Overview and Policy Messages: The Development Potential of Surging Capital Flows

2005 WAS A LANDMARK YEAR IN global development finance, in both the official and private spheres. International private capital flows to developing countries reached a record net level of $491 billion. The increase in private capital flows in 2005 was broad-based, with long-term bond issuance, bank lending, and portfolio equity showing strong gains. A wave of privatizations and cross-border mergers and acquisitions drew substantial foreign direct investment (FDI). Governments and private entities took advantage of favorable financial-market conditions to refinance outstanding debt and fund future borrowing, while local-currency bond markets in Asia and Latin America attracted substantial interest from international investors in search of higher yields and potential gains from currency appreciation. Meanwhile, financial integration among developing countries continued to deepen. Capital flows between developing countries (so-called South–South flows) are now growing more rapidly than North–South flows, particularly FDI. The strong gains in private capital flows have been supported by financial innovations, notably local-currency financing and structured financial instruments, such as credit default swaps and other derivatives, which have improved the ability of investors to manage their exposure to the risks associated with emerging market assets.

Development finance took center stage at a series of major international forums in 2005. With a decade remaining to attain the Millennium Development Goals (MDGs), expectations for a big push in development assistance escalated over the course of the year, with a strong focus on Sub-Saharan Africa, the only region not on track to meet any of the goals. There was broad agreement on the need to scale up aid significantly and to further reduce the debt burdens of heavily indebted poor countries (HIPCs) to provide additional financial resources needed to make progress on the MDGs. In keeping with those objectives, donors have enhanced their aid effort over the past few years and taken steps to improve the allocation of aid by providing more development assistance to the poorest countries, particularly those in Sub-Saharan Africa. Donors also have provided targeted support for trade facilitation and developed a framework for improving the effectiveness of aid. Overall, aid in the form of grants and concessional loans has risen, while net lending by the official sector on nonconcessional terms has declined significantly.

The global economy grew at a robust pace of 3.6 percent in 2005, with the developing world exceeding 5 percent growth for the third year running. Global economic and financial conditions remain favorable, on the whole, despite several potentially destabilizing developments, notably high and volatile oil prices, growing global financial imbalances, and rising short-term policy interest rates in some of the major industrial countries. International financial markets have remained resilient to the test of several major credit events, including the downgrading of two major U.S. automakers and the settlement of backlogged credit derivatives contracts that had come to the attention of U.S. regulatory authorities. The upward trend in private capital flows appears to have continued in the early months of 2006, and the short-run prospects are good. But the external environment could well prove less auspicious in the future than in recent years, depending critically on the course and dynamics of the necessary rebalancing of global savings and investment patterns to underpin the orderly unwinding of large and unsustainable global financial imbalances.

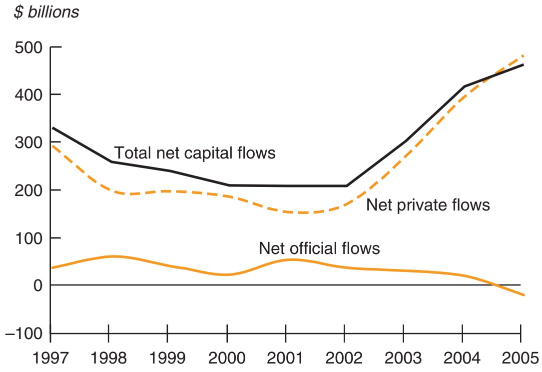
The surge in private capital flows offers national and international policy makers a major opportunity to bolster development efforts if they can successfully meet three challenges. The first is to ensure that more countries, especially poorer ones, enhance their access to developmentally beneficial international capital through improvements in their macroeconomic performance, investment climate, and use of aid. The second is to avoid sudden capital flow reversals by redressing global imbalances through policies that recognize the growing interdependencies between developed and developing countries' financial and exchange rate relations in the determination of global financial liquidity and asset price movements. And the third is to ensure that development finance, both official and private, is managed judiciously to meet the development goals of recipient countries while promoting greater engagement with global financial markets. These are the themes and concerns of this year's edition of *Global Development Finance*.

The broad surge in private capital flows continues

Net capital inflows from official and private sources increased from $418 billion in 2004 to $472 billion in 2005. While net official lending was negative, net flows of private capital to developing countries swelled for the third consecutive year, reaching $491 billion in 2005, the highest level on record (figure 1 and table 1). Demand for emerging market debt and equities remained strong, spurred by improved fundamentals in many developing countries and investors' search for higher yields in an environment where long-term interest rates remain low in major industrial countries, despite higher short-term interest rates. Developing countries' finances also received a boost from workers' remittances, which continued their steady increase of the past decade (box 1).

