Overview and Policy Messages: Striving for Stability in Development Finance

ALTHOUGH 2002 WAS A YEAR OF HESITANT global recovery, financial conditions facing many developing countries were once again challenging, especially for those countries (mainly middle-income countries) dependent on international financial markets. Conditions have improved a little in the early months of 2003, although the uncertainties surrounding Iraq have cast a shadow over both the global economy and financial markets.

Concern over the recent pattern of financial flows for global development that has prevailed in recent years is widespread—and understandably so.

Since 1998, developing countries have repaid external debt to private creditors in developed countries. In some cases these net repayments of debt have been required by timorous capital markets grown wary of overexposure to developing-country debt. In others they reflect reduced demand for debt by countries that have either found alternative forms of external finance or have reduced their overall demand for external investment funds. Combined with developing countries' steady accumulation of financial assets in high-income economies, however, these debt repayments mean that the developing world has become a net capital *exporter* to the developed world.

On a net basis, therefore, capital is no longer flowing from high-income countries to economies that need it to sustain their progress toward the Millennium Development Goals. The shortage is compounded in the poorest countries by a significant drop in official development assistance from bilateral donors.

What can or should be done to promote access by developing countries to external capital? What can be done to prevent growing economies from the disruptive effects of sharp reversals in financing? These are the central concerns of this year's *Global Development Finance*.

On the bright side, the steady drop in external debt financing has been cushioned by resilience in foreign direct investment (FDI). A further positive sign is the growth of local-currency bond markets in several emerging economies and the development of several promising innovations to manage credit risk. These issues, too, are covered in this report.

The developing world is learning to live with less external debt

The supply of debt capital to the developing world, which swelled in the early 1990s, was first reduced by the shock of the East Asian crisis of 1997–98, then by the turmoil in global fixed-income markets in the summer of 1998, and most recently by the problems in global high-yield markets in the aftermath of the 2001 slowdown. However, this broad-based decline in debt flows, first evident in East Asia and the Russian Federation, is now focused on Latin America.

Some early signs of improvement in the external-debt market cropped up as 2002 came to a close. The forecasts in this publication point to a further, gradual rise in debt flows in 2003 and 2004 (see chapters 1 and 3). It is unlikely, however, that private debt flows to developing countries will return to the levels of the 1990s. Nor would such a rebound necessarily be desirable.

While external bond and bank financing should continue to play an important role in the financing strategies of governments and private-sector borrowers in developing countries, the fixed commitments of debt service are not well suited to the swings in nominal income experienced by many developing countries, especially those dependent on primary commodities. Market reactions to debt-servicing strains add a whole new layer of volatility that can be severely damaging to growth and poverty reduction.

The movement from debt to equity has been underway in private financial markets since 1998. Policymakers should recognize the consequences of this important shift—and respond to the opportunities and policy challenges it poses.

Measures to promote the inflow of foreign equity capital are critical

FDI is less volatile than external debt. Its focus on long-term returns makes it clearly more appropriate for developing countries. And it can bring advantages both in technology and in operational and financial management. In this context, the resilience of FDI in the face of the sustained weakness in debt flows is a hopeful sign (see chapter 4).

In contrast to debt investors, companies have been willing to raise their exposures in the developing world, in part because their holdings in developing countries are a relatively small part of their overall capital stock, and in part because many mature companies now expect a large portion of their revenue growth and cost reduction (and thus their profit growth) to come from operations in developing countries, whether they are producing for export or for local sale.

FDI usually brings with it important benefits such as access to markets and transfers of technology and skills. In a world of volatile private capital flows, however, it is the financial aspects of FDI that are particularly desirable. Companies tend to invest in developing countries for the long haul. They see their returns rise and fall with the overall performance of the host economy and generally keep a significant share of earnings in the country.

A solid flow of FDI to developing countries should not be taken for granted, however. Indeed, net FDI to developing countries has already fallen from its peak of $179 billion in 1999 to $143 billion in 2002. With the bulk of net cross-border capital flows now coming in this form, it becomes increasingly important for policymakers and market participants to focus on sustaining FDI—and that depends critically on improvements in the investment climate. A healthy operating environment for the corporate sector—including a sound domestic institutional framework—is a necessary condition for profitable investment and the mitigation of risk, and therefore for the attraction of FDI (see chapter 5). It is also required to promote productivity, entrepreneurship, and investment for domestic firms and farms, the sources of 90 percent of developing-country investment and the main drivers of growth. Finally, it is the key determinant of whether domestic capital stays at home or flees abroad.

Growth and poverty reduction depend on prudent management of sovereign financial risks

Financial markets react swiftly to adverse news, making it all the more important to plan carefully to mitigate risk. Fortunately, bond markets in developing countries have moved in recent years toward issues denominated in local currency, although such issues tend to have shorter maturities, at least in the early years of market development. During such a transition, it is all too easy for a sovereign borrower to shift, rather than mitigate, its risk, with currency risks giving way to the rollover risks that occur when domestic debt is linked to a foreign currency (see chapter 3). The fact that the epicenter of most middle-income debt problems in recent years has been the local short-term money and bond markets serves as a graphic reminder of the case for prudent debt management.

