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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).

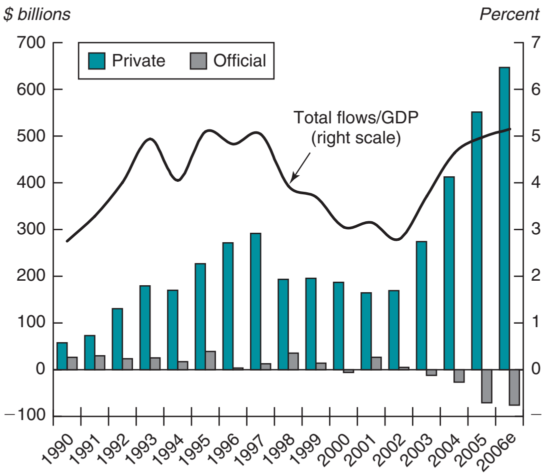
Table 2.1 Net capital flows to developing countries, 1998–2006

$ 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

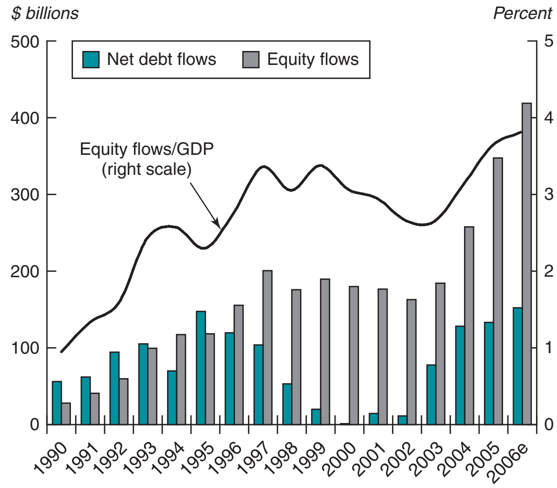
Sources: World Bank Debt Reporting System and staff estimates.
Note: e = estimate.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

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 . . .

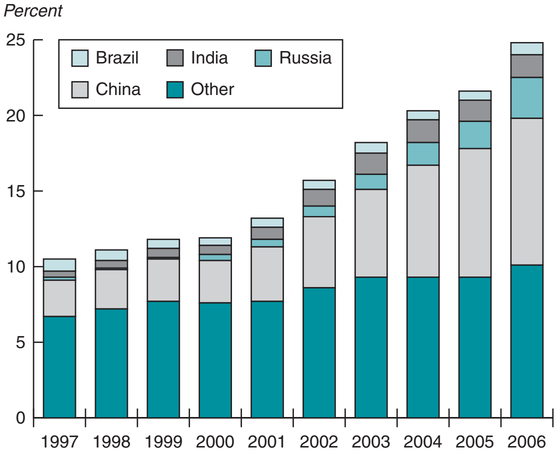
Equity continued to account for the bulk of capital flows, averaging 70 percent of the total during 2004–06. Foreign direct and portfolio equity flows increased by $235 billion over this period, while net private and official debt flows increased by just $75 billion (figure 2.2). The expansion in equity 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.

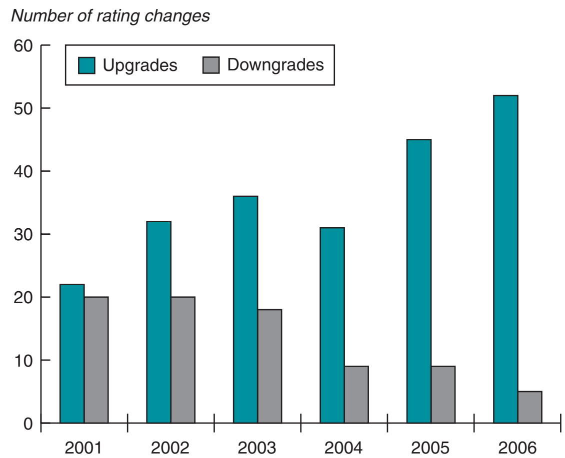
Current account balances for developing countries as a group continued to improve in 2006, reaching a record 3.1 percent of GDP, up from 2.7 percent in 2005. These balances rose by $247 billion between 2003 and 2006, with most of the increase concentrated in China ($162 billion) and Russia ($63 billion). 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