The increase in private capital flows has been broad-based, extending across most debt and equity components and across most of the developing world. Long-term bond flows (up $19 billion over 2004), medium- and long-term bank lending (up $28 billion), and portfolio equity (up $24 billion) showed the strongest gains. The cost of bond issuance has dropped for many developing countries, as long-term interest rates in industrial countries remain low (despite increases in short-term rates in the Euro Area, the United States, and elsewhere) and spreads on emerging market sovereign bonds continue to decline. Those spreads reached a record low of 174 basis points in May 2006 (figure 2). Short-term borrowing remained at approximately the same level as in 2004 and about $14 billion higher than in 2003, in sharp contrast to the negative flows of short-term debt that were seen from 1998 to 2001.

Figure 1 Financial flows to developing countries, 1997–2005



Source: World Bank Debtor Reporting System and staff estimates.

The rise in private flows also was widespread, with all regions experiencing an increase (table 2):

- A surge in flows to the Russian Federation and Turkey helped to boost flows to the Europe and Central Asia region to $192 billion in 2005, up from $160 billion in 2004. The region accounts for 39 percent of developing countries' private flows, almost double the share it commanded in 2001.
- Stronger bond and equity activity increased private flows to Latin America and the Caribbean from $59 billion in 2004 to $94 billion in 2005. But the region's share of private flows to the developing world plummeted from 45 percent in 2000 to 19 percent last year.
- Flows to East Asia and the Pacific increased to $138 billion from $125 billion the year before, despite lower FDI to China. A marked strengthening in flows to several regional economies explains the increase.

Table 1 Net capital flows to developing countries, 1997–2005

$ billions

	1997	1998	1999	2000	2001	2002	2003	2004	2005e
Current account balance	–84.5	–89.4	–4.0	47.1	18.8	69.8	122.3	153.1	248.4
as % GDP	–1.5	–1.6	–0.1	0.8	0.3	1.2	1.8	1.9	2.6
Financial flows:									
Net equity flows	199.3	179.4	195.9	182.9	183.3	166.1	186.8	248.8	298.9
Net FDI inflows	168.7	172.4	183.3	168.8	176.9	160.3	161.6	211.5	237.5
Net portfolio equity inflows	30.6	6.9	12.6	14.1	6.4	5.8	25.2	37.3	61.4
Net debt flows	107.2	54.3	16.3	–1.0	–1.5	10.7	72.8	119.1	120.1
Official creditors	13.1	34.3	13.9	–5.7	27.4	5.2	–12.3	–28.7	–71.4
World Bank	9.2	8.7	8.8	7.9	7.5	–0.2	–0.9	1.3	0.7
IMF	3.4	14.1	–2.2	–10.7	19.5	14.0	2.4	–14.7	–41.1
Others	0.5	11.5	7.3	–2.9	0.4	–8.6	–13.8	–15.4	–31.0
Private creditors	94.1	19.9	2.5	4.7	–28.9	5.5	85.1	147.8	191.6
Net medium- and long-term debt flows	85.0	85.7	22.0	11.5	–6.2	1.2	30.2	77.8	122.3
Bonds	38.4	40.6	30.6	20.5	11.0	10.8	26.4	43.0	61.7
Banks	44.0	50.3	–7.1	–5.2	–10.8	–2.8	9.8	39.4	67.4
Others	2.7	–5.2	–1.5	–3.8	–6.3	–6.8	–5.9	–4.6	–6.7
Net short-term debt flows	9.2	–65.8	–19.6	–6.8	–22.7	4.2	54.9	70.0	69.3
Balancing item[a]	–169.5	–127.8	–175.0	–183.6	–118.8	–74.7	–90.3	–116.2	–274.5
Change in reserves (– = increase)	–52.4	–16.4	–33.2	–45.4	–81.7	–171.9	–291.6	–404.8	–393.0
Memo items:									
Bilateral aid grants (ex technical cooperation grants)	25.3	26.7	28.5	28.7	27.9	32.5	43.7	50.3	52.6
Net private flows (debt+equity)	293.5	199.3	198.4	187.6	154.4	171.5	271.9	396.6	490.5
Net official flows (aid+debt)	38.3	61.1	42.4	23.0	55.3	37.7	31.4	21.6	–18.8
Workers' remittances	71.2	73.1	77.0	85.2	96.4	113.2	141.2	161.1	166.8

Sources: World Bank Debtor Reporting System and staff estimates.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing-country private entities.
e = estimate.

