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Global Economic Prospects

FINANCIAL MARKET OUTLOOK

The World Bank

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Financial Market Outlook

Global financial markets were largely stable during the past year, notwithstanding the recent uptick in volatility amid uncertainty over the timing of an eventual tapering off of quantitative easing. Yields for high-spread European sovereign debt have declined to around 400 basis points, and despite recent losses, developed country stock markets have rebounded and U.S. stock market indices have recovered their pre-crisis levels — even as Euro Area and Japanese stock market indexes remain some 30 percent lower than in 2007.

Improved financial conditions are reflected in a strong rebound in gross capital flows (international bond issuance, cross-border syndicated bank loans and new equity placements) to developing countries, which were 63 percent higher in the first five months of 2013 than during the same period in 2012. Flows strengthened in every region except the Middle East and North Africa, with the sharpest increase in Europe and Central Asia. All types of flows posted an increase of around 60 percent increase, while record levels of international bond issuance recorded by developing countries as a group. Syndicated bank lending increased by almost 70 percent versus a year ago. Despite the relative weakness in April, bank lending has been on the rebound since the second quarter of 2012. While many factors were at play, a slowing of the deleveraging process by European banks has been the key.

Foreign direct investment (FDI) inflows to developing countries increased by 9 percent during the first quarter of 2013 on a year-on-year basis, with a mixed picture across countries. FDI flows for 2013 as a whole are expected to reach \$719 billion in 2013, an increase of 7 percent. The rebound will come after the 5 percent decline in 2012 following increased uncertainty in global financial markets. The impact of the uncertainty was comparatively profound for high-income economies, where FDI inflows declined by 30 percent. The relative resilience of FDI in developing countries mostly reflects stable levels of re-invested earnings.

Since late May, financial market volatility has increased, with increased expectations about possible tapering of U.S. quantitative easing in coming months and uncertainty over its impacts. Although there have been some large stock market corrections in some Asian countries, so far the overall impact has been moderate. Bond yields on developing country debt are also on the rise as base rates and spreads increase.

Net private capital flows to developing countries are set to rise through 2015. A 5.7 percent increase, to \$1.25 trillion, is expected in 2013. While flows will rise in nominal terms, they are projected to ease when expressed as a percent of developing country GDP. The mixed result reflects on one hand projected improvements in developing country growth prospects over the medium-term and improved risk profiles, both of which should boost flows, and on the other a transition toward monetary policy tightening in the United States. Though the likelihood of a major crisis emanating from high-income countries has receded, the eventual tapering off of quantitative easing in the United States is likely to cause global financial conditions to tighten. As a result, the quantity of capital flows to developing countries is likely to decline as a percentage of their GDP even as the cost of capital rises.

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Recent developments in financial markets

The “risk-off” phase in global financial markets continued until June

Global financial markets have been mostly calm since the beginning of the year following the substantial improvements during the second half of 2012 (World Bank 2013). Investor confidence, as proxied by risk premia and credit default swap (CDS) rates, has remained relatively strong despite negative developments in Euro Area (box FIN.1): continued economic weakness, political gridlock in Italy that has stalled reforms, and the financial crisis in Cyprus that culminated in the imposition of capital controls—a first in the Euro Area.

Developing-country CDS rates have in general remained at low levels (figure FIN.1), although Argentina and Egypt are exceptions to this trend (figure FIN.2). Egyptian spreads rose due to the rising deficit and debt tied to the economic consequences of political turmoil, while Argentinean rates increased due to the uncertainty generated by a U.S. court decision concerning the repayment to creditors that did not participate in the 2005 and 2010 restructuring of Argentina’s debt following its sovereign default in 2001.¹

Some level of volatility has returned in global financial markets since late May as expectations about possible tapering of U.S. quantitative easing in coming months have increased. As investors have started to reposition themselves, there has been a considerable amount of sell-off in global stock markets (see discussion below). Though international bond yields for developing countries had already started to widen earlier in the year, the uptick has been sharper since May. The increase in borrowing costs seems to have limited the bond flows so far in June after a record number issuances during the first five months of the year. Most markets have experienced a moderate correction thus far, but the impact may intensify in the coming months.