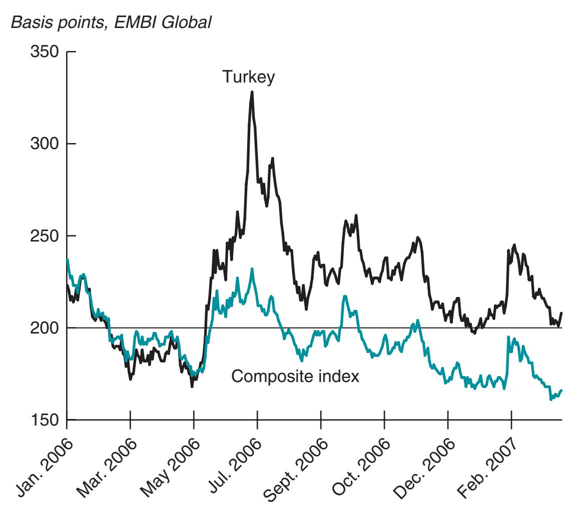
Source: IMF *International Financial Statistics.*

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



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

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



Source: JPMorgan Chase.

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.

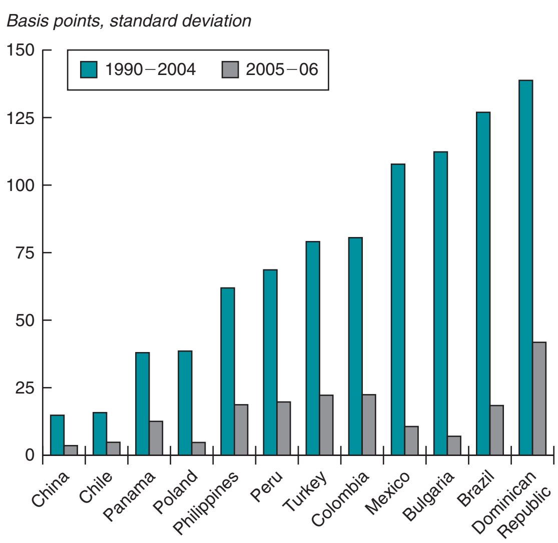
Markets maintain favorable view on emerging-market assets

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.

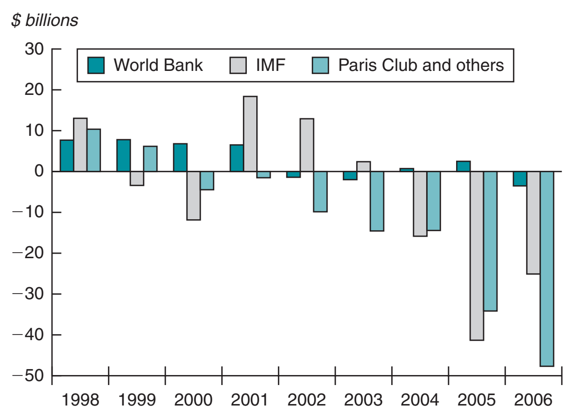
Official capital flows continue their sharp decline

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.