Box 1 International migrant remittances

Remittances are the largest source of external financing in many developing countries. According to official statistics, in 2005 remittance flows—defined as the sum of workers' remittances, compensation of employees, and migrant transfers in the balance-of-payments statistics collected by the International Monetary Fund—are estimated to have exceeded $233 billion worldwide, of which developing countries received $167 billion. Unrecorded flows moving through informal channels push the total far higher, as they are conservatively estimated to amount to at least 50 percent of the recorded flows.

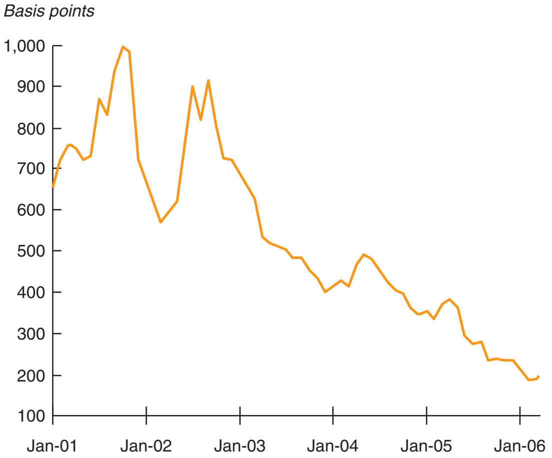
Remittances bring substantial benefits to developing countries:

- Household survey evidence, confirmed by cross-country analyses, indicates that remittances can have a significant impact on reducing poverty.
- Remittances are associated with increased household investment in education, entrepreneurship, and health—all of which have a high social return under most circumstances.
- Remittances tend to be countercyclical and thus support economic activity in the face of adverse shocks.
- By generating a steady stream of foreign exchange, remittances can improve a country's creditworthiness and enhance its access to international capital markets.

Recorded remittance flows to developing countries have doubled over the past five years, for several reasons. Increased scrutiny of financial transactions since the terrorist attacks of September 2001 has made remittances more visible. With the growth of competition in the remittance industry, costs have dropped in major corridors, while networks have expanded. Recently, high oil prices have swelled remittance flows from oil-exporting countries. Bahrain, Kazakhstan, Kuwait, Oman, Saudi Arabia, and the Russian Federation have been important sources of remittances to developing countries. The depreciation of the U.S. dollar (which raises the value of remittances denominated in other currencies) and growth in the number of migrants and their incomes have contributed further to the increase.

Source: World Bank, *Global Economic Prospects 2006;* World Bank staff calculations based on various data sources.

Figure 2 Benchmark spreads for emerging markets, 2001–6



Source: JPMorgan Chase.
Note: As of April 7.

The creditworthiness of most developing countries continued to improve in 2005, as upgrades by credit rating agencies handily outpaced downgrades. Moreover, the pace of credit upgrades rose to 46 in 2005, up from 31 in 2004. Many developing countries have taken advantage of the favorable financial conditions by issuing bonds with longer maturities in international markets—in some cases denominated in local currency. Others have been able to buy back existing debt using the proceeds of new bonds issued at lower rates. Also, many countries have pre-funded future financing requirements. Syndicated bank lending to developing countries set records in 2005. Gross bank lending of $198 billion, an increase of 77 percent over 2004, involved 1,261 transactions in a broad range of sectors, dominated by oil-and-gas projects and oil-import financing. Meanwhile, booming stock markets in emerging market economies boosted portfolio equity flows to a record $61 billion, up from $37 billion in 2004. However, private capital flows remain concentrated in just a few countries. In 2005 about 70 percent of bond financing and syndicated lending went to ten countries; three countries (China, India, and South Africa) accounted for almost two-thirds of all portfolio equity flows.

Rather than fueling domestic investment, the rise in net inflows of private capital in 2005 financed a substantial rise in developing countries' official reserve assets (almost as large as the record increase in 2004) and a very sharp increase in the accumulation of foreign assets by private entities—to $258 billion, again a record level (see figure 3).

The opening of capital accounts in the developing world has increased opportunities for capital outflows, enabling developing-country residents to improve their investment returns and reduce their risks through international diversification.

Global growth has propelled the surge in capital flows, but serious risks remain

Global growth has remained surprisingly resilient to the rise in world oil prices over the past few years. Despite a doubling of oil prices from early 2003 to late 2005, world GDP expanded by a robust 3.6 percent in 2005. Developing countries led the way, with GDP growth of 6.4 percent, more than twice the rate of high-income countries (2.8 percent).