Despite the recent weakness, developed country stock markets have outperformed those of developing countries in 2013

The developed country stock market indexes rose significantly during the first five months of 2013 before losing some value in June. Nevertheless, the year-to-date gain for the developed country composite index was 10.9 percent as of mid-June (figure FIN.3).

Among developed countries, the benchmark S&P 500 index for the United States reached a record level in late May as improving economic data reports seemed to confirm that the U.S. economy

Fig FIN.1 CDS rates for most developing regions remained stable despite the events in March

Source: World Bank; Bloomberg.

Fig FIN.2 Argentina’s CDS rates surged in March from already very high levels

Source: Bloomberg.

Box FIN.1 Recent developments in the Euro Area

A range of significant steps taken in 2012 and 2013 has calmed investors and led to a significant rebound in key markets:

- European Central Bank (ECB) President Mario Draghi's forceful "whatever it takes" speech on July 26, 2012;
- Introduction of a new Outright Monetary Transactions (OMT) facility
- Widespread fiscal consolidation that has brought down Euro Area government deficits from 6.4 percent of GDP in 2009 to an estimated 2.9 percent in 2012 (IMF 2013), although the deficits of Ireland, Poland, and Spain still exceed 5 percent of GDP;
- Euro Area-wide agreements to establish a banking union, to reinforce monitoring and respect of budgetary rules, to require countries to enter into binding reform contracts, and proposals to increase democratic legitimacy through direct election of European Commission President in 2014;
- Early repayment of more than 25 percent of ECB crisis loans by Euro Area banks during the first quarter of 2013 (the loans were not due until 2014 and 2015).

Other developments in 2013 have tested the resilience of this improved climate, however:

- Inconclusive elections in Italy and weak polls for other leaders, underscoring ongoing political risks;
- Uncertainty about governments' willingness to accept conditionality if the OMT were activated;
- Fears that the bailing in of bank depositors during the Cyprus rescue would lead to deposit flight in other European jurisdictions.

While these developments led to some widening of CDS rates and yields on high-spread Euro Area countries' debt, the increases were modest compared with earlier declines, and yields for high-spread countries except Portugal have remained around their December 2012 levels (box figure FIN.1).

Box Figure FIN.1.1

Source: World Bank; Bloomberg

was gaining momentum (figure FIN.4). Similarly, the Japan's Nikkei gained almost 50 percent between January and May, reflecting the expectations related to the monetary easing program announced by the Bank of Japan. The Nikkei has experienced a sharp decline of 15 percent since then, however, reducing the year-to-date gain to 25 percent. Equity market returns in Europe have been positive as well, though less robust due to the region's weak economic outlook. After a downward adjustment since May, the year-to-date gain of the Stoxx Europe 600 was only 4.8 percent. Overall, equity markets in Europe

Fig FIN.3 Developed country equities are outperforming developing country

Source: Bloomberg.

and Japan have recovered around 70 percent of their 2007 value, versus a more than full recovery in the United States.

In contrast with the strong performance in high-income markets earlier in the year, developing country stock market performance has been weak since the beginning of 2013, with the MSCI Emerging Markets index losing 6.4 percent of its value (figure FIN.3). Stock market indexes declined in Brazil (-19.1 percent), Russia (-11.9 percent), and China (-4.7 percent), whereas they remained more or less stable in India (-1.3 percent). The weakness in developing country stock markets reflects declining commodity prices and weak corporate earnings, together with a collection of country-specific factors. Recent curbs on property markets in China, for example, have contributed to the weakness in share values, while easing in commodity prices have affected stock market performance in Brazil and Russia.

After reaching record highs in early 2013, helped by strong foreign private capital inflows, equity markets in several East Asian countries—Indonesia, the Philippines, and Thailand—have experienced sharp sell-offs since late May. Despite the recent decline, stock market indexes in these countries were 10.3 percent, 7.4 percent, and 5.3 percent higher, respectively, on June 14 compared with the end of 2012.