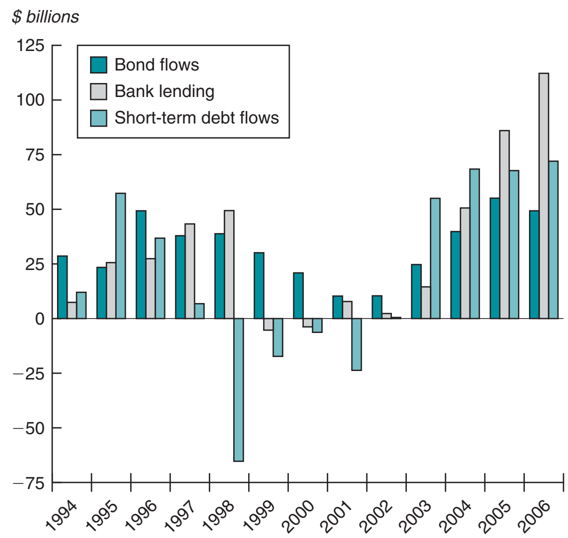
Private debt market developments

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

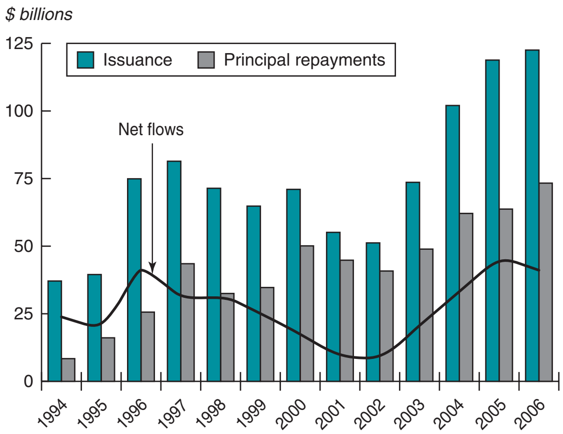
Net private bond flows (bond issuance less principal repayments) declined by $6 billion (10 percent) in 2006, to $49 billion (figure 2.9). The decline followed three years of strong expansion in net bond flows. The 2006 figure was still higher than the level reached in 1996, just before the Asian crisis. 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 2.8 Net private debt flows to developing countries, 1994–2006



Sources: World Bank Debt Reporting System and staff estimates.

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

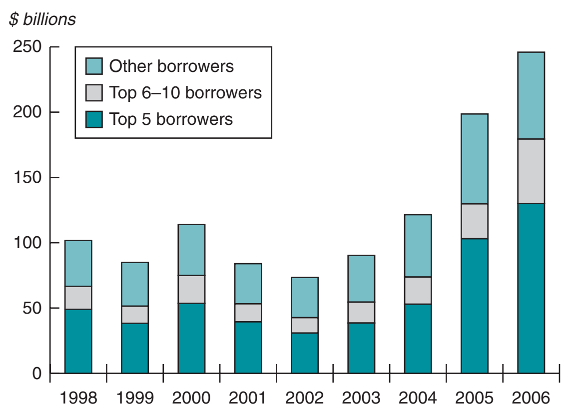
Sources: World Bank Debt Reporting System and staff estimates.
Note: e = estimate.

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.

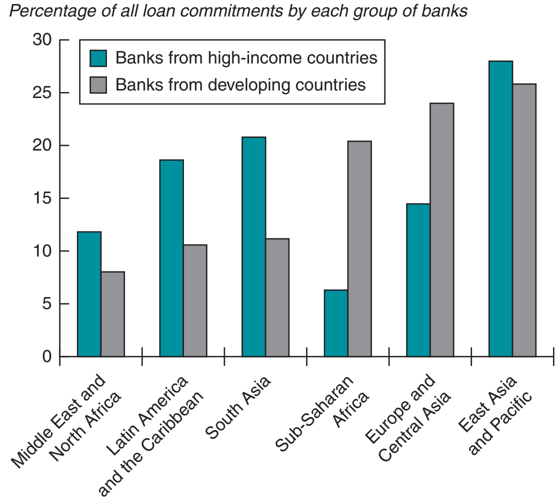
Banks from developing countries are playing an active role

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 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]

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

Percentage of all loan commitments by each group of banks



Sources: Dealogic Loanware and World Bank staff estimates.