Workers' remittances are an increasingly important source of external financing

An under-recognized trend in the external finances of developing countries—especially some of the smallest and poorest—is the steadily growing importance of workers' remittances (see chapter 7). Such flows now rank second in importance only to FDI in the overall external financing of developing countries (see chapter 1). At $80 billion in 2002, remittances were about double the level of official aid–related inflows and showed a remarkably steady growth through the 1990s. The strong U.S. labor market was especially important in fueling the growth of remittances, and the United States is now by far the largest source of remittance flows.

Demographic trends suggest that remittance flows from high-income countries will grow over the medium term, with the demographic dependency ratio falling in poor countries and rising in rich ones. However, heightened security concerns and a softening labor market in the high-income economies will probably check these flows over the next year or two. This prospect highlights the importance of the issues of trade in services and migration.

The international community must help borrowers manage pressures to reduce debt

Intense pressures to pay down external debt have placed many countries under severe stress in recent years, usually with particularly adverse consequences for poor people. There is now a growing consensus that the mechanisms available to cushion these debt pressures are in need of reform.

For low-income economies, significant progress has been made in providing debt relief under the Heavily Indebted Poor Countries Initiative. However, continued weakness in commodity prices, and thus in the export earnings of many poor countries, means that several countries will require additional resources before their debt can be considered sustainable (see chapter 6).

For highly indebted middle-income countries, the International Monetary Fund (IMF) has proposed the creation of a sovereign debt restructuring mechanism that would provide an orderly framework for restructuring external sovereign bond debt (see chapter 3).

The proposed framework is intended to be useful not only *after* a sovereign default, but also ahead of such an event, as its existence would make both debtors and creditors act in a more measured fashion, avoiding some of the extreme actions that have complicated recent defaults on sovereign debt.

The discussion of this proposal reminds us that the current set-up has not worked well and that the debt difficulties of middle-income countries are likely to persist in a world of low nominal income growth (see chapter 2).

Policymakers in the industrial countries can help stabilize development financing—

—by improving aid and trade policies—

Although much of the policy and many of the institutional reforms needed to stabilize development financing must come from governments in developing countries, the authorities in the developed world can play an important role. The major economies can support development most directly through coherent aid and trade policies that promote development. The commitments made in advance of the United Nations Conference on Financing for Development in Monterrey in March 2002 promised a modest increase in aid flows. These point to a welcome reversal of the downward trend through most of the 1990s, but their scale is incommensurate with the commitment to reach the Millennium Development Goals by 2015.

The effectiveness of aid can be improved by reallocating funds to poorer countries that have the policies, institutions, and governance that can be expected to reduce poverty. In those same countries, aid is also likely to be more productive if channeled through government institutions, with the close involvement of civil society, rather than through project-oriented institutions with intrusive management by donors.

Most important of all, industrial countries can spur development by reducing agricultural subsidies and trade barriers that discriminate against developing countries' exports. Industrial countries spend more than $300 billion each year in agricultural subsidies, about six times the amount they spend on foreign aid. Unless progress is made on agricultural protection and subsidies, negotiations within the World Trade Organization (WTO) are likely to be stalled, to the detriment of growth and development.

—and by ensuring broader macroeconomic stability

The major economies also play an important role through their macroeconomic policies and performances, which shape the global opportunities open to developing countries (see chapter 2). Developing countries benefit most when the major economies achieve steady, sustainable growth, avoiding booms and busts. Central banks in the major economies have established conditions favorable for the growth of global liquidity. With nominal interest rates within the Organisation for Economic Co-operation and Development (OECD) at their lowest levels in 50 years and real short-term interest rates generally close to zero, the core condition for reversing the flow of capital from developing to developed countries is in place. Through the 1990s, the countries of the OECD made important gains in reducing budget deficits, but much of this progress has been reversed in the past two years. The expectation of large, continuing budget deficits may further reduce developing countries' access to funds, while fiscal stimulus packages, which provided an important near-term boost to growth, have now generally reached their limits of effectiveness.

The widespread debt difficulties of the corporate sector in the United States and Europe were an important feature of the global downturn in 2001, contributing not only to a pronounced, sustained downturn in capital spending, but also to a rise in spreads in high-yield debt markets. Given the large number of investors who are active in both industrial and emerging markets, the rise in spreads on high-yield debt helped lift interest-rate spreads in markets for the external debt of developing countries (see chapter 3). In Japan, corporate-debt woes and their effects on the banking system held back growth throughout the 1990s and added to deflationary pressures throughout the economy.

Japan serves as a graphic example of the costs of delaying necessary corporate adjustments. By contrast, the high-profile corporate bankruptcies in other mature economies—especially the United States—in 2002 can be seen as a mixed blessing. On the one hand, they underlined the severity of the downturn and the magnitudes of the necessary adjustments in corporate spending. On the other, they served to highlight that corporate restructuring is proceeding.