The decoupling in the equity market performance of developed and developing countries likely reflects a decline in the investors' perceptions of

the riskiness of high-income countries' financial assets and growing concerns about asset prices bubbles and growth prospects in some middle-income countries. Such sentiment is likely to encourage investors to shift their portfolios away from developing to developed markets, and may help explain why yields on developing country debt are rising (see discussion below).

Developing country bond yields have risen since January

The cost of international bond financing — proxied by 10-year U.S. Treasury bond yield + EMBIG cash bond spread—has gone up to 5.42 percent as of mid-June after reaching a record low level of 4.36 percent in early January (figure FIN.5). Most of the increase in average borrowing cost has occurred since May, with the 106 basis points (bps) increase the result of a 85 bps widening in EMBIG cash bond spreads and a 22 bps rise in 10-year U.S. Treasury bond yields.

Unlike previous episodes of rising yields, the rise between February and May did not occur during a period of heightened global risk aversion. Moreover, the widening in secondary-market bond spreads was not associated with a decline in benchmark U.S. yields. U.S. Treasury yields tend to fall during the periods of heightened risk-aversion in global financial markets, as they are

Fig FIN.4 Performance in selected stock markets

Fig FIN.5 Cost of bond financing increased in February and March

considered safe assets. Over the past few years, developing country bond yields have tended to remain relatively constant, even as benchmark yields (U.S. 10-year Treasury yield) fluctuated—implying that spreads have risen as benchmark yields fell. During the first half of 2013, developing-country spreads have increased as benchmark U.S. 10-year Treasury yields have risen (figure FIN.6), despite the continued trend toward upgrading of developing country debt by rating agencies.²

These developments could be consistent with the beginning of a new trend where the price of risk returns to levels that are more normal. The trend decline in spreads for developing countries over the last five years has been partly explained by their improved credit quality. The decline also reflects very low policy rates and quantitative easing in major high-income countries (World Bank 2010; IMF 2013), with easy monetary conditions having suppressed the price of risk in both developed and developing countries.

The most recent surge in both developing country spreads and high-income yields reflects a forward-looking response of financial markets to talk of an eventual tapering off of U.S. quantitative easing. While these increases are expected to ease in the short term as the timing of the Fed becomes clearer, over the long term both base rates and developing country yields are likely to rise.

Fig FIN.6 Bonds spreads widened despite “the risk-off” phase

Fig FIN.7 Gross flows have remained robust since September 2012

Despite weak performance of their stock markets in recent months, developing countries' gross capital inflows have remained robust

Gross capital flows (international bond issuance, cross-border syndicated bank loans and equity placements) to developing countries rose by 63 percent year-on-year during the first five months of 2013, reaching a historic high of \$306 billion (figure FIN.7). All types of flows posted an increase of around 60 percent, with record levels of international bond issuance. Flows to every region

Fig FIN.8 Syndicated bank lending has risen since July 2012 due to less deleveraging

Box FIN.2 Regional gross capital flows

Gross capital flows to developing countries have rebounded in all regions, except the Middle East and North Africa. A surge in bank lending to firms in the Russia Federation helped to boost flows to the European and Central Asia region to about \$105 billion during the first five months of 2013, more than twice their \$46 billion level of last year. Bank lending to Russia increased more than threefold from last year as syndicated loans from European lenders more than doubled.

All types of capital inflows to the East Asia and Pacific region increased, totaling \$92 billion during the first five months of 2013, compared with \$55 billion the same period in 2012. Syndicated bank lending in the region almost doubled, reaching \$27 billion compared with \$14 billion in 2012. Flows to South Asia strengthened mainly due to strong bond issuance by India. Meanwhile, Sub-Saharan Africa saw a marked strengthening in bank lending (led by South Africa and Nigeria) and an increase in bond flows, which together much more than offset a small decline in equity flows. Notably, Rwanda came to the international bond market for the first time with a \$400 million 10-year Eurobond in April 2013, capitalizing on investors' growing appetite for developing-country debt.