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]

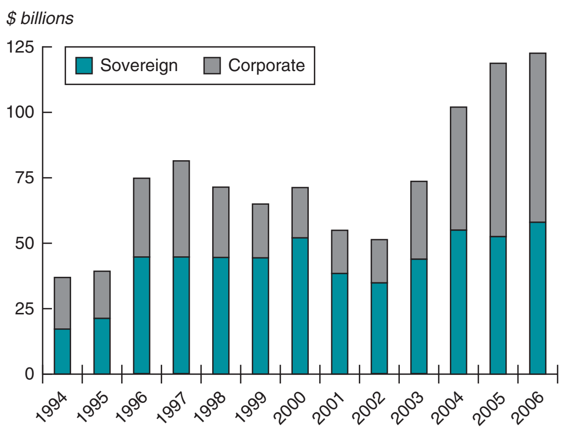
Bond issuance is shifting toward the private sector

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.

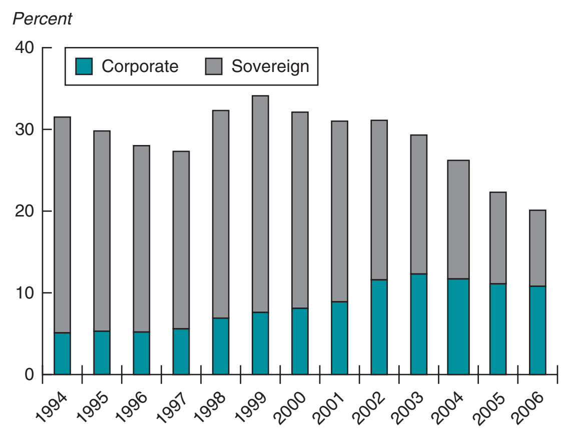
Brazil, Colombia, Mexico, and República Bolivariana de Venezuela bought back almost $30 billion in sovereign debt in 2006 (table 2.7). Brazil accounted for $15 billion, an amount equal to more than 60 percent of its external debt at the end of 2005. These debt-management operations reduced Brazil's average 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



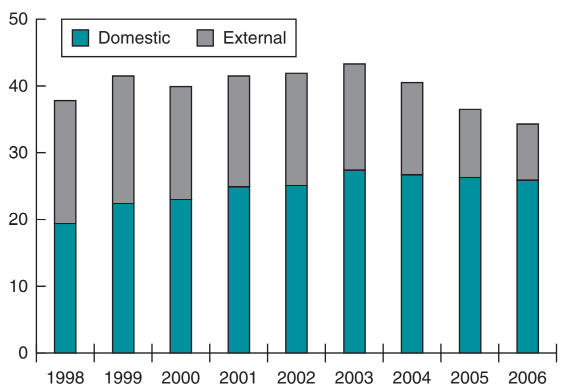
Sources: World Bank Debt Reporting System and staff estimates.

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.

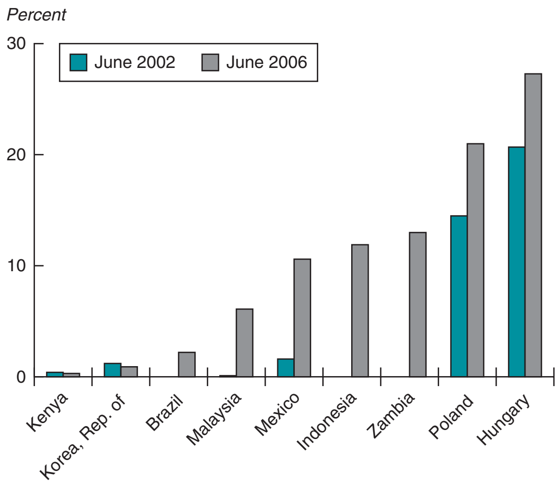
Returns on emerging-market sovereign bonds issued in local markets (measured by JPMorgan's GBI-EM composite index) averaged 13 percent in 2006 (in dollar terms), about 3 percentage points above the average return on emerging-market sovereign bonds issued in external markets (measured by JPMorgan's EMBI 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.