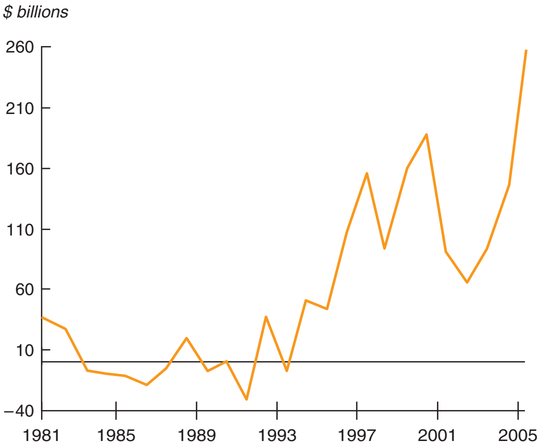
The impact of higher oil prices on economic growth and inflation has been more subdued than in previous episodes. Global growth was down only 0.5 percentage points, and the expansion among developing countries was 0.7 percentage points, slower than in 2004. The reduced impact

Table 2 Net private capital flows to developing countries by region, 1998–2005
$ billions

	1998	1999	2000	2001	2002	2003	2004	2005
East Asia and Pacific	6.5	28.8	28.0	39.2	58.9	81.5	125.4	137.7
Europe and Central Asia	66.7	50.9	51.5	33.1	59.7	101.1	160.2	191.7
Latin America and the Caribbean	98.9	95.8	85.2	59.5	28.2	49.9	59.3	94.4
Middle East and North Africa	8.1	2.6	3.3	4.8	8.3	7.8	8.3	14.6
South Asia	5.3	3.5	9.7	5.8	10.1	15.8	22.7	23.6
Sub-Saharan Africa	13.7	16.7	9.9	12.1	6.3	15.8	20.7	28.4

Sources: World Bank Debtor Reporting System and staff estimates.

Figure 3 Capital outflows by private entities in the developing world, 1981–2005



Sources: International Financial Statistics, IMF; and World Bank staff calculations.
Note: The size of the increase in private assets is hard to judge, since it is calculated as a residual and thus includes errors and omissions from elsewhere in the balance of payments.

reflects several factors, notably lower oil intensities, more flexible product and labor markets, exchange rate flexibility, and more credible monetary policy. Higher nonoil commodity prices have offset the impact of higher oil prices on the terms of trade of some countries.

Higher oil prices have had a major influence on the external and fiscal positions of most developing countries, however. For net oil *exporters*, higher oil prices have meant significant increases in external and fiscal surpluses, and higher foreign exchange reserves. For net oil *importers*, healthy current-account surpluses and ample foreign exchange reserves made it possible to cover the sizable increase in oil-import bills. Considerable increases in foreign aid for some of the poorest countries, particularly those in Sub-Saharan Africa, provided an additional source of foreign currency. But fiscal deficits have risen alarmingly in countries that subsidize domestic energy prices.

Despite high oil prices, growth in developing countries is expected to remain above 5 percent per year during the period 2006–8, well above the performance of the past two decades, and with inflationary pressures in check. The main risks to this relatively benign outlook are broadly unchanged since the last edition of *Global Development Finance*. The possibility that global imbalances might unwind in a disruptive fashion remains a risk—particular for heavily indebted countries and those with close economic ties to the United States. A second risk is that a sharp supply shock might send oil prices even higher, with potentially serious consequences for the most energy-dependent developing economies. A fall in nonoil commodity prices could have similar consequences for some of the poorest countries, which have benefited from higher metals and mineral prices. There is also a possibility that the current glut of liquidity in global financial markets may have caused investors to underprice the risk of emerging market assets (both debt and equity). Political risk has reemerged as a key concern for investors in several emerging market economies, where elections could portend major changes in policy direction. Finally, there is a risk that avian influenza (bird flu) could mutate into a form that is easily transmitted between humans and for which the population has limited immunity. Depending on the severity of the eventual disease, such a pandemic could kill between 14 million and 70 million people and lower global GDP by between 2 and 5 percent (with the latter number implying a global recession).

Capital flows are being transformed

Financial integration among developing countries

For much of its postwar history, development finance has been characterized as a one-way flow of capital from industrial countries to the developing world. But as developing countries have become more integrated with the global economy, they have emerged as important sources of capital flows in their own right. In the past decade, with rising incomes in developing countries and increasingly open policies toward trade and financial markets, developing countries have become a significant source of FDI, bank lending, and even official development assistance (ODA) to other developing countries.

