1	3.5
Current account balance/GDP (%)	−6.1	3.9	5.2	8.1	8.3	7.9	7.6
Brazil							
GDP at market prices (2000 $)[b]	2.7	5.7	2.9	3.7	4.2	4.1	3.9
Current account balance/GDP (%)	−2.1	1.9	1.9	1.5	1.0	0.3	0.6
Chile							
GDP at market prices (2000 $)[b]	6.4	6.2	6.3	4.2	5.1	5.0	4.9
Current account balance/GDP (%)	−2.7	1.7	0.6	3.8	1.7	0	−0.7
Colombia							
GDP at market prices (2000 $)[b]	2.5	4.8	5.3	6.8	5.5	4.8	4.5
Current account balance/GDP (%)	−1.9	−0.9	−1.7	−1.9	−2.4	−2.7	−2.9
Costa Rica							
GDP at market prices (2000 $)[b]	5.2	4.1	5.9	7.6	5.7	4.6	4.3
Current account balance/GDP (%)	−3.6	−4.3	−4.8	−4.7	−4.6	−4.2	−4.2
Dominica							
GDP at market prices (2000 $)[b]	1.8	3.2	3.6	2.5	2.6	2.5	2.4
Current account balance/GDP (%)	−16.6	−6.4	−6.1	−6.3	−6.5	−6.7	−6.9
Dominican Republic							
GDP at market prices (2000 $)[b]	6.0	2.0	9.3	10.7	6.8	5.2	4.8
Current account balance/GDP (%)	−3.2	4.3	−1.9	−2.5	−2.6	−2.5	−1.8
Ecuador							
GDP at market prices (2000 $)[b]	1.8	7.9	4.7	4.6	3.4	3.2	3.1
Current account balance/GDP (%)	−2.3	−1.7	0.8	3.0	1.8	0.4	0.2
El Salvador							
GDP at market prices (2000 $)[b]	4.6	1.8	2.8	4.2	3.4	3.4	3.3
Current account balance/GDP (%)	−2.0	−4.0	−4.6	−5.6	−4.4	−4.1	−4.0
Guatemala							
GDP at market prices (2000 $)[b]	4.1	2.7	3.2	4.6	3.9	4.1	4.0
Current account balance/GDP (%)	−4.6	−4.4	−4.3	−5.5	−4.4	−3.4	−3.0
Guyana							
GDP at market prices (2000 $)[b]	4.9	3.3	−3.0	4.5	3.8	3.0	3.0
Current account balance/GDP (%)	−15.1	−2.5	−18.6	−15.1	−14.0	−14.3	−14.5
Haiti							
GDP at market prices (2000 $)[b]	−1.3	−2.2	2.3	2.8	3.0	3.3	3.5
Current account balance/GDP (%)	−1.8	−1.7	1.4	−0.4	−2.0	−3.5	−3.6
Honduras							
GDP at market prices (2000 $)[b]	3.3	5.0	4.3	5.2	3.9	4.0	4.0
Current account balance/GDP (%)	−7.7	−5.7	−0.5	−1.6	−2.3	−1.9	−2.0
Jamaica							
GDP at market prices (2000 $)[b]	1.9	1.1	1.4	2.7	3.1	3.0	2.9
Current account balance/GDP (%)	−2.7	−5.7	−11.1	−8.1	−7.7	−8.0	−7.8
Mexico							
GDP at market prices (2000 $)[b]	3.5	4.1	2.8	4.8	3.5	3.7	3.6
Current account balance/GDP (%)	−3.7	−1.0	−0.6	−0.2	−1.2	−1.5	−1.8
Nicaragua							
GDP at market prices (2000 $)[b]	3.4	5.1	4.0	3.5	3.0	3.2	3.1
Current account balance/GDP (%)	−28.7	−15.5	−16.3	−12.8	−14.2	−15.1	−14.1

(*Continues*)

Table A.9 (*Continued*)

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
Panama							
GDP at market prices (2000 $)[b]	5.1	7.6	6.4	7.5	6.1	5.0	4.8
Current account balance/GDP (%)	−4.8	−7.5	−8.5	−3.7	−3.4	−4.3	−4.6
Paraguay							
GDP at market prices (2000 $)[b]	1.8	4.1	2.7	3.8	3.8	3.4	3.1
Current account balance/GDP (%)	−2.2	2.0	−0.3	−3.4	−2.0	−1.6	−1.2
Peru							
GDP at market prices (2000 $)[b]	4.0	5.2	6.4	8.0	6.6	5.7	5.2
Current account balance/GDP (%)	−5.5	0	1.5	2.8	1.8	1.2	−0.4
St. Lucia							
GDP at market prices (2000 $)[b]	3.1	3.9	6.5	6.1	5.7	5.2	4.9
Current account balance/GDP (%)	−11.4	−6.4	−7.1	−6.5	−6.2	−5.8	−5.3
St. Vincent and the Grenadines							
GDP at market prices (2000 $)[b]	2.1	5.4	2.8	3.2	3.4	3.1	3.0
Current account balance/GDP (%)	−19.8	−10.5	−12.5	−12.4	−12.1	−11.3	−10.6
Trinidad and Tobago							
GDP at market prices (2000 $)[b]	3.2	6.5	7.0	12.0	4.7	6.3	5.8
Current account balance/GDP (%)	0.2	11.9	27.0	33.4	27.2	20.7	20.2
Uruguay							
GDP at market prices (2000 $)[b]	3.0	11.8	6.8	6.9	5.1	4.1	3.8
Current account balance/GDP (%)	−1.5	0.3	0	−1.6	−0.9	−0.8	−1.1
Venezuela, R. B. de							
GDP at market prices (2000 $)[b]	2.1	17.9	10.3	10.3	6.5	3.3	3.0
Current account balance/GDP (%)	2.6	14.1	18.5	14.4	8.2	5.6	3.1

Source: World Bank.
Note: Growth and current account figures presented here are World Bank projections and may differ from targets contained in Bank documents. Barbados, Cuba, Grenada, and Suriname are not forecast owing to data limitations. e = estimate; f = forecast.
a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 2000 $.

improvements in productive capacity—will most likely continue to bolster economic activity in the coming months. There remains scope for further loosening of monetary policy, although the central bank has reduced the pace of monetary easing (during the most recent meetings, the Selic target rate was cut by 25 basis points as compared with 50 basis points earlier during the current easing cycle). Additionally, the recently reelected administration has launched a growth acceleration plan (PAC) whose centerpiece is an investment program of $240 billion, equivalent to 27 percent of 2006 GDP, to be carried out over 2007–10. These factors will support a strong GDP growth of around 4.1 percent in the forecast period.

Lower oil prices and the declining contribution of government spending are expected to slow the growth rate of domestic demand in República Bolivariana de Venezuela, resulting in a significant slowdown in GDP growth from 10.3 percent in 2006 to 6.5 percent in 2007 and around 3 percent in the following two years. While this should prevent further deterioration in the current account balance and reduce inflationary pressures, inflation is expected to remain high until domestic supply catches up with demand levels. GDP growth in other energy exporters is projected to slow from 6.2 percent in 2006 to about 4.4 percent by 2008. In the case of Mexico, the anticipated cycle in the United States will reduce export growth and is projected to slow GDP by 1.3 percentage points to 3.5 percent in 2007, followed by somewhat stronger growth in 2008–09.

In Argentina, the slowdown is expected to be more gradual. Growth in industrial production has been strong recently, which has attracted additional capital inflows that have supported strong domestic demand. As a result, growth is projected to remain strong in 2007 (7.5 percent). Macroeconomic policy restraint will be needed to align growth with potential output over the medium term, as sustained expansionary policy raises the risk that growth will have to slow more abruptly to reestablish equilibrium between demand and supply.

Risks and uncertainties

A major uncertainty for the region concerns the future path of commodity prices and export demand, both of which are likely to be sensitive to growth developments in the United States. A more forcible spreading of the housing recession to other sectors in the U.S. economy could have important consequences for Latin American and Caribbean countries with close trade links with the United States, notably Mexico. Indirect channels may also be important. In particular, a sharp slowdown in U.S. demand could cause commodity prices to weaken much more rapidly than anticipated in the baseline. The combination of weaker demand and lower prices for the exports of countries in the region could generate significant difficulties for some countries, where underlying problems may have been hidden by the commodity boom of the past few years.

In general, the region has become more resilient to external shocks in the past few years and most countries have taken steps to restructure and reduce debt burdens as well as to establish ample international reserves. For many countries, reserves accumulation was supported not only by recent favorable international financial market conditions but also by improved competitiveness and stronger current account positions. These developments, combined with a higher share of FDI in capital inflows, have reduced the vulnerability of the region to sudden capital flow reversals. The end-February 2007 declines in equity markets that started in China and quickly reverberated in other markets (Brazil's market fell 6.6 percent, Russia's fell 3.3 percent, Turkey's fell 4.5 percent, and the Dow Jones Industrial Average fell by around 3 percent) did not produce lasting negative effects on sovereign bond spreads (the EMBI Global rose to about 195 basis points but has since leveled off at 190 basis points, a historically low level for this index).

Several Latin American and Caribbean countries have adopted a number of policies that could significantly reduce their long-term growth potential, increasing the likelihood of a sharp growth disruption should today's virtuous cycle of strong external growth, robust export prices, and low interest rates turn into a vicious circle characterized by falling commodity prices, rising interest rates, and slower demand. With the external environment toughening and some internal tensions remaining, markets may become more volatile going forward, as was illustrated by the recent increase in the VIX index, a measure of investors' forecasts regarding risk and an indication of risk aversion.

Middle East and North Africa[4]

Recent developments

The low- and middle-income countries of the Middle East and North Africa[5] region continued on a robust growth path during 2006, with real GDP increasing by 5 percent (3.2 percent in per capita terms), a significant improvement from the 4.3 percent gain posted the year before (table A.10). Notwithstanding a further 20 percent hike in oil prices during 2006, GDP growth for the resource-poor economies[6] of the region accelerated from 3.8 percent in 2005 to 5.6 percent, partly reflecting a rebound in growth among Maghreb countries following a severe drought in 2005. Growth among the oil-exporting economies dipped to 4.5 percent in 2006 from 4.7 percent in 2005, principally as hydrocarbon production in Algeria languished, restricting overall growth in that country to 1.4 percent.

Rising oil prices during the first eight months of 2006 served to bolster revenues and domestic demand among the major oil-exporting countries in the region. Many governments have used revenues to boost spending. Measures included substantial investments to augment oil-sector capacity, infrastructure projects, and other nonoil-sector investments in human and social capital, all of which should help boost future supply. However, a significant share of the additional spending, such as substantial civil service wage increases in several countries, and increased spending on fuel subsidies, merely stoked demand and may prove difficult to sustain should oil prices decline further.