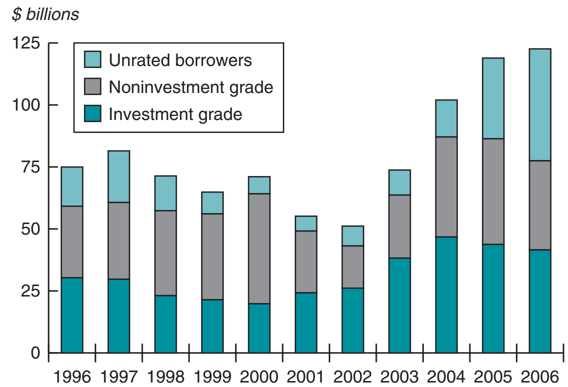
Foreign participation has risen substantially over the past few years in some countries. In Mexico, for example, foreign holdings of domestic debt increased from less than 2 percent in 2002 to more than 10 percent in 2006. In Brazil foreign

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



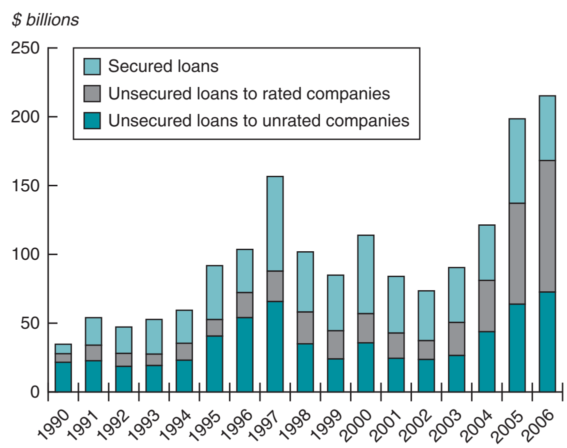
Source: World Bank staff estimates.

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.

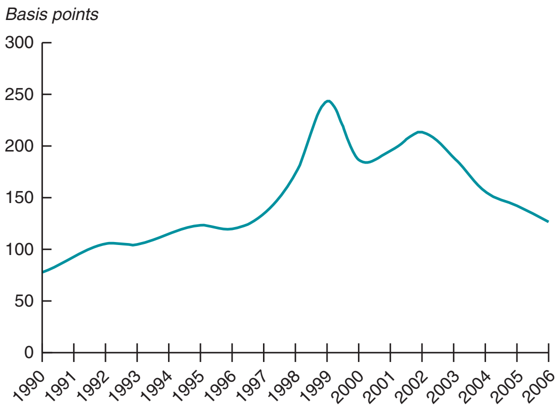
Despite their small share, foreign investors have played an important role in certain segments of domestic debt markets. Nonresidents held 84 percent of 20-year bonds during the early stage of their introduction in Mexico; more than 40 percent of 20-year bonds and at least 80 percent of inflation-indexed 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

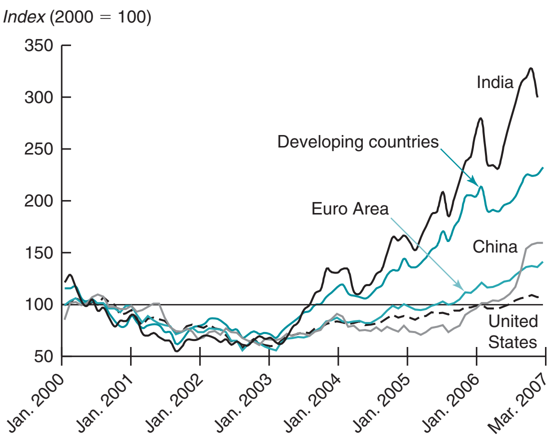
Sources: World Bank Debt Reporting System and staff estimates.
Note: e = estimate.

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)

	May–June, 2006[a]	Average rate of change[b] 2006	Average rate of change[b] 2004–06	Standard deviation[c] 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.