In contrast, gross capital flows to Latin America and the Caribbean increased by 23 percent, to \$79 billion, in the first five months of 2013 versus a year prior. Equity placement rose by 154 percent due to a strong issuance activity by Brazilian firms, including the largest developing-country corporate bond issuance on record (\$11 billion) by the oil company Petrobras. In contrast, bank lending to the region fell by 34 percent.

Capital flows to the Middle East and North Africa have been weak so far in 2013, with only one syndicated loan deal for Jordan (\$288 million) and two bond issues for Lebanon and Morocco (\$1.1 billion and \$750 million, respectively). Only Tunisia was able to raise capital through equity issuance, through four transactions valued totaling \$119 million.

Box Figure FIN 2.1 Regional gross capital flows (\$ billions)

Source: World Bank; Dealogic.

except the Middle East and North Africa strengthened (box FIN.2). The sharpest increase experienced by Europe and Central Asia, where the flows more than doubled.

Syndicated bank lending to developing countries totaled \$91 billion during the first five months of 2013, 69 percent higher compared with a year ago. Despite the relative weakness in April, bank lending has been on a rebound since the second quarter of 2012 (figure FIN.8). While many factors were at play, an easing of deleveraging by

European banks has been key. As of early June 2012, three quarters of European banks had complied with the ECB's capital ratio requirements. Moreover, according to the April ECB Bank Lending Survey, Euro Area banks have eased the pace at which they are tightening credit standards.³ Euro Area banks have also begun repaying ECB crisis loans; some have repaid loans well in advance (box FIN.1).

More than 50 percent of the bank lending to developing countries during the first five months

Fig FIN.9 The average spread and term of bank loans have remained relatively stable in recent months

*as of May
Source: World Bank; Dealogic.

of 2013 went to resource-related companies, mostly for refinancing (26 percent), acquisition (22 percent), and trade finance purposes (17 percent). The average maturity of the bank loans declined slightly to 5.3 years, with the share of long-term syndicated bank lending (minimum maturity of five years) falling to 35 percent from 55 percent in 2012 (figure FIN.9).

The average cost of bank financing increased by 8 bps to 3.4 percent as average bank spreads rose by 16 bps (figure FIN.9), while the benchmark 6-month U.S. dollar LIBOR has eased in 2013. All of the increase in average spreads was on loans for acquisition purposes, while spreads on loans for other purposes fell (figure FIN.10).

Fig FIN.10 Spreads on loans for acquisition purposes rose

*as of May 2013. Simple averages of each loans.
Source: World Bank; Dealogic.

The increase in equity flows to developing countries—initial public offering (IPO) and follow-on issuance—was due to the strong follow-on issuance in East Asia, Europe and Central Asia, and Latin America and the recovery of the overall IPO activity from last year's low level. While China still dominates overall equity volume, equity issuance also increased in other countries, including Brazil, Chile, Indonesia, Malaysia, Mexico, the Philippines, Russia, and Thailand.

International bond flows to developing countries have been particularly robust thus far in 2013, reaching a historical high of \$158 billion for the first five months of the year, including the record monthly issuance of \$45 billion in April. Developing countries issued more than \$20 billion per month between September 2012 and May 2013, with the exceptions of December and February, the latter of which was when the Chinese Lunar New Year fell this year (figure FIN.11).

Investor appetite for developing-country debt has been driven up by the low yield environment created by quantitative easing in high-income countries. This created an opportunity for several non-investment-grade (non-IG) companies to tap into international bond markets. In fact, the share of non-investment grade corporate issuance has risen to 31 percent of the value of bonds issued by developing countries (compared with 18 percent in 2012) and 46 percent of the number of bonds (versus 34 percent in 2012). In addition, there was a long line of first-time international sovereign bond issuers, including Honduras (\$500 million) and Rwanda (\$400 million).

Fig FIN.11 Corporates dominated bond flows

Source: World Bank; Dealogic.

The heavy issuance trend may now be coming to an end, however. During the first two weeks of June there were only five sovereign issuances from Chile, Russia, Turkey, and Brazil, raising just \$1 billion in the first two weeks of June (versus an average of approximately \$30 billion of debt issuance per month by developing countries since September 2012). While the increase in borrowing costs since May has likely held back bond issuance in recent weeks, there may be other contributing factors, in particular the prospect of a change in monetary policy stance in the United States.