Though their oil import bill has soared, oil importers such as Morocco and Tunisia have also benefited from the region's boom in oil revenues as FDI flows from the Gulf Cooperation Council (GCC), comprised of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates, and the Republic of Yemen have picked up considerably, while recovery in the Euro Area has served to boost tourism revenues and remittance inflows. Strong Suez Canal revenues in Egypt and better crops following a drought in the Maghreb are additional

Table A.10 Middle East and North Africa forecast summary
annual percent change unless indicated otherwise

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
GDP at market prices (2000 $)[b]	3.8	4.8	4.3	5.0	4.5	4.6	4.8
GDP per capita (units in $)	1.6	3.0	2.6	3.2	2.7	2.8	3.1
PPP GDP [c]	4.7	4.8	4.3	5.3	4.5	4.6	4.8
Private consumption	3.8	6.3	2.6	6.4	5.6	6.9	6.6
Public consumption	4.3	2.7	5.8	3.8	4.8	5.0	5.0
Fixed investment	3.3	8.1	12.0	12.5	11.4	9.4	8.9
Exports, GNFS[d]	4.4	8.6	3.4	5.2	4.7	4.1	4.4
Imports, GNFS[d]	1.6	15.2	4.5	12.6	11.2	10.8	9.5
Net exports, contribution to growth	−0.8	−1.7	−2.0	−4.4	−6.6	−8.9	−10.9
Current account balance/GDP (%)	−0.3	2.6	6.6	6.3	4.0	2.9	1.9
GDP deflator (median, LCU)	7.4	9.1	13.5	8.5	3.5	4.4	4.0
Fiscal balance/GDP (%)	−2.7	−2.7	0.8	0.6	0.5	0.9	0.6
Memo items: GDP							
MENA geographic region[e]	3.4	5.0	5.3	5.4	5.0	4.9	4.9
Resource poor, labor abundant[f]	4.2	4.8	3.8	5.6	4.9	5.1	5.5
Resource rich, labor abundant [g]	3.3	4.9	4.6	4.3	4.0	4.2	4.1
Resource rich, labor importing [h]	3.0	5.2	6.8	6.0	5.7	5.2	4.9
Egypt, Arab Rep. of	4.3	4.2	4.6	6.9	5.3	5.4	6.0
Iran, Islamic Rep. of	3.7	5.1	4.4	5.8	5.0	4.7	4.5
Algeria	1.7	5.2	5.3	1.4	2.5	3.5	4.0

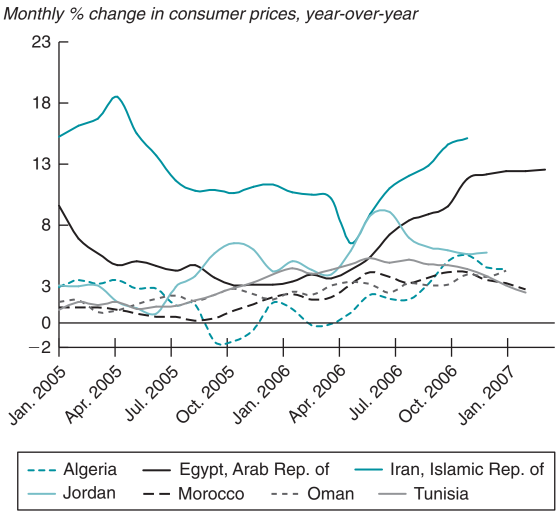
Source: World Bank.
Note: e = estimate; f = forecast; LCU = local currency units.
a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 2000 $.
c. GDP measured at PPP exchange rates.
d. GNFS denotes goods and nonfactor services.
e. Geographic region includes high-income countries: Bahrain, Kuwait, and Saudi Arabia.
f. Egypt, Jordan, Lebanon, Morocco, and Tunisia.
g. Algeria, the Islamic Republic of Iran, Syria, and the Republic of Yemen.
h. Bahrain, Kuwait, Oman, and Saudi Arabia.

factors that explain the acceleration of growth in these countries from 3.8 to 5.6 percent between 2005 and 2006. An exception to the strong growth performance was Lebanon, where the conflict between Israel and Hezbollah and political uncertainty caused GDP to contract by about 5.5 percent in 2006.

Despite strong demand growth, industrial production declined by 0.2 percent in 2006, reflecting capacity constraints among both oil importers and oil exporters, real effective exchange rate appreciation related to Dutch disease in several countries, and OPEC-dictated cuts in hydrocarbon production. The combination of rapidly expanding demand and declining or relatively stagnant industrial production led to a 2 percentage point increase in regional inflation, a notion of concern, although the increase was moderate in relation to the scope of the region's oil price boom, suggesting that countries are coping better with these pressures than they have in the past. Rising imported agricultural and other raw-material prices, coupled with increased domestic energy costs (several countries lifted subsidies on gasoline and other fuels), also contributed to the pickup in consumer inflation from 3.2 percent at the end of 2005 to 5.6 percent in the final months of 2006. Inflation in the Islamic Republic of Iran remains in the double digits, while the consumer price index picked up in Algeria, Egypt, and Oman over the course of 2006. Tighter policy in Tunisia and Morocco has helped reestablish a downward trajectory for inflation in those countries. Inflation in Jordan has declined somewhat in recent months, though it is still higher than it was a year earlier (figure A.7).

Tourism revenues, which rose by 11 percent to $17.8 billion in 2006, account for 7 percent of the region's external receipts, and an even larger share for resource-poor countries. Gross remittance inflows to countries in the region were up 8.8 percent in 2006, double the pace of 2005, standing at $25.1 billion. Together, remittances and tourism represent some 28 percent of recipients' foreign

Figure A.7 Rising inflation in selected countries of the Middle East and North Africa



Sources: World Bank; Datastream.

currency revenues. While Morocco is the most important destination for remittances ($5.2 billion), Jordan received a larger share of its income (17.5 percent of GDP in 2006) from this source, mainly reflecting transfers from citizens working in regional high-income oil-exporting countries. Partly because of these revenues, the current account position of resource-poor and oil-importing countries remained in balance, despite deterioration in merchandise trade balances.

The divergence between higher oil prices (on average, oil prices were up 20 percent in 2006) and reduced oil export volumes meant that petroleum and related receipts of the region's low- and middle-income oil exporters increased by only $10 billion (compared with a $30 billion increase in 2005). This, combined with a rapid increase in domestic demand, meant that the aggregate current account surplus of these countries edged lower from 11.2 to 10.9 percent of GDP. Moreover, despite strong oil revenues, aggregate fiscal surplus slipped from 5.5 to 4.4 percent of GDP. In contrast, the same reduction in energy subsidies that served to increase domestic inflation rates among the region's oil importers also helped them to reduce their fiscal deficits from an average of 6.8 percent of GDP in 2005 to a still-high 6.2 percent in 2006.

For the region, 2006 was a year of ample financial liquidity, strong revival of privatization, and robust cross-border mergers and acquisitions, particularly in the banking industry. Regional investment demand, fueled in part by intraregional FDI flows, increased by more than 12 percent for the second year in a row. Total FDI flows reached a new high of more than $19 billion in 2006, or 3 percent of regional GDP (table A.11), concentrated in Egypt, Jordan, Lebanon, and Tunisia. In contrast with equity markets elsewhere in the developing world, markets in the region considered as a whole have yet to recover from the turbulence introduced in May/June 2006. Prices in dollar terms remain below levels of early June, although this mainly reflects weakness in Iranian and Iraqi markets. Prices elsewhere continue to rise rapidly, outpacing the rest of the developing world (figure A.8).

The combination of high trade surpluses and large capital inflows has boosted the region's financial resources, adding to central banks' foreign exchange reserve holdings and increased foreign investment, not only in the energy sector but also in infrastructure, real estate, and tourism. As in other regions, sovereigns in the Middle East and North Africa continued to reduce their external debt through debt repayment.

Traditionally strong local and regional banks have benefited from the favorable combination of growing local economies, ample oil-generated foreign currency liquidity, closer regional financial integration, and a new wave of privatization and banking sector reform implemented in several countries, including Egypt, Algeria, and Lebanon. Shares of several state-owned banks (for example, Bank of Alexandria in Egypt) have been offered to both local and foreign investors. Rising real estate prices have created a growing market opportunity for banks to expand lending. However, the combination of increased bank borrowing from overseas markets to help finance this sharp rise in activity, efforts to strengthen capital adequacy through foreign equity injections, and a surge in other capital inflows may make the region vulnerable to overpricing of assets and sudden corrections similar to those of May/June 2006.

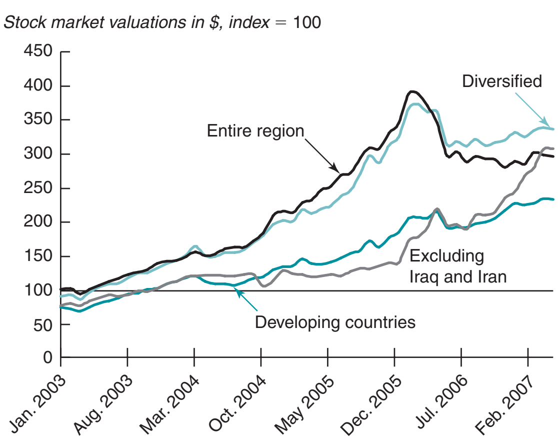
Aid grants provided by bilateral donors to the Middle East and North Africa region increased substantially over the last few years, although

Table A.11 Net capital flows to the Middle East and North Africa
$ billions

	1998	1999	2000	2001	2002	2003	2004	2005	2006e
Current account balance	−14.6	3.1	22.5	13.2	8.4	12.8	12.9	38.1	42.1
as % of GDP	−4.1	0.9	5.9	3.3	2.1	2.9	2.6	6.6	6.3
Financial flows									
Net private and official flows	7.6	0.5	1.2	4.8	6.0	9.3	10.4	20.7	13.9
Net private flows (debt + equity)	9.2	3.0	3.9	6.0	8.5	11.8	14.3	24.3	23.4
Net equity flows	4.0	3.5	5.0	4.0	4.6	8.4	7.5	16.1	20.8
Net FDI inflows	3.8	2.8	4.8	4.1	4.9	8.1	6.8	13.8	19.2
Net portfolio equity inflows	0.2	0.7	0.2	−0.1	−0.3	0.3	0.7	2.3	1.6
Net debt flows	3.6	−3.0	−3.8	0.8	1.4	0.9	2.9	4.6	−6.9
Official creditors	−1.6	−2.5	−2.7	−1.2	−2.5	−2.4	−4.0	−3.6	−9.5
World Bank	−0.2	0.2	−0.3	−0.1	−0.3	−0.3	−0.6	0	−0.9
IMF	0	0	−0.2	−0.1	−0.3	−0.6	−0.5	−0.7	−0.1
Other official	−1.4	−2.8	−2.2	−1.0	−2.0	−1.6	−2.8	−2.8	−8.5
Private creditors	5.2	−0.5	−1.1	2.0	3.9	3.4	6.8	8.2	2.6
Net medium- and long-term debt flows	1.8	−1.4	0.8	3.8	4.5	0.2	2.4	4.9	0.6
Bonds	1.3	1.4	1.2	4.4	5.0	0.7	3.3	2.6	−2.3
Banks	2.0	−1.6	0.5	−0.1	−0.2	−1.0	−0.8	3.4	4.4
Other private	−1.5	−1.2	−0.9	−0.5	−0.2	0.5	−0.2	−1.0	−1.5
Net short-term debt flows	3.3	1.0	−1.9	−1.8	−0.6	3.1	4.5	3.2	1.9
Balancing item[a]	5.4	−4.5	−19.0	−8.8	−2.3	0	−9.1	−37.7	−19.0
Change in reserves (− = increase)	1.6	0.9	−4.7	−9.2	−12.1	−22.1	−14.3	−21.1	−37.0
Memo items									
Bilateral aid grants[b]	4.9	4.7	4.1	4.6	7.8	10.7	27.2	11.9	15.4
of which									
Technical cooperation grants	1.6	2.1	1.5	1.8	2.1	2.1	1.8	2.2	2.9
Other	3.3	2.6	2.6	2.8	5.7	8.6	25.4	9.7	12.6
Net official flows (aid + debt)	3.3	2.2	1.4	3.4	5.3	8.3	23.2	8.3	5.9
Workers' remittances	13.1	12.8	12.9	14.7	15.8	20.3	23.0	24.0	25.1
Repatriated FDI Income	1.7	2.0	2.6	3.3	3.3	4.4	6.0	6.7	—