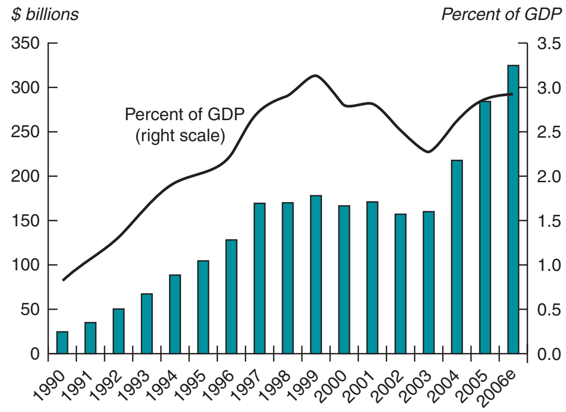
Meanwhile, the value of listings issued in London increased by a factor of 14 (from $0.7 billion to $9.6 billion) and the value of listings issued in Hong Kong (China) quadrupled (from $7.2 to $30.4 billion). The $20 billion raised by two Chinese banks through IPOs in Hong Kong represents a major breakthrough 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.

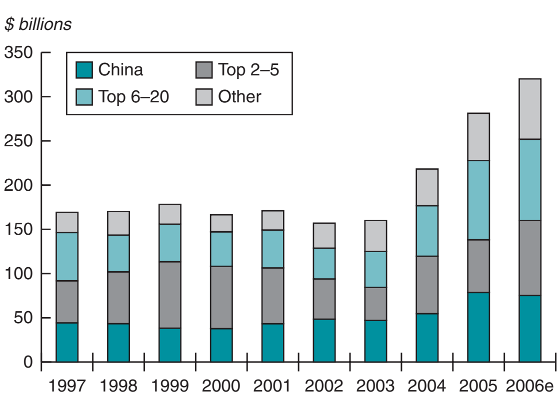
FDI continues to be concentrated in a few of the largest middle-income countries, although the degree of concentration has declined somewhat over the past few years. FDI to China declined slightly in 2006, but China still accounted for almost one-quarter of FDI inflows to developing countries, down from 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).

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.

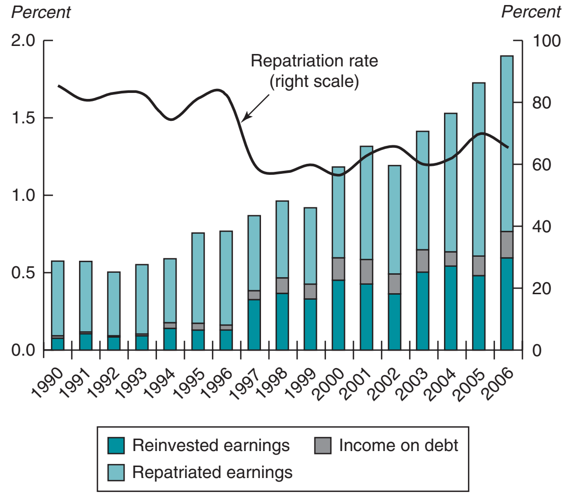
Not all of this income represents an outflow from developing countries' balance of payments.

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.

Figure 2.22 FDI income relative to GDP, 1990–2006



Sources: World Bank Debt Reporting System and staff estimates.

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

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.

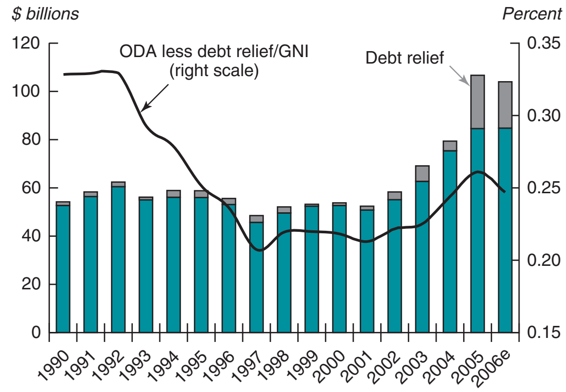
Little progress on official aid commitments