Overall, growing FDI between developing countries in recent years has sometimes compensated for reductions in FDI flows from high-income countries. But South–South capital flows, in particular, have also opened opportunities for low-income countries, because developing-country investors are often possibly better able to handle the special risks encountered in poor countries. Banks from developing countries play an increasingly prominent role in cross-border lending to low-income countries—borrowers in low-income countries received 17 percent of total South-South cross-border syndicated lending flows in 2005, up from 3 percent in 1985. Moreover, 27 percent of foreign bank assets in low-income countries are held by developing-country banks, compared to just 3 percent in middle-income countries. South–South FDI is significant for many low-income countries, particularly those located close to major investors.

Although South–South capital flows remain relatively small compared to North-South flows, they have the potential to change the landscape of development finance over the next few years, particularly if growth in developing countries continues to outstrip that in advanced countries and the trend toward deeper trade and financial integration persists.

Financial innovations

The market for debt issued by developing countries is expanding beyond the dollar-denominated, high-yield, sovereign debt instruments that had come to define the emerging market asset class, as exemplified by Brady bonds (which will drop to only 6 percent of the original amount outstanding once announced buybacks are completed). Today, the emerging market asset class includes a range of instruments in both local and foreign currency that offer the capacity to tap dollar and euro investors alike and cater to the funding needs of both sovereign and corporate borrowers on both the cash and derivatives sides of the market.

Credit default swaps—derivatives that provide insurance against defaults—are being applied in new ways in emerging markets. This has potentially important implications for the pricing and supply of debt capital to developing countries, offering investors a new way to take on exposure and enhancing the markets' ability to gauge credit risk. By transferring banks' credit risk from lending and trading activities to other market participants, credit derivatives have altered, perhaps fundamentally, the traditional approach to credit risk management and the lending business. While the emergence of this market could improve the ability of financial systems to diversify risk across a greater number of market participants, it remains a relatively immature and potentially vulnerable market because of infrastructural shortcomings, a lack of regulatory frameworks robust enough to cope with the market's dynamic nature, and the concentrated participation of a small number of dealers in emerging markets, which carries the risk that failure of a single player could have a destabilizing impact on the market.

Domestic debt markets

Local-currency bond markets in developing countries have, since the crises of the 1990s, emerged as a major source of long-term development finance. They are now the fastest-growing segment of emerging market debt. Driven largely by domestic institutional and individual investors, these markets grew from $1.3 trillion at the end of 1997 to $3.5 trillion in September 2005. Their rapid growth has enabled major developing countries to improve debt management by reducing currency and maturity mismatches. Robust domestic bond markets have also improved financial intermediation and contributed to domestic growth, as both the government and corporate sectors have readier access to long-term capital. However, bringing the local-currency bond markets in emerging economies up to the standards of mature markets will require concerted efforts akin to those of the East Asian countries, which have yielded early successes. But local-currency debt markets also present new challenges for policy makers. The development of domestic debt markets requires modern and professional debt management procedures—to manage debt on an integrated basis (that is, both local and international debt)—especially in countries with few capital controls.

The global role of the euro

Since its introduction on January 1, 1999, the euro has assumed an increasingly important international role. It has emerged as a principal issuing currency in the global debt market, as a vehicle for foreign exchange transactions, and as an important reserve currency for official holdings of foreign-exchange reserves. The elimination of exchange risk within the Euro Area has created a pan-European market for euro-denominated securities, attracting both sovereign and private borrowers, not only from Euro Area countries, but also from other countries—among them emerging market economies such as Brazil, Colombia, China, Mexico, and Turkey. Today's euro-denominated bond market rivals the dollar-based fixed-income markets in important respects, including size, depth, and product range.

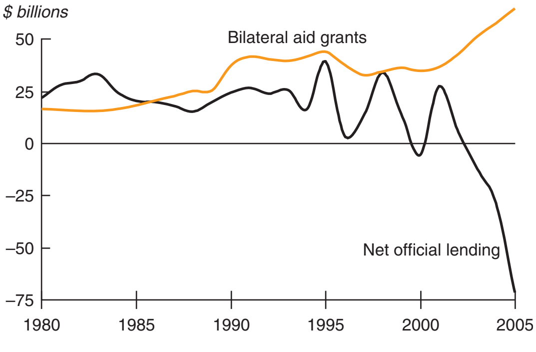
The euro is used increasingly in debt issuance, because it is the home currency of a large set of investors. It is less popular as a currency of denomination for reserves, owing to the dominance of the dollar as a vehicle for foreign exchange transactions and currency interventions—as well as the greater liquidity of the market for U.S. Treasury securities. Nevertheless, if the deteriorating U.S. current-account deficit sufficiently undermines confidence in the dollar, more official reserve holdings could be moved into euro-denominated assets, with the potential for a period of financial instability if the shift is abrupt.