Sources: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate; — = not available.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.
b. Including aid grants provided to Iraq, which are not included in the financial flows because they do not report to the Debtor Reporting System.

Figure A.8 Stock market valuations in the Middle East and North Africa



Sources: World Bank; Datastream.
Note: Diversified economies are countries whose exports comprise a mix of goods and services and include Jordan, Lebanon, Morocco, and Tunisia.

much of the increase in flows was in the form of debt relief to Iraq by Paris Club creditors ($13.9 billion during 2005 and $3.4 billion in 2006). Assistance provided to Iraq accounted for more than 40 percent of total ODA flows to the region in the last two years. In January 2007, a gathering of donors (Paris III) pledged some $7.5 billion to facilitate the rebuilding process in Lebanon, grounded in a renewed program of fiscal and economic reforms.

Medium-term outlook

Prospects for the region through 2009 are broadly favorable. A gradual easing of growth among the resource-rich economies, in tandem with softening oil prices, implies that oil revenues are likely to decline. Weaker output growth among oil exporters is projected to be compensated for by a pickup among the resource-poor economies. On balance,

Table A.12 Middle East and North Africa country forecasts

annual percent change unless indicated otherwise

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
Algeria							
GDP at market prices (2000 $)[b]	1.7	5.2	5.3	1.4	2.5	3.5	4.0
Current account balance/GDP (%)	3.2	13.2	20.4	23.2	17.9	16.2	12.8
Egypt, Arab Rep. of							
GDP at market prices (2000 $)[b]	4.3	4.2	4.6	6.9	5.3	5.4	6.0
Current account balance/GDP (%)	0.9	5.0	3.0	1.5	1.3	−0.7	−0.5
Iran, Islamic Rep. of							
GDP at market prices (2000 $)[b]	3.7	5.1	4.4	5.8	5.0	4.7	4.5
Current account balance/GDP (%)	1.6	0.9	7.4	5.3	2.4	2.2	1.0
Jordan							
GDP at market prices (2000 $)[b]	5.1	8.4	7.3	6.3	5.0	5.0	5.5
Current account balance/GDP (%)	−4.3	−0.2	−19.6	−23.0	−22.2	−17.3	−9.8
Lebanon							
GDP at market prices (2000 $)[b]	7.2	6.3	1.0	−5.5	4.5	2.9	3.5
Current account balance/GDP (%)	..	−16.5	−18.8	−22.9	−20.9	−19.3	−17.1
Morocco							
GDP at market prices (2000 $)[b]	2.2	4.2	1.7	7.3	3.5	4.5	4.6
Current account balance/GDP (%)	−1.4	1.8	2.1	4.1	2.9	2.0	0.8
Oman							
GDP at market prices (2000 $)[b]	4.6	3.1	5.6	6.4	5.7	4.8	4.8
Current account balance/GDP (%)	−3.7	2.3	15.7	21.2	23.1	18.7	15.3
Syrian Arab Rep.							
GDP at market prices (2000 $)[b]	5.1	3.9	4.5	5.1	3.2	3.5	3.2
Current account balance/GDP (%)	1.0	−2.5	1.2	1.2	−2.1	−2.3	−2.7
Tunisia							
GDP at market prices (2000 $)[b]	4.7	6.0	4.2	5.3	5.6	6.0	6.2
Current account balance/GDP (%)	−4.3	−2.0	−1.1	−1.2	−1.5	−1.2	−1.1
Yemen, Republic of							
GDP at market prices (2000 $)[b]	5.5	2.5	3.8	3.9	2.5	3.0	2.5
Current account balance/GDP (%)	−4.3	1.7	4.6	−4.5	−8.4	−11.4	−11.0

Source: World Bank.
Note: Growth and current account figures presented here are World Bank projections and may differ from targets contained in Bank documents. Djibouti, Iraq, Libya, and the West Bank and Gaza are not forecast owing to data limitations. e = estimate; f = forecast.
a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 2000 $.

regional GDP growth is projected to ease only modestly from 5 percent growth in 2006 to 4.8 in 2009 (table A.12).

For oil exporters, a projected decline in oil prices and the resurgence of non-OPEC supply underpin an expected slowdown in growth from 4.5 percent in 2006 to 4.2 percent by 2009. Already, OPEC has cut production by some 0.55 million barrels per day (mbpd) in contrast to the average increase of 1.7 mbpd during 2004 and 2005. Falling oil prices and production levels are expected to restrain government spending in the region. While oil revenues remain very high and should continue feeding domestic demand in oil-producing countries, capacity constraints are expected to limit domestic production growth, causing imports to continue to rise rapidly as export volumes and prices ease. As a result, the current account balances of developing oil exporters are projected to decline from a 10.9 percent of GDP surplus in 2006 to about 4.4 percent of GDP in 2009, while fiscal surpluses are expected to narrow from 4.4 percent of GDP to about 2.9 percent of GDP in 2009.

For resource-poor and oil-importing economies, growth is expected to ease to about 4.9 percent in 2007, as one-off factors that boosted growth in 2006 fade. Output should pick up once again beginning in 2008 and reach 5.5 percent in 2009 as the supply effects of the recent FDI boom begin to be felt. Stronger growth in high-income Europe should bolster exports of North African countries, for which Europe is the destination of 40–80 percent of merchandise exports[7] and is a dominant source of tourism and remittance revenues. Oil importers' current account positions are expected to remain broadly stable as the beneficial effects of lower oil prices are offset by increased leakages from strengthening domestic demand. Government revenues should benefit from reduced expenditures on energy subsidies both because of lower prices and measures to reduce these subsidies. As a result, the fiscal deficit of oil importers is projected to improve from 6.2 percent of GDP in 2006 to 2.9 percent of GDP in 2009.

For resource-poor economies in the Middle East and North Africa, inflationary pressures are expected to recede over 2007–09, in part as the workout of oil-price-related pressures from earlier lifting of fuels subsidies comes into play. From a 5.8 percent pace in 2006,[8] CPI should ease to 4 percent in 2007. Thereafter, inflation is expected to diminish to 3.4 percent by 2009, on the back of further terms-of-trade improvement and nascent gains in productivity. For oil exporters in the current regional sample, price pressures are anticipated to remain elevated, due to continued fiscal and monetary stimulus in the Islamic Republic of Iran. From a GDP-weighted 8.7 percent advance in 2006, inflation is predicted to range between 10.5 and 11 percent through 2009, as Iranian inflation accelerates to 17 percent by the end of the forecast period.

Risks and uncertainties

The past few years represent the region's best growth performance in a decade. A major uncertainty facing the region concerns its ability to sustain such growth in the face of a less supportive international environment characterized by slower growth, lower oil prices, and increased competition. Downside risks can be clearly envisioned under a more substantial deterioration of conditions in the external environment than posited in the baseline assumptions. Additionally, the economic and political challenges of the next few years are magnified by rapidly growing populations and large cohorts of youth, who are looking for—or will be looking for—work.

For the oil exporters of the region, the future path of oil prices, global oil demand, and non-OPEC supply are critical sources of uncertainty. OPEC faces the very difficult challenge of maintaining prices at levels that are high enough to maximize revenues for the group, but which are not so high as to induce substantial additional supply. The group's past success in achieving this balancing act is not encouraging, although long-term trends suggest that the organization's market power is likely to grow and therefore its capacity to manage global demand and supply conditions are likely to strengthen.

Managing the windfall oil revenues of the last years is a continuing challenge for oil exporters. The risk of overheating domestic demand and its potential inflationary consequences loom as an overarching threat. It appears, however, that in contrast with earlier episodes of oil booms, judicious use of oil stabilization funds and other financial management approaches have served to counter overheating and to augment the nonoil supply potential of the economy. Continued pursuit of these approaches should remain a priority. Importantly, domestic reform efforts may stand at some risk against the background of abundant liquidity and rapid growth. Should oil prices take a sudden and sustained downturn, economies may find adjustment difficult.

The emergence of large-scale capital flows within the broader region, largely among the GCC and from GCC to the resource-poor economies in the region, offers new opportunities as well as risks. The 2005/06 crash of GCC equity markets serves as a reminder of the potential of overshooting in a new financial environment. At the same time, FDI-based flows from the GCC to the Maghreb and Mashreq appear to be more deeply integrated with the structures of the host economies, and hence less subject to the risks associated with capital flight.