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	—

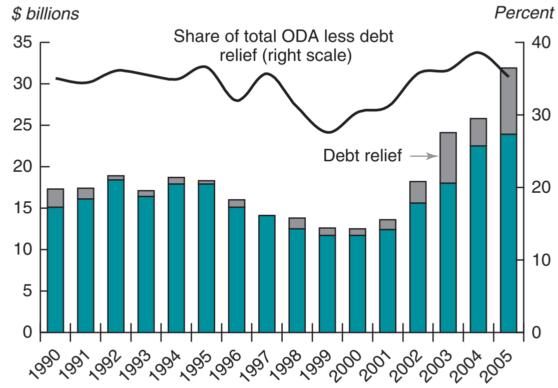
Source: OECD Development Assistance Committee.
Note: — = not available. e = estimate.

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 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.

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



Source: OECD Development Assistance Committee.

Donors are providing more assistance to countries affected by conflict

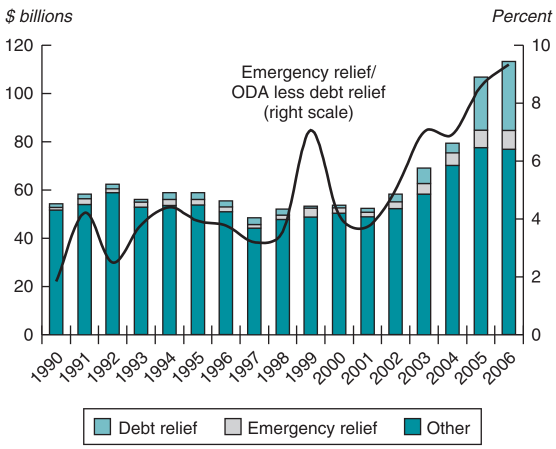
The allocation of aid to countries in or recovering from conflict has risen substantially over the past few years. The share of bilateral ODA disbursements to Iraq and Afghanistan increased from 8 percent in 2003 to 17.5 percent in 2005. Another 4.5 percent of bilateral ODA was allocated to Sudan and 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.

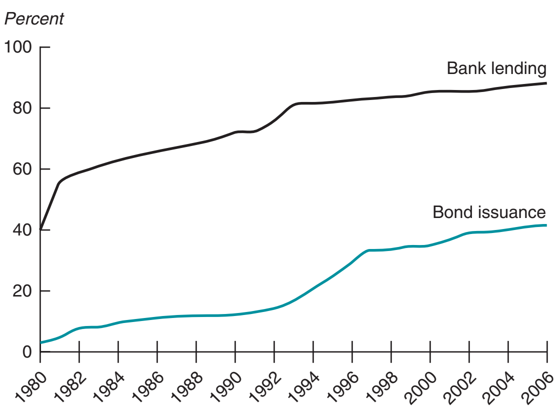
. . . but few have been able to gain access to the private bond market

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

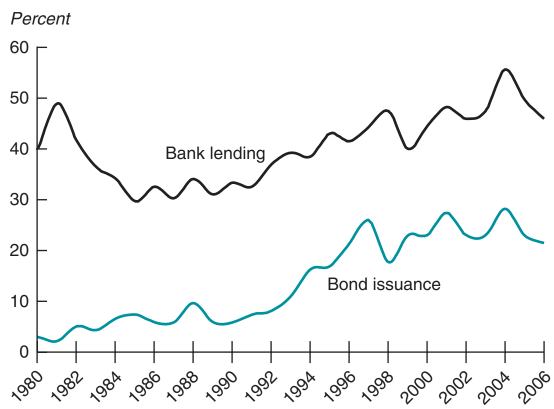
The number of countries that access either the external bond market or syndicated bank lending varies substantially from year to year, in response to the complex interaction of several supply and demand factors (figure 2.27). In 2006, 46 percent of developing countries contracted syndicated bank loans, 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.