Foreign direct investment inflows to developing countries were robust in the second half of 2012 following a weak first half of the year

After slowing during the first half of 2012, the pace of foreign direct investment (FDI) inflows to developing countries picked up considerably in the final quarter of the year. Nevertheless, inflows declined by 5 percent for the year as a whole, to \$670 billion, from \$701 billion in 2011 (figure FIN.12).⁴ The weakness in the flows earlier in the year was mostly the result of increased uncertainty in global financial markets due to Euro Area problems.

The impact of the market uncertainty on FDI flows was more profound for high-income economies, where FDI inflows declined by 32

percent (figure FIN.13). Most developed countries experienced declines compared to 2011. Belgium, Finland, and the Netherlands experienced net disinvestments in 2012, while FDI inflows to Denmark and Germany declined by almost 90 percent. The relative resilience of FDI in developing countries mostly reflects stable re-invested earnings and intra-company loans. The share of global FDI flows going to developing countries reached a historical high of 45 percent in 2012.

Among developing regions, the largest contraction in FDI flows for 2012 as a whole was in South Asia, which experienced a 20 percent decline due to slow growth and regulatory uncertainties in India and Pakistan. Most Eastern European economies also experienced a drop in FDI inflows, reflecting economic weakness in high-income Europe. Latvia, Lithuania, and Serbia faced the largest declines. Flows to East Asia, as well, dropped, with China, Malaysia, and Thailand all experiencing contractions. Despite the 8 percent reduction in inflows to China, largely resulting from ongoing structural changes in the country's economy, the country was the top FDI recipient in the world in 2012.

In contrast, FDI inflows to Latin American economies rose by 10 percent in 2012, supported by still high (though weakening) commodity prices and increased investment from the United States. Argentina, Chile, and Colombia, in particular, experienced significant increases.

Fig FIN.12 FDI inflows to developing countries

*Value for 2013Q1 is an estimate.

Source: World Bank; Central banks of selected countries.

Fig FIN.13 Almost half of the global FDI inflows in 2012 went to developing countries

Source: World Bank; Central banks of selected countries.

For 2013, high-frequency data indicate a 9 percent rise in FDI flows to developing regions during the first quarter on a year-over-year basis, with a mixed picture across countries. Flows eased in most Asian economies, including Malaysia and Thailand, while flows to Chile, India, and Russia were robust. Particularly strong FDI flows to Russia during the first quarter of the year reflect the closing of a special acquisition deal.⁵

FDI flows to developing countries as a whole will likely rebound in the second half of the year. Several countries in emerging Europe, including Russia and Serbia, have announced plans to accelerate privatization efforts this year. FDI flows to developing countries are expected to increase by 7 percent reaching \$719 billion in 2013.

Hot money flows: a new heat wave from the East?

The loose monetary policy environment in high-income countries since the 2008/09 global financial crisis has prompted a trend among investors to borrow cheaply and invest in high-yielding foreign markets. Investors have been attracted to developing country local currency assets (equity and bonds) because of their stronger growth potential, and interest rate differentials. This has led to significant levels of the flows (hot money flows) to equity and local currency debt securities. Flows to a few large middle-income countries were particularly strong in 2010. Managing the volatility in these flows can be quite challenging, and as a

result some countries have introduced special measures, including capital controls.

Recent data on portfolio investment flows for major middle-income countries presents a mixed picture (figure FIN.14). Despite the current relatively low risk environment and high levels of market liquidity, flows to local stock and bond markets have moderated for Turkey but have picked up in Brazil, while flows to Mexico surged in the last quarter of 2012 and were at record high levels for the year.

As an alternative measure, high-frequency data on flows to emerging market mutual funds indicate a decline in recent months (figure FIN.15). The drop has been particularly sharp for emerging market equity funds, which showed net outflows in March and May. The fall partly reflects weak corporate earnings and country specific factors (discussed earlier). In addition, downside risks for returns on emerging market mutual funds assets have risen, in particular due to the possibility that U.S. Treasuries will rise earlier and higher than expected.