South Asia

Recent developments

GDP in South Asia expanded a robust 8.6 percent in 2006, reflecting generally expansionary policy conditions, although down slightly from 2005 due primarily to a deceleration of growth in Pakistan (table A.13). Inflation remains high and has shown limited signs of declining, despite lower oil prices in the second half of the year and a modest tightening of fiscal and monetary policies. Price pressures are partly being kept in check by product-specific tax cuts and direct and indirect subsidization of consumer energy prices, but by

Table A.13 South Asia forecast summary
annual percent change unless indicated otherwise

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
GDP at market prices (2000 $)[b]	5.2	7.8	8.7	8.6	7.9	7.5	7.2
GDP per capita (units in $)	3.2	6.1	7.0	7.0	6.4	6.0	5.8
PPP GDP[c]	6.4	7.9	8.8	8.7	8.0	7.5	7.3
Private consumption	4.0	5.7	7.3	8.5	7.1	6.5	6.2
Public consumption	3.9	5.3	8.9	5.6	5.3	4.8	4.6
Fixed investment	5.5	10.2	14.0	12.3	11.2	10.5	10.2
Exports, GNFS [d]	9.0	14.5	19.1	21.8	13.5	13.0	12.7
Imports, GNFS [d]	7.9	32.9	21.7	24.2	12.9	12.0	11.7
Net exports, contribution to growth	−3.6	−2.6	−3.4	−4.4	−4.4	−4.4	−4.3
Current account balance/GDP (%)	−1.6	−1.3	−1.9	−2.4	−2.3	−2.1	−2.1
GDP deflator (median, LCU)	8.0	4.9	4.6	7.6	8.6	6.7	6.1
Fiscal balance/GDP (%)	−7.8	−6.7	−6.7	−6.2	−5.9	−5.6	−5.3
Memo items: GDP							
South Asia excluding India	4.4	6.1	6.8	6.4	6.1	6.2	6.2
India	5.5	8.3	9.2	9.2	8.4	7.8	7.5
Pakistan	3.9	6.4	7.8	6.6	6.4	6.3	6.1
Bangladesh	4.8	6.3	6.0	6.2	6.0	6.1	6.4

Source: World Bank.
Note: e = estimate; f = forecast; LCU = local currency units.
a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 2000 $.
c. GDP measured at PPP exchange rates.
d. GNFS denotes goods and nonfactor services.

supporting real incomes these measures are contributing to strong domestic demand. Higher oil prices in the first half of 2006 and strong domestic demand contributed to deterioration in the region's current account balance despite strong exports and remittances inflows.

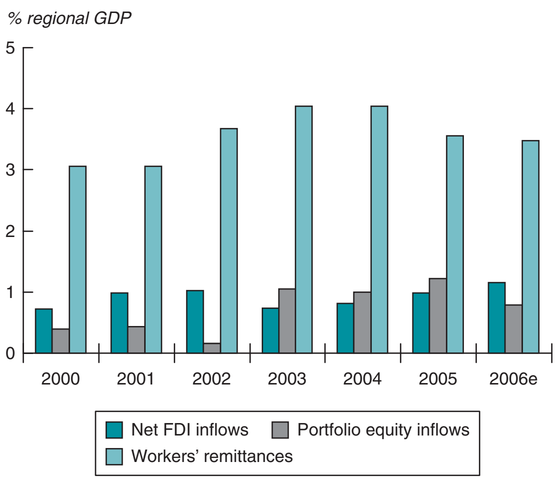
With the exception of Nepal, which is only now emerging from political strife, growth throughout the region was strong in 2006. In India, GDP increased by 9.2 percent, although signs of slowing appeared toward the end of the year. In the fourth quarter, GDP growth slowed to 8.6 percent, due mainly to weak (1.5 percent) agriculture growth (down from 8.7 percent in the fourth quarter of 2005), despite a firming in manufacturing output to 10.7 percent (relative to 8.2 percent in the fourth quarter of 2005). In Pakistan, GDP increased by 6.6 percent in 2006, significantly down from the 7.8 percent growth rate recorded the previous year. In part, the slowdown reflects a weakening of industrial production in the third quarter, itself likely a reflection of the waning effect of the boost to production provided by the reintroduction of quotas on Chinese clothing and textile exports the year before. Indeed, growth in the value of merchandise exports in the region declined from 30 percent in mid-year to 16 percent by the end of the year.

Output among the smaller countries in the region increased a strong 6.4 percent, the notable exception being Nepal, where economic activity expanded a disappointing 1.9 percent on account of political turmoil. Output in the Maldives was supported by a rebound in tourism and post-tsunami reconstruction efforts, while a new hydroelectric plant helped boost output in Bhutan.

Notwithstanding robust export growth, robust domestic demand and a 20 percent increase in oil prices for the year as a whole caused the regional current-account deficit to deteriorate from 1.9 percent of GDP to 2.4 percent in 2006, with Sri Lanka exhibiting the largest deterioration. Strong remittance inflows have helped finance foreign purchases in the region for some time now (figure A.9), with such remittances having helped to propel the current account of Bangladesh to a 0.6 percent of GDP surplus in 2006.

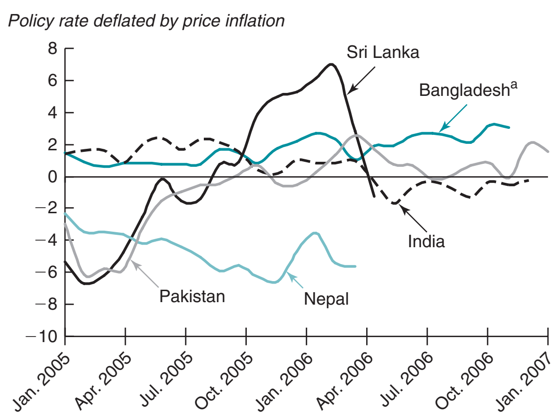
Rapid growth and the relatively expansionary stance of fiscal and monetary policies in the region have provoked a rise in inflation. Successive hikes in policy rates in India have led to higher interest rates across the spectrum, but higher inflation means that real rates remain low (figure A.10). In Pakistan, tighter monetary policy brought inflation down to 6.6 percent in January 2007 and to 7.9 percent during 2006 from 9.3 percent in 2005,

Figure A.9 Strong workers' remittances in South Asia



Source: World Bank.
Note: e = estimate.

Figure A.10 Real interest rates in South Asia



Source: World Bank.
a. Deposit rates deflated by consumer price inflation.

although it showed signs of accelerating more recently, rising again to 7.7 percent year-over-year in March 2007. Prices have been rising particularly rapidly in Sri Lanka, reflecting pressures on domestic demand resulting from loose monetary policy. Strong capital inflows have also played a role, boosting domestic liquidity and stock market valuations. As of early March, the Standard & Poor's/IFC Global (S&P/IFCG) index[9] was up 92 percent compared to January 2006, despite the global decline in market valuations the previous month.

Net capital inflows to South Asia increased to $40.1 billion (3.6 percent of GDP) in 2006, up from $28.3 billion (2.8 percent of GDP) in 2005, with most of the increase in going to India (table A.14). Strong capital inflows were largely due to a $12 billion expansion in net private debt flows, while net equity inflows to the region increased only slightly, as a $3 billion increase in FDI was partly offset by a decline in portfolio equity flows. At $22.9 billion in 2006, net equity inflows nonetheless account for the bulk (60 percent) of net private inflows to the region.

Much of the FDI inflows into India were concentrated in the service sector (telecommunications in particular) in response to liberalization policies designed to attract FDI, such as easing ownership restrictions. FDI outflows from India are also on the rise due to increasing cross-border M&A purchases by Indian companies, mainly in high-income economies. Since 2004, FDI flows from India to the United Kingdom exceeded flows from the United Kingdom to India. The Indian multinational Tata acquired the Dutch steel company Corus for more than $10 billion in early 2007. FDI inflows to Pakistan increased from $2.2 billion in 2005 to $3.5 billion in 2006 with much of investment in the oil and gas and financial sectors, along with installments made on a major telecom privatization deal in 2005.

Reserve accumulation in India picked up significantly in 2006, by $39 billion, to reach $171 billion, 6 percent of the total stock of reserves held by all developing countries. Given the strong rise in imports, foreign reserves in terms of months of import cover (for merchandise trade) declined to 11.2 months on average for 2006 from 13 in 2005.

Medium-term outlook

Regional GDP growth should moderate to about 7.5 percent and 7.2 percent in 2008 and 2009, respectively, due to a combination of tighter policy conditions and weakening of external demand (table A.15). Despite these factors, sustained high government deficits—currently running about 6.5 percent as a share of GDP in India, over 8.0 percent in Sri Lanka, and about 3.5 percent in Bangladesh and Pakistan—and strong international capital inflows are expected to keep domestic demand expanding rapidly, albeit not as strongly as in recent years. Robust domestic

Table A.14 Net capital flows to South Asia

$ billions

	1998	1999	2000	2001	2002	2003	2004	2005	2006e
Current account balance	−9.5	−5.3	−6.3	2.2	11.4	10.6	−11.5	−19.6	−26.7
as % of GDP	−1.8	−0.9	−1.1	0.4	1.8	1.4	−1.3	−2.0	−2.4
Financial flows									
Net private and official flows	7.6	6.0	10.3	8.1	7.3	14.0	24.7	28.3	40.1
Net private flows (debt + equity)	5.3	3.5	9.8	6.0	9.7	15.6	23.7	24.9	37.7
Net equity flows	2.9	5.5	6.8	8.8	7.7	13.6	16.1	22.1	22.9
Net FDI inflows	3.5	3.1	4.4	6.1	6.7	5.6	7.3	9.9	12.9
Net portfolio equity inflows	−0.6	2.4	2.4	2.7	1.0	8.0	8.8	12.2	10.0
Net debt flows	4.7	0.5	3.5	−0.7	−0.4	0.4	8.6	6.2	17.2
Official creditors	2.3	2.5	0.5	2.2	−2.4	−1.7	1.0	3.4	2.5
World Bank	0.8	1.0	0.7	1.5	−1.0	−0.2	2.0	2.2	1.8
IMF	−0.4	−0.1	−0.3	0.3	0.1	−0.1	−0.3	0	−0.1
Other official	2.0	1.6	0	0.4	−1.5	−1.5	−0.7	1.2	0.8
Private creditors	2.4	−2.0	3.0	−2.8	2.0	2.0	7.6	2.8	14.8
Net medium- and long-term debt flows	3.7	−2.1	3.9	−1.9	0.2	1.3	4.9	1.2	12.0
Bonds	4.2	−1.2	5.4	−0.4	−0.7	−3.1	4.1	−2.9	2.0
Banks	0.7	−0.5	−2.0	−1.1	1.0	4.4	1.1	4.2	9.9
Other private	−1.1	−0.4	0.5	−0.3	−0.1	0	−0.3	−0.1	0.1
Net short-term debt flows	−1.3	0.1	−0.9	−0.9	1.8	0.7	2.6	1.6	2.8
Balancing item[a]	4.8	4.6	0.7	−0.1	8.2	11.3	14.0	−3.0	28.3
Change in reserves (− = increase)	−2.9	−5.3	−4.6	−10.2	−27.0	−35.9	−27.2	−5.7	−41.7
Memo items									
Bilateral aid grants	3.2	3.4	3.1	4.2	3.7	5.4	5.0	6.6	3.9
of which									
Technical cooperation grants	1.1	1.1	1.0	1.0	1.2	1.5	1.5	1.6	1.8
Other	2.1	2.3	2.1	3.2	2.5	3.9	3.5	5.0	2.2
Net official flows (aid + debt)	5.5	5.9	3.6	6.4	1.3	3.7	6.0	10.0	6.4
Workers' remittances	13.4	15.1	17.2	19.2	24.2	31.1	31.3	35.6	38.8
Repatriated FDI Income	0.4	0.4	1.6	1.2	1.3	1.9	1.5	2.0	—