Net official flows continue to decline

Official lending falling

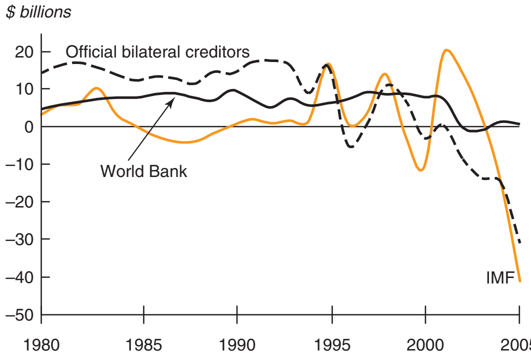
Net official flows of grants and loans continued to fall in 2005—for the fourth consecutive year—as a sharp decline in net official lending more than offset gains in bilateral aid grants (table 1 and figure 4). Net official lending came to –$71.4 billion in 2005, the third consecutive year of net outflows from developing countries. In three years, developing countries have repaid $112 billion in loans to creditors. This largely reflects repayments of nonconcessional loans mostly by middle-income countries. In contrast, aid (comprised of concessional loans and grants) has increased significantly during this period, particularly for low-income countries.

Figure 4 Net official lending and foreign aid grants to developing countries, 1980–2005



Source: World Bank Debtor Reporting System and staff estimates.

Figure 5 Net official lending, 1997–2005



Source: World Bank Debtor Reporting System and staff estimates.

The dramatic decline in net official lending over the past few years reflects, for the most part, large repayments to the International Monetary Fund (IMF) and large prepayments to bilateral official creditors (figure 4). In 2005 net debt *outflows* from developing countries to the IMF totaled $41.1 billion, down from a net debt *inflow* of $19.5 billion in 2001, implying a –$60.6 billion swing in net lending by the IMF over the period 2001–5. The sharp decline is due to large repayments on emergency assistance loans made to Indonesia and the Russian Federation in 1997/8, and to Argentina, Brazil, and Turkey in 2001/2. The sharp decline in 2005 reflects large repayments by Argentina ($2.4 billion), Brazil ($16.8 billion), Indonesia ($1.0 billion), the Russian Federation ($2.3 billion), and Turkey ($4.2 billion). Moreover, gross lending by the IMF has declined from about $30 billion in 2002–3 to only $4 billion in 2005. This reflects the marked improvement in international financial stability, supported by the favorable global economic and financial conditions. The IMF's outstanding credit has declined from special drawing rights (SDR) 71 billion in 2002/3 to SDR 23.5 billion in March 2006. Despite the low level of IMF credit outstanding, net lending by the IMF could continue to decline over the next few years with large scheduled repayments by Indonesia, Turkey, and Uruguay.

Net lending by the official bilateral creditors declined by $27.0 billion in 2005 mainly due to large prepayments to the Paris Club by the Russian Federation ($15 billion), Poland ($5.6 billion) and Peru ($2.0 billion). Russia financed a $15 billion prepayment to the Paris Club using domestic financial resources, as its fiscal revenues increased dramatically in the wake of higher world oil prices. The prepayments by Peru and Poland were financed by borrowing in private capital markets, effectively substituting private debt for official (Paris Club) debt. Large prepayments to the Paris Club are expected to continue into 2006. In May 2006, Algeria and the Russian Federation made offers to prepay all of its remaining Paris Club debt, totaling $22 billion and $8 billion, respectively. Paris Club creditors have indicated their willingness to accept the proposals. Poland has announced its intention to prepay some of its €12.3 billion debt to the Paris Club, which will be due between 2005 and 2009.

More aid for the poorest countries, and more debt relief

Net disbursements of ODA by OECD DAC member countries increased dramatically in 2005, reaching $106.5 billion, up from $79.6 billion in 2004. Expressed as a share of gross national income (GNI) in donor countries, ODA has risen from 0.22 percent in 2001 to 0.33 percent in 2005, just below the 0.34 percent peak reached in the early 1990s. However, most of the record $27 billion increase in 2005 reflects debt relief provided by Paris Club creditors to Iraq (nearly $14 billion) and Nigeria (a little over $5 billion). Nevertheless, even excluding debt relief, ODA rose by 8.7 percent in real terms, up from a 5.6 percent average annual increase over 2002–4.