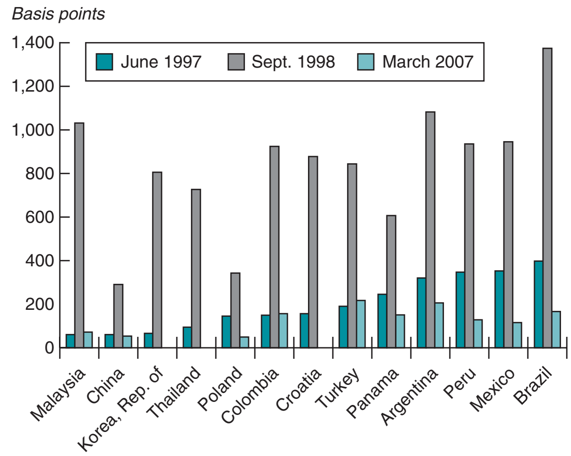
Despite some risks, foreign participation in domestic debt markets could benefit low-income countries in several ways. Broadening the investor base to allow greater participation by foreign investors has the potential to raise demand for bond issues considerably and to diversify issuance across a broader 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

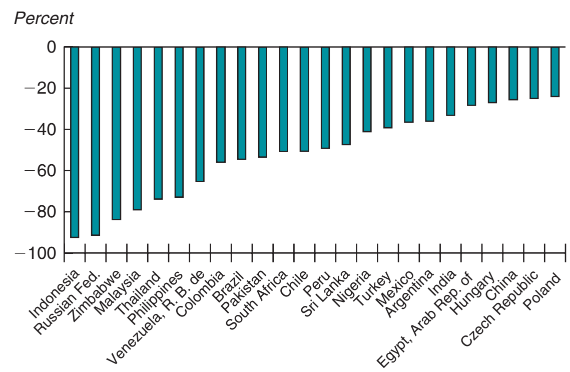
Bank and the IMF, together with developing countries under the Financial Sector Assessment Program (FSAP), are working to identify vulnerabilities in financial systems and recommend reforms needed to build stronger and more diversified financial sectors, which often entails developing domestic debt markets. 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]

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).

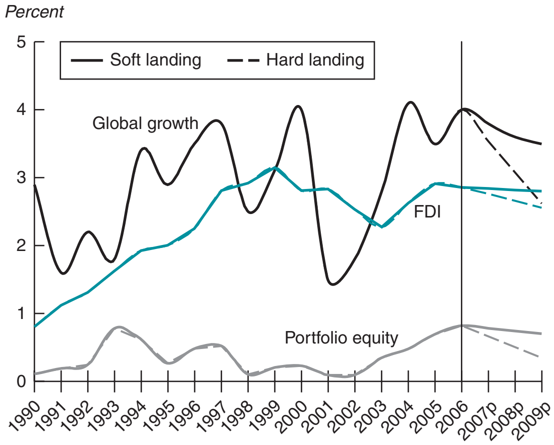
Prospects for capital flows

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.

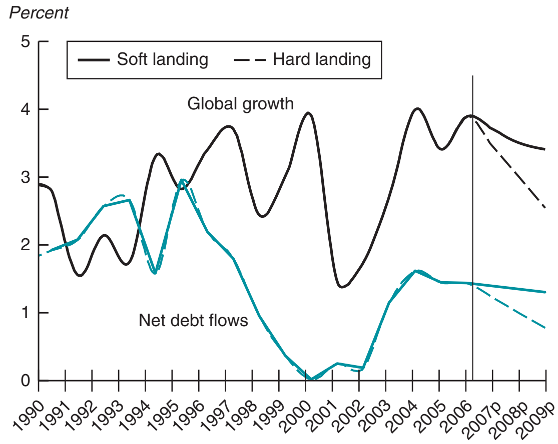
Under the "soft-landing" scenario, global growth declines from 4 percent in 2006 to 3.5 percent in 2009, consistent with the base-case projection reported in chapter 1 (see table 1.1). In the "hard-landing" scenario, global growth falls more abruptly, to 2.5 percent in 2009, as the result of a recession 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 2.30 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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