Sources: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate; — = not available.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

Table A.15 South Asia country forecasts

annual percent change unless indicated otherwise

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
Bangladesh							
GDP at market prices (2000 $)[b]	4.8	6.3	6.0	6.2	6.0	6.1	6.4
Current account balance/GDP (%)	−0.4	−0.5	−0.2	0.6	0.2	−0.5	−0.8
India							
GDP at market prices (2000 $)[b]	5.5	8.3	9.2	9.2	8.4	7.8	7.5
Current account balance/GDP (%)	−1.2	−1.4	−1.9	−2.2	−2.1	−2.0	−2.0
Nepal							
GDP at market prices (2000 $)[b]	5.0	3.7	2.7	1.9	3.0	4.5	4.7
Current account balance/GDP (%)	−6.4	−0.7	0	0.6	−0.6	−1.6	−2.4
Pakistan							
GDP at market prices (2000 $)[b]	3.9	6.4	7.8	6.6	6.4	6.3	6.1
Current account balance/GDP (%)	−3.7	−0.8	−3.3	−4.9	−4.3	−3.6	−3.0
Sri Lanka							
GDP at market prices (2000 $)[b]	5.2	5.4	6.0	7.4	6.0	6.2	6.3
Current account balance/GDP (%)	−4.6	−3.4	−3.2	−4.9	−4.0	−3.9	−3.3

Source: World Bank.
Note: Growth and current account figures presented here are World Bank projections and may differ from targets contained in other Bank documents. Afghanistan, Bhutan, and the Maldives are not forecast owing to data limitations. e = estimate; f = forecast.
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2000 $.

demand, combined with the delayed pass-through of higher oil prices, is expected to maintain inflationary pressures in the region and to sustain import growth in the double digits. As a result, the external sector is expected to make a significant negative contribution to growth, with the regional current account deficit projected to exceed 2.0 percent of GDP over the forecast horizon.

In India, more restrictive policy conditions are expected to lead to deceleration in investment growth and weaker private consumption and government spending, contributing to a slowdown in GDP growth to 7.8 percent and 7.5 in 2008 and 2009, respectively. In Pakistan, growth is also forecast to ease, although more gradually, as policy conditions are expected to remain broadly accommodative in the lead-up to the 2007 presidential elections, which are scheduled to take place during September and October. Recent heightened political tensions are expected to hamper business and consumer confidence and to partly contain the impact of stimulative policy conditions. Tightening of fiscal and monetary policies is expected in 2008, leading to further restraint of domestic demand and further deceleration of growth to 6.1 percent in 2009.

Among the smaller economies in the region, growth in Sri Lanka is projected to hover close to 6.0 percent during 2007–09, down from 7.4 percent in 2006, due to disruptive effects of civil war, which are partially mitigating the positive growth impacts of the ongoing recovery from the tsunami (including the reconstruction of roads and buildings). Growth is projected to strengthen in Nepal due to improved political conditions and cessation of fighting. In Bhutan, growth is expected to remain robust, rising by a projected 17 percent in 2007—a sharp acceleration from the estimated 5.5 percent in 2006—driven primarily by the stimulative effects of the Tala hydropower project (the plant is expected to begin operating at full capacity in mid-2007), and to a lesser extent by the expanding tourism industry. Growth in Bhutan is expected to decelerate to 10 percent in 2008 and 5 percent in 2009 as the stimulative impacts of the hydropower project unwind. In Afghanistan, GDP growth is expected to accelerate over the forecast horizon, initially due to an anticipated recovery from drought in the agricultural sector, and over the forecast horizon due to the stimulative impact of donor-led construction projects. In the Maldives, an expansion of GDP growth is expected to be supported by the ongoing reconstruction effort following the devastating December 2004 tsunami.

Risk and uncertainties

The high growth rates posted in recent years have helped South Asia make significant progress toward achieving the Millennium Development Goals. Most notably, the percentage of people living on less than a dollar a day declined to just over 30 percent in 2003 from 40 percent in 1990, and is now projected to reach about 13 percent in 2015—below the initial goal of 20 percent. These headline numbers, while heartening, mask persistent social inequalities, as well as considerable subregional and subnational variation. Sustained growth will be necessary for continued poverty reduction, and achieving further improvements in institutional service delivery will be critical to making progress in all other dimensions of the MDGs.[10]

Sustaining high growth will require continued economic reform, expansion of infrastructure capacity, and further reduction of security threats. These efforts will also contribute to higher capital inflows, which have been spurred by progress in these areas in recent years. Revamping tax collection systems to reduce evasion and improve tax collection to help finance the extensive government agendas is also important. In Pakistan, for example, tax evasion is reportedly very high: it is estimated that less than 1 percent of the population pays income tax.

Given vibrant domestic demand and high oil prices, a significant portion of the cushion that was built up in terms of foreign currency reserves and a regional current account surplus (last recorded in 2003) has been absorbed. Since 2003, the period for which imports could be covered by foreign reserves has declined by about four months in both India and Pakistan. While reserves in India remain significantly above the level of three months worth of imports, they are much closer to that level now in Pakistan and below it in both Bangladesh and Sri Lanka, suggesting that each country would be vulnerable to a significant terms-of-trade shock, such as another hike in oil prices. In Pakistan, relatively modest (5.5 percent as of end-2006) increases in reserve holdings since 2003 in conjunction with a more than doubling of imports (GNFS) resulted in a sharp fall in the import-cover ratio, an unsustainable trend.

Downside risks to growth are also tied to the inexorable lifting of restrictions on Chinese textile and clothing exports at end-2007 and to a stronger than projected slowdown of demand from the United States in 2007, an important trade partner for most countries in the region.

The recent surge in cross-border bank lending to multinational corporations in India has raised concerns that borrowing abroad by the corporate sector could contribute to inflationary pressures, which would require a more aggressive monetary policy response and possibly have negative repercussions for growth prospects over the medium term.

Increased political instability represents another main risk. Heightened security concerns could hurt investor sentiment and undermine foreign capital inflows, which have contributed to the region's record four-year expansion. The continued easing of political tensions between the governments of India and Pakistan bodes well for continued progress toward improved relations.

Sub-Saharan Africa

Recent developments

Strong global growth, improved macroeconomic performance, significant aid flows, rising FDI, and a continued spell of relative political stability helped GDP in Sub-Saharan Africa expand by 5.6 percent in 2006, the third consecutive year that growth exceeded 5 percent (table A.16). Despite high oil prices, oil-importing countries in the region (even when excluding South Africa) continued to grow rapidly, with output increasing by close to 5.0 percent. Output growth among oil exporters was also strong, but the expansion slowed from 7.4 percent in 2005 to 6.9 percent in 2006 as some countries pushed against production constraints and unrest in the Niger Delta undermined growth in Nigeria's oil sector.

Growth was broadly based, with output in half of the countries in the subcontinent advancing by 5.0 percent or more. Only 7 of 34 oil-importing economies grew by less than 2.0 percent: the Comoros, Eritrea, Guinea-Bissau, Swaziland, the Seychelles, Togo, and Zimbabwe. While export growth has been strong, domestic demand has provided the largest contribution to growth. Investment is estimated to have contributed more

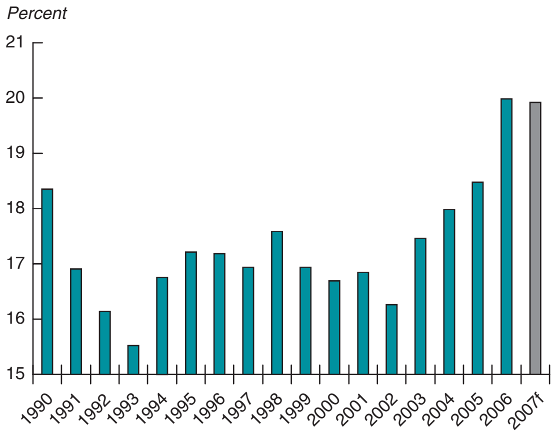
Table A.16 Sub-Saharan Africa forecast summary

annual percent change unless indicated otherwise

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
GDP at market prices (2000 $)[b]	2.3	5.3	5.8	5.6	5.8	5.8	5.4
GDP per capita (units in $)	−0.4	2.9	3.4	3.5	3.7	3.8	3.4
PPP GDP[c]	3.4	5.5	6.0	5.9	6.2	6.0	5.7
Private consumption	1.2	5.6	5.9	5.9	4.9	4.7	4.8
Public consumption	2.6	4.4	6.5	6.7	6.3	6.3	6.4
Fixed investment	3.7	9.0	10.0	15.5	11.6	12.3	9.4
Exports, GNFS[d]	4.7	6.4	7.4	5.8	6.9	6.4	6.8
Imports, GNFS[d]	4.4	9.4	10.2	12.7	8.6	8.6	8.4
Net exports, contribution to growth	0.5	−1.4	−2.4	−4.8	−5.5	−6.5	−7.2
Current account balance/GDP (%)	−2.1	−1.1	−0.1	−0.5	−1.4	−2.3	−2.7
GDP deflator (median, LCU)	10.1	7.0	6.7	7.2	5.0	4.5	4.5
Fiscal balance/GDP (%)	−4.0	−0.7	1.1	3.3	0.9	−1.4	−3.0
Memo items: GDP							
Sub-Saharan Africa excluding South Africa	2.6	5.5	6.2	5.9	6.6	6.2	5.7
Oil exporters	2.7	6.0	7.4	6.9	8.3	7.4	6.6
CFA countries	2.6	4.1	3.8	3.2	3.4	4.2	3.5
South Africa	1.8	4.8	5.1	5.0	4.4	5.2	4.9
Nigeria	2.8	6.0	6.9	5.6	6.4	6.6	5.9
Kenya	1.9	4.9	5.8	5.9	5.1	5.2	4.9

Source: World Bank.
Note: e = estimate; f = forecast; LCU = local currency units.
a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 2000 $.
c. GDP measured at PPP exchange rates.
d. GNFS denotes goods and nonfactor services.

Figure A.11 Ratio of nominal investment to nominal GDP among Sub-Saharan oil importers



Source: World Bank.
Note: f = forecast.

than 2 percentage points to the growth of oil-importing economies in 2006 and investment has risen to represent some 20 percent of GDP among oil-importing countries from an average of 17 percent in the 1990s (figure A.11). Resource-poor and landlocked countries, typically expected to perform poorly in an environment characterized by high oil prices, have also recorded stronger economic growth from a historical perspective (3.8 and 5.9 percent, respectively).