ODA is likely to decline as a percentage of GNI in 2006–7, as the debt relief component falls to more normal levels, before increasing gradually through the end of the decade. Donors have made commitments to increase ODA by $50 billion by 2010, half of which is targeted to go to Sub-Saharan Africa. Based on those commitments, ODA should reach 0.36 percent of GNI in 2010. Extrapolating this rate of increase would mean that the UN target of 0.7 percent would not be attained until 2030, 15 years after the 2015 deadline set for attaining the MDGs.

The international community made significant progress in 2005 to reduce debt burdens in some of the poorest countries. Debt relief provided under the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Reduction Initiative (MDRI) will significantly reduce the debt burdens of poor countries that qualify. The 18 countries that reached the completion point prior to May 2006, under the HIPC Initiative, will see their total debt stock fall from an average level of 55 percent of GDP (before HIPC debt relief) to 13 percent (after MDRI debt relief).

Debt relief together with other special-purpose grants—for technical cooperation, emergency and disaster relief, and administrative costs—has accounted for a rising portion of ODA over the past few years. The increase in ODA as a share of GNI since 2001 reflects higher special purposes, rather than more flexible forms of funding. Donors have reallocated aid to the poorest countries, particularly those in Africa, and have continued to shift their resources from concessional loans to grants, with the goal of avoiding unsustainable increases in the debt burdens of aid recipients.

To ensure economic stability, developing countries must manage capital flows effectively

The current surge in private capital flows has occurred in the midst of much-improved domestic policies and global financial conditions compared with those that prevailed during the capital flows surge of the 1990s. This time around, governments have so far generally managed to avoid excessive expansion of aggregate demand, large current-account deficits, and sharp appreciations of the real exchange rate. However, the policy agenda for managing capital flows is broad and complex, and considerable challenges remain.

Effective macroeconomic policies

The improved response to the surge in capital flows this time around has been supported by the adoption of more flexible exchange rate regimes and a monetary policy framework that favors price stability. Inflation has fallen dramatically in virtually all developing countries, from a median of 11 percent in the mid-1990s to a median of 4.5 percent during 2002–5. At the same time, the greater autonomy in monetary policy afforded by more flexible exchange rates has allowed authorities to lower local interest rates. Flexible exchange rates and lower interest rates have drastically reduced the incentive to resort to short-term external borrowing, a major vulnerability that contributed to the financial crises of the 1990s. Governments also have taken steps to accelerate development of domestic capital markets (especially local bond markets) to create more diversified financial markets that would be more capable of handling volatile flows in portfolio capital. These developments, along with the shift from debt finance to equity (particularly FDI), have contributed to the marked improvement in developing countries' net external liability position. The ratio of external debt to GNI for developing countries as a whole fell from a peak of 44 percent in 1999 to about 34 percent in 2004, while since the mid-1990s short-term debt has declined in most developing countries relative to long-term debt and foreign exchange reserves.

Progress has been made in simplifying the very complex web of capital controls and exchange rate restrictions imposed by many countries. But the gradual opening of capital accounts must be accompanied by a further strengthening of macroeconomic policies, the development of local capital markets and the institutions needed to regulate them, and the establishment of a system of risk management robust enough to respond to the needs of a more flexible exchange rate and open capital account. Liberalization of the capital account once implemented is difficult to reverse. A return to capital controls should be seen only as a policy of last resort, to be used to dampen excessive exchange rate volatility or to moderate large inflows of capital when other policies, such as interest rates and intervention in foreign exchange markets, prove fruitless.

Despite the considerable improvement in policies in recent years, the surge in capital flows still presents substantial risks to developing countries. Future risks to economic and financial stability will likely take a different form and character than those encountered in the past—and may expose institutional and macroeconomic weaknesses that cannot be anticipated at this juncture. One warning sign of potential troubles has been the surge in portfolio inflows that has been associated with a dramatic escalation of stock market prices and valuations in many developing countries, particularly in Asia, raising the risk of asset price bubbles. Other signs of possible trouble are appreciated exchange rates and current account deficits in some Eastern European countries. The impact of individual risks could be magnified if several were to occur simultaneously.