The performance of South Africa, the region's largest economy, continued to surprise on the upside, with GDP expanding by 5.0 percent for the third consecutive year. Robust domestic demand underpinned this growth, with consumer demand and investment responding to low interest rates, rising real incomes, and public-sector investment in transportation and sports infrastructure in the runup to the FIFA World Cup in 2010. GDP grew at a 5.6 percent annualized clip in the fourth quarter, despite an 8.4 percent contraction in the agricultural sector, due to particularly rapid growth in mining and manufacturing. Overall, the external sector's contribution to growth has been negative, reflecting strong import growth fueled by robust household consumption. As a result (notwithstanding high prices for metals), South Africa's current account deficit ballooned to 6.4 percent of GDP in 2006, which contributed to the sharp depreciation of the rand during May and June. Overall, the rand has depreciated 17.4 percent as of March 2007 on a trade-weighted basis since March 2006, which has contributed to boost inflation to 6.1 percent in March 2007, up from 3.4 percent a year earlier. Nevertheless, consumer confidence remains at historically high levels, although recent retail sales data point to some softening in consumer demand.

In Nigeria, the region's second-largest economy, a vibrant private sector and strong investment spending kept overall growth at 5.6 percent in 2006, despite an estimated 1.6 percent contraction in the oil sector caused by unrest in the Niger Delta. Non-oil GDP expanded in excess of 8.0 percent, boosted by government infrastructure spending. Despite the strength of domestic demand, inflation declined during the course of the year as a stronger currency reduced import costs and the inflationary effects of the removal of subsidies in 2004 and 2005 played out on the year-on-year comparison. There were, however, some signs of a resurgence in inflationary pressures in the third and fourth quarters. Among other oil exporters, growth has been particularly robust in Angola (16.9 percent), Sudan (11.8 percent), and Mauritania (14.2 percent), which began oil production in February 2006.

Elsewhere, high international metal and mineral prices are generating buoyant domestic demand and prompting additional investments, which have contributed to strong growth in Burundi, the Democratic Republic of Congo, Ghana, Mali, Mozambique, Tanzania, and Zambia. Economic performance was also strong in reform-oriented economies such as Burkina Faso, Ghana, Mali, Mozambique, Senegal, and Tanzania, as well as in countries emerging from conflict—Burundi, Sierra Leone, Liberia, and the Democratic Republic of Congo.

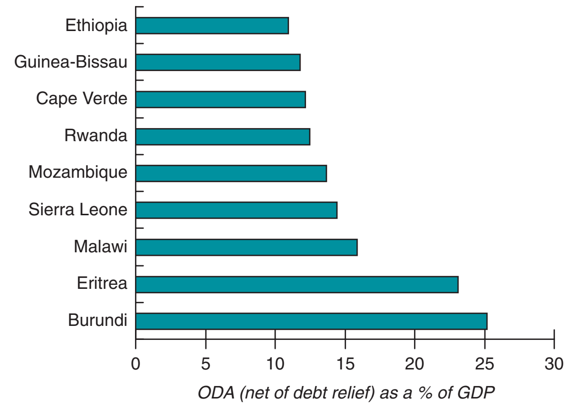
Growth throughout the continent, however, is still hampered by multiple and diverse obstacles. Drought-related crop failure, high fuel costs, and energy rationing have contributed to weakened results for East African oil-importing countries. In addition, while the number and the intensity of conflicts in Sub-Saharan Africa have subsided, the risks associated with political turmoil remain high and are undermining growth in Chad, Côte d'Ivoire, the Democratic Republic of Congo, Eritrea, Lesotho, Nigeria, the Seychelles, Somalia, Sudan, Swaziland, and Zimbabwe. Limited progress on reforms and stagnant oil production in Cameroon and Gabon, in conjunction with the ongoing sociopolitical crisis in Côte d'Ivoire and a moderate real-effective appreciation of the currency have undermined economic performance in the CFA zone countries, where growth is significantly weaker than elsewhere on the subcontinent.

High fuel costs and energy scarcity, which combined have led to rationing and widespread blackouts, have kept economic growth below potential in a number of countries, most notably in East Africa. Power outages have become more frequent in recent years, as rapidly increasing demand is outpacing the increase in generating capacity, which has suffered from years of underinvestment and neglect, in part due to pricing policies that have forced electricity providers to produce at a loss. The problem is especially acute in rapidly growing economies such as Ghana, Kenya, Senegal, and Tanzania. Even oil-producing countries like Nigeria are facing power shortages due to lack of generating capacity. With most electricity grids operating at or near capacity and demand expected to increase by more than 5 percent per year over the medium term, the energy problem is likely to constrain growth over the medium term, especially in the mining and manufacturing sectors.

Oil-exporting countries have been the principal beneficiaries of the estimated 43.5 percent increase in FDI into the Sub-Saharan Africa region outside South Africa. As in the past, FDI has flowed mostly into resource-rich countries and predominantly into extraction and related services, for which cross-border mergers and acquisitions tripled in the first half of 2006. Because linkages between mining industries and the local economies are limited, a distinct two-speed growth pattern has emerged, with the resource sectors growing faster than the rest of the economy.

Current accounts have come under pressure in several oil-importing economies in the region (notably, as discussed, in South Africa), although higher commodity prices and increased official and private transfers have helped contain the deterioration. Net ODA, excluding debt relief, to Sub-Saharan Africa climbed to $13.2 billion in 2005 up from $7.7 billion in 2002, but it declined in 2006. In almost half of the oil-importing countries, aid (excluding debt relief) accounted for more than 5.0 percent of GDP on average over 2003–05. In countries including Burundi, Eritrea, Malawi, Sierra Leone, Mozambique, Rwanda, Guinea-Bissau, and Ethiopia, ODA exceed 10 percent of GDP on average (figure A.12).

Figure A.12 ODA (net of debt relief) in selected Sub-Saharan African countries, 2003–05



Sources: OECD; World Bank.

The pace of foreign exchange reserve accumulation is picking up in the region, with reserves rising by $33 billion in 2006, following increases of just over $20 billion in 2004–05, with about half of the accumulation in just three countries: Nigeria ($5.9 billion), Angola ($5.4 billion), and South Africa ($4.5 billion). Reserves provided cover for at least three months of imports in 80 percent of the countries in the region in 2006, up from two-thirds in 2005.

Net private capital inflows to Sub-Saharan Africa recorded another year of significant gains in 2006, as foreign investors continued to search for higher yields and as robust growth and improvements in macroeconomic stability, creditworthiness, and the investment climate made some countries more attractive to investors. Total net capital inflows increased from $28.9 billion or 4.6 percent of GDP in 2005, to $39.8 billion, or 5.6 percent of GDP in 2006 (table A.17). The region's share of net capital flows to developing countries remains small at 7.0 percent, relatively unchanged from the 6.4 percent share received on average over the previous three years. Net private capital flows exceeded bilateral aid grants in 2006, the first time since 1999. Net equity flows increased $7 billion to $31 billion, and net private lending almost doubled to $10.6 billion, while net official lending declined by $1 billion. The increase in net private lending was mainly in the

Table A.17 Net capital flows to Sub-Saharan Africa
$ billions

	1998	1999	2000	2001	2002	2003	2004	2005	2006e
Current account balance	−17.7	−9.9	3.5	−4.9	−5.9	−3.2	−6.0	−0.9	−3.8
as % of GDP	−5.4	−3.1	1.0	−1.5	−1.7	−0.7	−1.1	−0.1	−0.5
Financial flows									
Net private and official flows	14.4	17.8	10.9	12.2	10.0	18.3	23.9	28.9	39.8
Net private flows (debt + equity)	13.9	17.4	10.2	12.2	7.4	16.9	22.0	29.6	41.6
Net equity flows	15.7	18.7	11	14.3	9.9	15.3	19.1	24.0	31.0
Net FDI inflows	7.1	9.7	6.8	15.2	10.3	14.6	12.4	16.6	18.5
Net portfolio equity inflows	8.6	9.0	4.2	−0.9	−0.4	0.7	6.7	7.4	12.5
Net debt flows	−1.3	−0.9	−0.1	−2.1	0.1	3.0	4.8	4.9	8.8
Official creditors	0.5	0.4	0.7	−0.1	2.6	1.4	1.9	−0.7	−1.8
World Bank	1.3	1.1	1.5	1.8	2.2	2.2	2.5	2.4	1.8
IMF	−0.3	0	0.1	0.1	0.5	−0.1	−0.1	−0.4	0.1
Other official	−0.5	−0.7	−0.8	−2.0	0	−0.7	−0.4	−2.7	−3.7
Private creditors	−1.8	−1.3	−0.8	−2.1	−2.5	1.6	2.9	5.6	10.6
Net medium- and long-term debt flows	−1.3	−0.7	0.3	0	−0.7	2.5	1.3	2.5	7.4
Bonds	0.3	1.2	1.0	1.9	2.7	4.6	1.2	0.4	1.3
Banks	−1.3	−1.7	−0.7	−1.6	−2.7	−1.3	0.4	2.2	6.4
Other private	−0.2	−0.2	0	−0.3	−0.7	−0.7	−0.3	−0.2	−0.4
Net short-term debt flows	−0.5	−0.6	−1.1	−2.1	−1.8	−1.0	1.6	3.2	3.3
Balancing item[a]	2.0	−6.6	−8.4	−6.8	−3.8	−11.0	4.4	−7.1	−3.2
Change in reserves (− = increase)	1.2	−1.3	−6.0	−0.5	−0.3	−4.0	−22.3	−20.9	−32.8
Memo items									
Bilateral aid grants	14.0	13.2	13.6	13.9	18.4	27.2	29.6	36.5	36.9
of which									
Technical cooperation grants	3.9	3.3	3.6	3.8	4.4	5.1	5.4	5.8	7.0
Other	10.1	9.9	10.0	10.1	14.0	22.1	24.2	30.7	29.9
Net official flows (aid + debt)	14.5	13.6	14.3	13.8	21.0	28.6	31.5	35.8	35.1
Workers' remittances	4.3	4.4	4.6	4.6	5.0	5.8	7.6	8.7	8.7
Repatriated FDI Income	3.4	4.4	7.1	7.5	7.3	7.3	8.2	11.2	—

Sources: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate; — = not available.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

form of cross-border bank loans, up $5 billion to $7.4 billion, most of which were medium- and long-term loans. Net FDI flows to the region rose by $2 billion to $18.5 billion, and continued to be largely resource-seeking, with Nigeria, South Africa, Sudan, Equatorial Guinea, and Angola accounting together for more than two-thirds of total regional net FDI inflows. Net portfolio equity inflows have increased from less than $1 billion in 2003 to $12.5 billion in 2006, and now account for 30 percent of all private capital flows to the region, significantly higher than the 12 percent share for all developing countries.

Despite improvements in creditworthiness and favorable financing conditions, few countries in the region managed to gain access to the international bond market over the past few years. In 2006, the Seychelles became the first country in the region aside from South Africa to issue a sovereign or corporate bond in the international market in the past two decades. Four additional countries—Ghana, Kenya, Nigeria, and Zambia—are expected to launch debut sovereign bond issues in international markets this year. There has been, however, growing interest on the part of foreign investors in local currency bond markets, most notably in Botswana, Nigeria, Kenya, and Zambia. High commodity prices in conjunction with currency appreciations have boosted returns on local currency bonds in commodity-exporting countries such as Nigeria and Zambia. In the latter, the share of outstanding public debt held by nonresidents increased from a negligible amount in 2004 to 13 percent by the end of 2006. A lack of timely, comprehensive data makes it difficult to assess the prominence of foreign participation in domestic debt markets, however.

It is worth noting that cross-border lending from banks located in other developing countries plays a prominent role in the region. Over the

Table A.18 Sub-Saharan Africa country forecasts

annual percent change unless indicated otherwise

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
Angola							
GDP at market prices (2000 $)[b]	0.8	11.2	20.6	16.9	25.1	14.2	13.4
Current account balance/GDP (%)	−6.1	3.5	16.1	18.6	15.4	7.1	5.4
Benin							
GDP at market prices (2000 $)[b]	4.8	3.1	3.9	4.3	4.4	4.2	4.1
Current account balance/GDP (%)	−6.8	−7.8	−6.9	−7.3	−6.1	−6.4	−6.6
Botswana							
GDP at market prices (2000 $)[b]	6.2	5.9	6.2	4.8	4.3	4.2	4.1
Current account balance/GDP (%)	8.1	2.9	14.3	14.8	12.3	11.7	12.9
Burkina Faso							
GDP at market prices (2000 $)[b]	4.0	3.9	4.8	5.7	5.5	5.7	5.4
Current account balance/GDP (%)	−5.6	−10.7	−11.7	−9.7	−9.8	−9.1	−8.3
Burundi							
GDP at market prices (2000 $)[b]	−2.0	4.8	0.9	5.4	5.1	5.3	5.1
Current account balance/GDP (%)	−3.4	−8.1	−12.7	−16.1	−15.3	−14.8	−14.8
Cameroon							
GDP at market prices (2000 $)[b]	1.4	3.7	2.0	3.9	4.1	3.9	3.5
Current account balance/GDP (%)	−3.0	−2.6	−1.8	0.5	−1.7	−3.1	−3.3
Cape Verde							
GDP at market prices (2000 $)[b]	5.8	4.5	5.9	5.8	6.1	6.3	6.2
Current account balance/GDP (%)	−8.3	−7.3	−4.5	−6.7	−8.8	−10.9	−13.2
Central African Republic							
GDP at market prices (2000 $)[b]	1.6	1.3	2.2	3.3	3.6	3.4	3.1
Current account balance/GDP (%)	−4.3	−4.6	−3.3	−3.9	−3.6	−4.1	−4.4
Chad							
GDP at market prices (2000 $)[b]	2.3	29.5	5.6	1.7	−1.4	5.1	2.1
Current account balance/GDP (%)	−5.5	−18.7	0.7	0.1	2.0	−0.9	−3.7
Comoros							
GDP at market prices (2000 $)[b]	1.1	−0.2	4.2	1.3	2.6	2.7	2.4
Current account balance/GDP (%)	−6.8	−3.4	−5.0	−6.8	−6.0	−4.8	−3.5
Congo, Democratic Rep. of							
GDP at market prices (2000 $)[b]	−5.6	6.6	6.5	5.3	7.2	6.8	6.4
Current account balance/GDP (%)	2.0	−8.8	−4.4	−4.1	−4.6	−4.6	−4.8
Congo, Rep. of							
GDP at market prices (2000 $)[b]	1.5	3.6	7.7	6.3	0.9	6.1	6.2
Current account balance/GDP (%)	−16.5	15.5	12.0	19.4	5.1	6.7	3.6
Côte d'Ivoire							
GDP at market prices (2000 $)[b]	2.3	1.8	1.8	1.3	1.9	2.5	2.6
Current account balance/GDP (%)	−4.0	1.6	0.7	2.1	2.1	1.1	−0.5
Equatorial Guinea							
GDP at market prices (2000 $)[b]	18.4	10.0	6.5	1.2	6.9	9.0	−1.4
Current account balance/GDP (%)	−42.4	8.8	4.7	2.7	5.7	10.5	11.0
Eritrea							
GDP at market prices (2000 $)[b]	—	1.9	4.8	1.7	1.9	2.0	1.8
Current account balance/GDP (%)	—	−13.6	−6.3	−2.9	−3.0	−2.9	−2.8
Ethiopia							
GDP at market prices (2000 $)[b]	2.3	12.3	8.7	7.3	6.1	5.5	5.4
Current account balance/GDP (%)	−0.8	−6.9	−9.3	−11.0	−10.0	−8.8	−7.6
Gabon							
GDP at market prices (2000 $)[b]	2.4	1.4	2.8	1.2	3.5	2.1	2.3
Current account balance/GDP (%)	5.7	12.8	17.5	20.5	13.1	8.8	4.1
Gambia, The							
GDP at market prices (2000 $)[b]	3.3	5.1	5.0	6.4	3.8	4.1	3.9
Current account balance/GDP (%)	−1.6	−11.1	−16.1	−14.5	−11.5	−11.2	−7.6
Ghana							
GDP at market prices (2000 $)[b]	4.3	5.6	5.9	6.1	5.9	6.0	6.1
Current account balance/GDP (%)	−6.4	−3.6	−8.2	−8.1	−7.5	−8.1	−7.8

(*Continues*)

Table A.18 (*Continued*)

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
Guinea							
GDP at market prices (2000 $)[b]	3.9	2.7	3.3	3.1	2.9	3.2	3.0
Current account balance/GDP (%)	−5.7	−4.3	−3.7	−4.2	−4.7	−5.7	−6.5
Guinea-Bissau							
GDP at market prices (2000 $)[b]	1.5	2.2	3.5	1.9	3.4	3.7	3.4
Current account balance/GDP (%)	−24.0	−4.9	−3.4	−4.8	−15.4	−15.5	−16.3
Kenya							
GDP at market prices (2000 $)[b]	1.9	4.9	5.8	5.9	5.1	5.2	4.9
Current account balance/GDP (%)	−1.6	−2.2	−2.6	−4.3	−4.6	−4.2	−3.4
Lesotho							
GDP at market prices (2000 $)[b]	3.4	3.1	1.2	2.8	1.6	1.2	2.2
Current account balance/GDP (%)	−13.3	−5.6	−2.7	−1.9	−0.8	−0.4	−1.9
Madagascar							
GDP at market prices (2000 $)[b]	1.7	5.3	4.6	4.8	5.0	5.3	5.1
Current account balance/GDP (%)	−7.8	−12.4	−11.2	−9.4	−8.1	−8.4	−8.8
Malawi							
GDP at market prices (2000 $)[b]	3.4	7.1	2.6	8.3	5.4	5.6	5.4
Current account balance/GDP (%)	−8.5	−4.7	−12.9	−8.3	−2.9	−1.4	−0.7
Mali							
GDP at market prices (2000 $)[b]	4.0	2.2	6.1	4.9	5.3	5.2	5.1
Current account balance/GDP (%)	−8.9	−8.4	−9.0	−8.8	−6.1	−5.9	−5.4
Mauritania							
GDP at market prices (2000 $)[b]	2.9	5.2	5.4	14.2	7.4	8.4	6.7
Current account balance/GDP (%)	−0.3	−20.1	−43.9	−3.1	−4.0	−8.0	−8.0
Mauritius							
GDP at market prices (2000 $)[b]	5.3	4.7	2.5	4.6	2.9	2.7	2.5
Current account balance/GDP (%)	−1.6	−1.9	−3.7	−7.0	−6.9	−5.6	−4.2
Mozambique							
GDP at market prices (2000 $)[b]	5.2	7.5	7.7	7.4	7.1	6.8	6.7
Current account balance/GDP (%)	−18.2	−5.6	−9.8	−12.7	−11.4	−11.6	−13.8
Namibia							
GDP at market prices (2000 $)[b]	4.2	6.0	4.2	4.4	4.6	4.3	3.8
Current account balance/GDP (%)	4.1	10.0	7.3	12.8	12.5	9.5	6.6
Niger							
GDP at market prices (2000 $)[b]	1.8	0	6.8	3.4	4.1	4.3	4.5
Current account balance/GDP (%)	−6.9	−7.6	−7.9	−7.3	−10.0	−9.8	−10.0
Nigeria							
GDP at market prices (2000 $)[b]	2.8	6.0	6.9	5.6	6.4	6.6	5.9
Current account balance/GDP (%)	−0.8	6.8	11.9	11.3	7.4	6.5	5.2
Rwanda							
GDP at market prices (2000 $)[b]	0.2	4.0	6.0	4.4	5.0	4.9	4.6
Current account balance/GDP (%)	−3.5	−3.9	−4.4	−7.7	−8.3	−6.9	−6.5
Senegal							
GDP at market prices (2000 $)[b]	2.9	5.6	5.5	3.3	4.7	5.1	4.6
Current account balance/GDP (%)	−6.0	−7.0	−8.0	−10.3	−9.4	−8.6	−8.2
Seychelles							
GDP at market prices (2000 $)[b]	4.6	−2.0	−2.3	−1.1	−0.8	−0.5	1.1
Current account balance/GDP (%)	−7.4	−9.1	−25.8	−15.6	−18.8	−20.6	−23.3
Sierra Leone							
GDP at market prices (2000 $)[b]	−4.7	7.4	7.3	7.1	6.1	6.2	6.0
Current account balance/GDP (%)	−9.0	−5.4	−8.1	−6.2	−5.4	−5.5	−5.5
South Africa							
GDP at market prices (2000 $)[b]	1.8	4.8	5.1	5.0	4.4	5.2	4.9
Current account balance/GDP (%)	−0.2	−3.2	−3.8	−6.4	−6.0	−6.4	−6.7
Sudan							
GDP at market prices (2000 $)[b]	5.7	5.2	8.0	11.8	10.1	9.2	8.1
Current account balance/GDP (%)	−6.7	−4.1	−10.9	−7.6	−7.3	−8.4	−8.9

(*Continues*)

Table A.18 (*Continued*)

	1991–2000[a]	2004	2005	2006e	2007f	2008f	2009f
Swaziland							
GDP at market prices (2000 $)[b]	3.1	2.1	1.8	1.5	1.4	1.1	1.2
Current account balance/GDP (%)	−2.6	4.6	1.7	1.5	−0.3	−2.4	−4.3
Tanzania							
GDP at market prices (2000 $)[b]	2.9	6.7	6.8	5.7	7.1	6.6	6.2
Current account balance/GDP (%)	−12.5	−2.2	−6.0	−11.3	−12.5	−11.1	−11.2
Togo							
GDP at market prices (2000 $)[b]	2.2	3.0	1.2	1.9	1.6	1.8	2.1
Current account balance/GDP (%)	−8.5	−10.0	−12.0	−11.8	−9.6	−10.0	−10.2
Uganda							
GDP at market prices (2000 $)[b]	6.8	5.5	6.6	5.1	5.7	5.8	5.7
Current account balance/GDP (%)	−7.0	−2.8	−2.9	−4.8	−5.3	−6.2	−6.2
Zambia							
GDP at market prices (2000 $)[b]	0.7	5.4	5.1	5.7	5.8	5.7	5.5
Current account balance/GDP (%)	−10.5	−10.3	−7.8	−8.3	−9.1	−8.9	−8.5
Zimbabwe							
GDP at market prices (2000 $)[b]	0.9	−3.8	−6.5	−3.9	−3.7	−2.5	−2.1
Current account balance/GDP (%)	−7.5	20.7	8.5	−1.8	−1.2	−1.1	−1.2

Source: World Bank.
Note: Growth and current account figures presented here are World Bank projections and may differ from targets contained in other Bank documents. Liberia, Mayotte, Somalia, and São Tomé and Principe are not forecast owing to data limitations. e = estimate; f = forecast; — = not available.
a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 2000 $.