Prudent accumulation of reserves

The current account in many developing countries, particularly major oil exporters and emerging Asia, has moved from deficit to sizable surplus, intensifying the demand for reserve accumulation. That many of these countries have accumulated foreign exchange reserves far in excess of the level required for intervention and liquidity purposes partly reflects a desire to self-insure against global financial shocks. As the volume of reserves increases, however, so does the importance of balancing their use for intervention, investment, and insurance purposes against their domestic resource costs. For countries with large holdings of foreign exchange reserves, allowing local institutional investors to diversify their investment portfolio globally—while ensuring their more effective regulation—could provide a viable channel of capital outflow, as well as an opportunity to further diversify risk. This would transfer currency risks, currently concentrated on the books of central banks, to domestic institutional investors with a longer investment horizon and a greater ability to manage such risks. Such an approach is also more desirable for many developing countries than inducing adjustments through the current account as a way of absorbing reserves. In addition to allowing institutional investors greater scope to invest overseas, consideration should be given to enabling local residents to invest in approved international assets, as the Republic of Korea has done.

Careful management of oil-export revenues

Oil-exporting countries face particular challenges in managing volatile export revenues. Although high oil prices are now expected to persist, considerable uncertainty remains, and oil exporters should save a part of the windfall—for example, to reduce debt and make productive physical and social investments. Some countries have put aside a fraction of their oil revenues in a stable portfolio of diversified financial assets (referred to as "funds for the future"), thus reducing the risk of overconsumption of oil revenues and the potential for Dutch disease. Such funds require robust governance and legal frameworks to effectively insulate earmarked oil wealth from political decisions guided by short-term agendas. The government must set and adhere to clear objectives for their investment, protection, and eventual use. Countries that depend heavily on oil revenues should also consider using derivatives to reduce the volatility of future income.

Improvements in standards for the corporate sector

A growing number of developing countries have made considerable efforts to meet international standards for transparency, corporate governance, and the regulation and supervision of financial systems. Although this is a global trend, individual countries take different approaches to adapting international standards to their corporate environment. Some, for example, are issuing codes that set compliance targets in tandem with laws setting minimum compulsory standards, while others are using codes to raise public awareness in advance of upcoming regulatory reform. The adoption of national codes of corporate governance in at least 60 countries by the end of 2005—including all of the Asian crisis countries, plus China, Colombia, Turkey, and Ukraine—underscores the growing recognition of the importance of corporate governance in enhancing investor confidence, a recognition that bolsters the resilience and stability of capital markets globally. Priority must now be given to effectively implementing and enforcing these new domestic policy and institutional reforms at the national level.

Multilateral cooperation is key to resolving global financial imbalances

Developing-country policies must be reinforced by renewed international efforts to promote stability and maintain a financial environment conducive to a balanced expansion and deployment of capital flows in developing countries. One major risk to stability is the growing imbalance in global payments and the associated market anxiety about the possibility of a disorderly adjustment of the imbalance through sudden changes in exchange rates and global interest rates. Such changes could destabilize and disrupt international financial markets, which would cause all countries to suffer.

Although a coordinated policy of intervention in foreign currency markets—similar to the Plaza Agreement of September 1985—is neither desirable nor feasible (given the changes in global financial market conditions and actors over the past two decades); a degree of multilateral cooperation is needed to address the current global imbalances. That approach, based on the mutual interests of deficit and surplus countries, should reflect the structural asymmetry between international reserve currencies and other currencies. At its center must be consensus on a blend of exchange rate and aggregate spending adjustments adequate to rebalance global aggregate demand toward surplus countries without causing a global recession. Ordinarily, policy coordination among key players is unnecessary, because floating exchange rates, accompanying monetary policies (oriented primarily toward domestic targets for inflation and economic activity), and independent central banks do their job to facilitate adjustment to any shocks hitting the world economy. But when the sustainability of the sources of finance for global payment imbalances is in doubt, as it is at present, multilateral cooperation to prevent sudden and disorderly market reactions becomes highly desirable, especially if the growing global imbalances create pressure for protectionist trade policies in some countries.

Developing countries, in particular, have much to gain from multilateral cooperation, and much to lose from its absence, and they would suffer disproportionately if instability were induced and a disorderly unwinding of global financial imbalances ensued. The world economy is moving toward a multipolar international monetary system in which the monetary and financial policies of the United States, Euro Area, Japan, and several key emerging market economies, including China, all exert substantial influence. Policymakers in emerging market economies should therefore strive to strengthen institutions and promote policies and mechanisms that will improve their ability to navigate in a world of increasingly integrated and interdependent financial and production systems.