2004–06 period 20 percent of cross-border South-South syndicated loan commitments went to borrowers in low- and lower-middle-income countries in Sub-Saharan Africa, of which three-quarters were provided by Chinese banks, compared to a much smaller 6 percent share of the North-South syndicated loan commitments.

Workers' remittances remained unchanged at $8.7 billion in 2005–06, an amount equal to less than one-quarter of net private capital flows ($41.6 billion) and bilateral aid grants ($37 billion), but are almost certainly underestimated by a wide margin.

Medium-term outlook

GDP growth for the region as a whole is projected to remain broadly stable, coming in at about 5.4 percent in 2009. In South Africa, higher interest rates are projected to dampen growth this year, despite strength in the mining and manufacturing sectors, before the latter forces and preparation for the FIFA World Cup in 2010 generate a recovery in 2008. For the region as a whole, South Africa's continued solid growth is expected to be partly offset by weaker growth among oil exporters and other commodity-rich countries as prices ease and capacity constraints impose themselves.

Growth is projected to remain strong in reform-oriented economies such as Burkina Faso, Mali, Mozambique, and Tanzania, while robust government spending ahead of elections should boost output in countries like Senegal and Ghana. The pace of the expansion is expected to slow marginally but remain robust in Ethiopia and Kenya, while limited progress on reforms in Cameroon and Gabon, in conjunction with the ongoing sociopolitical crisis in Côte d'Ivoire and currency appreciation, will keep growth in the CFA zone countries below 5 percent.

In the baseline projection, emerging electrical shortages due to insufficient generating capacity are expected to constrain output in Burundi, Kenya, Malawi, Rwanda, Tanzania, Uganda, and Zambia, but improved rainfall in East and West Africa should help replenish hydroelectric dams, thereby improving electrical supply, and easing the stress on manufacturing production. An end to drought should also boost agricultural growth and domestic incomes, although weaker agricultural prices and high fertilizer prices may negatively affect crops and could represent a drag on growth.

Lower commodity prices, and in particular lower oil prices, and appreciating currencies should help reduce inflation in Sub-Saharan Africa, notwithstanding robust economic growth. Food supply remains the wild card, as drought-induced food scarcity could result in an overshooting in inflation rates, notwithstanding lower fuel prices.

Aid continues to play a prominent role in the region, accounting for more than 10 percent of GDP for one-quarter of countries. Preliminary data show that the amount of aid allocated to the region by bilateral donors increased by only about 2 percent in 2006, excluding the nearly $11 billion in debt relief provided to Nigeria by its Paris Club creditors. Donors will have to scale up the amount of aid provided to the region significantly over the next four years in order to achieve their objective of doubling aid to the region by 2010 ($50 billion) from the 2004 level ($25 billion).

To ensure that the scaling up in aid is most effective, it is necessary that the right mix of policies are implemented to avoid a buildup in inflationary pressures and currency appreciation in the recipient countries, and the subsequent Dutch disease symptoms. It is necessary to ensure that the large aid inflows will not result in undesirable structural changes and that the public sector, which in many cases is the largest recipient of aid, will not crowd out the private sector as public spending surges.

Risks and uncertainties

Sub-Saharan Africa's economic growth is subject to a series of global risks, including a sharper-than-expected slowdown in the global economy, which would cause commodity demand and prices to drop sharply. This would reverberate throughout the region, cutting incomes and undermining private consumption. In the baseline, we project investment growth rates of about 9 percent in oil-importing economies, and of around 13 percent for oil-exporting countries. A sharp drop in commodity prices may prompt investors to postpone their investments. A second significant risk is that of sharp increases in food prices on the global markets, which would disproportionately affect low-income countries, where food accounts for a large share of private expenditure.

At a regional level, political and social instability continue to remain a palpable risk, notwithstanding notable improvements on these fronts in the recent past. Political turmoil remains severe and is undermining growth in Chad, Côte d'Ivoire, the Democratic Republic of Congo, Eritrea, Lesotho, the Seychelles, Somalia, Sudan, Swaziland, and Zimbabwe. The move toward more democratic institutions is illustrated by the fact that this year, 17 countries are scheduled to hold presidential or legislative elections (or both). Notable is the possibility that elections will be finally held in Côte d'Ivoire toward the end of the year. If the elections are successfully conducted, they would restore a sense of stability in a country marred by five years of political and social tensions. In controversial election races, however, there is scope for political violence that would derail growth.

The possibility of drought is also a concern, especially in East Africa, which tends to be more frequently and more severely affected by the problem. A severe drought would cause food prices to surge and would further reduce the supply of energy, which is already at critically low levels.

Notes

1. In addition to the Prospects for the Global Economy Web site (http://www.worldbank.org/outlook) the World Bank's *East Asia Update* provides more detailed information on recent developments and prospects for the East Asia and Pacific region. (http://www.worldbank.org/eapupdate/). This appendix partly summarizes that more extended publication.

2. Regional oil exporters (oil and natural gas) included in the forecast are Azerbaijan, Kazakhstan, Russia, and Uzbekistan; regional oil importers are Albania, Armenia, Bulgaria, Belarus, Croatia, the Czech Republic, Estonia, Georgia, Hungary, the Kyrgyz Republic, Latvia, Lithuania, Moldova, FYR Macedonia, Poland, Romania, the Slovak Republic, Turkey, and Ukraine. Slovenia is grouped with the high-income countries and is not included in the regional aggregates here.

3. The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia became EU members in 2004, and Bulgaria and Romania joined in 2007.

4. The World Bank's Middle East and North Africa Web site, *Economic Developments and Prospects-2007* (http://www.worldbank.org/mena) provides a more comprehensive discussion of recent economic developments, projections, and policy priorities for the region. It should be noted that the country composition of the region—and hence references to economic growth and other concepts—differs between the Middle East and North Africa region's EDP report and this appendix. In particular, high-income Gulf Cooperation Council countries are considered an integral part of the Middle East and North Africa in the region's analysis and forecasting exercises.

5. For the purposes of this appendix the developing countries of the region are Algeria, Egypt, Jordan, the Islamic Republic of Iran, Lebanon, Morocco, Oman, Syria, Tunisia, and the Republic of Yemen. Among middle-income

economies, Djibouti, Iraq, and Libya were excluded from the projections due to a lack of data. Important regional economies such as Bahrain, Kuwait, and Saudi Arabia are included in the high-income aggregate. Among the high-income group, data limitations excluded Qatar and the United Arab Emirates from the analysis.

6. The resource-poor economies are Egypt, Jordan, Lebanon, Morocco, and Tunisia; all except Egypt are oil importers.

7. For Egypt, Europe is the destination of 40 percent of exports. Ratios are similar for other economies: 50 percent for Algeria, 60 percent for Syria, 70 percent for Morocco, and 80 percent for Tunisia.

8. Consumer price changes are aggregated using real GDP weights.

9. The S&P/IFCG index tracks the performance of the most actively traded stocks in various emerging markets, including India.

10. See http://ddp-ext.worldbank.org/ext/GMIS/gdmis.do?siteId=2&menuId=LNAV01REGSUB5.

Reference

IMF (International Monetary Fund). 2006. *World Economic Outlook: Financial Systems and Economic Cycles.* Washington, DC: IMF.

International private capital flows to developing countries reached a record net level of $647 billion in 2006 as a wave of cross-border mergers and acquisitions boosted foreign direct investment (FDI) flows and much-improved domestic policies and favorable international economic conditions enhanced the ability of corporations based in developing countries to raise unprecedented sums of capital on global debt markets.

In a year characterized by heightened uncertainty over the course of global economic growth and shifting views on global inflationary trends and monetary policy responses, the continued expansion of private capital flows to developing countries speaks well for the resiliency of emerging economies and for the broader investment opportunities that globalization of the corporate sector offers to international fund managers and investors. The manner in which investors retreated from emerging markets during the broad equity sell-off in mid-2006, however, is also a telling reminder of underlying vulnerabilities and lingering weaknesses. As the tide of easy credit ebbs, it is important that emerging market governments renew their commitment to the sound policies of the recent past and recognize the implications of changes in the financial climate.

Supporting low-income countries in establishing access to private sources of capital remains an integral part of financing for development. For poor countries, which have limited access to market-based external financing, the development community should step up efforts to enhance aid flows to meet the development goals articulated under the Monterrey Consensus in 2002 and endorsed by the G-8 in July 2005.

Global Development Finance 2007, I: Review, Analysis, and Outlook is the World Bank's annual review of recent trends in and prospects for financial flows to developing countries. This year's special topics—low-income countries' access to commercial debt markets and financial globalization of the corporate sector in developing countries—highlight two areas of increasing importance to the future growth and financial stability of emerging market economies.

"Prospects for the Global Economy" is an online companion to *Global Development Finance*. It provides information on the global economic outlook, detailed regional forecasts, and additional features such as interactive graphs, analytical tools, and access to underlying data. This online publication is available in English, French, and Spanish at www.worldbank.org/globaloutlook.

Global Development Finance 2007, II: Summary and Country Tables includes a comprehensive set of tables with statistical data for 136 countries that report debt under the World Bank Debtor Reporting System, as well as summary data for regions and income groups. It contains data on total external debt stocks and flows, aggregates, and key debt ratios, and provides a detailed, country-by-country picture of debt. *Global Development Finance 2007* debt data are also available in electronic format: *GDF Online* (an electronic subscription database) and the *GDF CD-ROM*. Each of these electronic databases provides access to 217 time series indicators from 1970 to 2005, and country group estimates for 2006.

The Little Book on External Debt is a new publication that provides a quick reference to key debt data in aggregate and for individual countries.

With analysis and data extending from short-term bank lending to long-term bond issuance in local and foreign currency, *Global Development Finance 2007* is unique in its breadth of coverage of the trends and issues of fundamental importance to the financing of the developing world, including coverage of capital raised by corporations in developing countries. The report is an indispensable resource for governments, economists, investors, financial consultants, academics, bankers, and the entire development community.

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