Looking forward, Japan's recently-begun quantitative easing program may contribute to an increase inflows to developing countries (box FIN.3). The Bank of Japan's commitment to purchase \$75 billion of government bonds a month (just short of the Fed's monthly purchase of \$85 billion) is likely to weaken returns in Japanese markets, making developing-country assets relatively more attractive. While Japanese investors tend to have a stronger home bias than U.S. investors, Japan's domestic market is smaller than

Fig FIN.14 A mixed picture for hot money flows

Source: World Bank; Central banks of selected countries.

Fig FIN.15 The flows to emerging market mutual funds declined sharply after January

Source: World Bank; Haver.

Box FIN.3 Japan's monetary easing and developing countries

In November 2012, the Bank of Japan (BoJ) signaled that it would undertake monetary easing measures to combat deflation. Specific quantitative and qualitative easing measures, subsequently announced in April 2013, include the monthly purchase of ¥7.5 trillion (\$75 billion) of Japanese government bonds. The aim is to double the monetary base in two years. The BoJ will also increase the average maturity of bonds that it purchases from three to seven years, and will continue these measures “as long as necessary.”

At \$75 billion in monthly purchases, the BoJ's quantitative easing (QE) program is similar in size to the QE3 program in the United States, under which the Federal Reserve is currently purchasing \$85 billion of U.S. government bonds each month. Both programs seek to depress the return on low-risk assets in order to push investors into riskier assets.

While the immediate beneficiary of quantitative easing is domestic assets, spillover into international capital markets is inevitable. In the case of Japan's program, the level of the outflows may be larger, in part because at \$8.8 trillion for bonds and \$3.3 trillion for equities, the Japanese market is only 22 and 8 percent, respectively, the size of U.S. markets. Though the bulk of these flows are likely to go to other high-income countries—only 2.4 percent of Japanese external holdings are in developing countries—Japanese investors have recently shown greater interest in local currency bond and equity markets in several developing countries (box table FIN 3.1) via Uridashi funds (typically foreign currency bonds) and larger Toshin investment trust funds (predominantly equity). According to the Investment Trusts Association of Japan, Japanese portfolio investment in local debt securities increased in Mexico (by 34 percent), Turkey (28 percent), and Thailand (17 percent) during the first two months of 2013. A less pronounced increase was seen in the Philippines (5.9 percent) and South Africa (4.4 percent).

Although the depreciation of yen will make Japanese investors' holding of foreign assets relatively more expensive, it is possible that Japan's QE program may bring about an increase Japanese multinationals' direct investment in developing countries by lowering their cost of capital. Among East Asian developing countries, rising outward FDI flows from Japan in recent years have been particularly important for Thailand, accounting for 40 percent of the latter country's FDI inflows in 2012, up from 28 percent in 2009.

Box Table FIN 3.1 Japanese outward investment position by destination, 2011 (\$ billions)

	FDI	Portfolio Investment		
		Total	PI: Equity	PI: Debt
Total	935.4	3,279	647	2,632
Developed Countries	742.5	3,203.5	618.6	2,584.9
Developing Countries	192.8	75.6	28.3	47.3
P.R.China	73.5	10.3	9.8	0.5
Thailand	31.0	2.3	1.5	0.9
Indonesia	13.9	5.8	3.3	2.6
Malaysia	9.9	4.3	1.6	2.7
Philippines	9.0	2.7	0.3	2.5
Viet Nam	5.6	0.1	0.1	0.0
India	13.6	5.0	3.4	1.6
Mexico	2.6	11.6	0.5	11.1
Brazil	30.0	28.1	5.6	22.4
Russia	1.5	2.0	1.2	0.8
R.South Africa	2.2	3.2	0.9	2.3
ASEAN	107.6	27.2	13.3	13.9

Source: Bank of Japan.

the U.S. market and thus the impact on domestic asset prices is likely to be larger and the incentive to invest abroad stronger. Japanese investors have already shown increased interest in developing countries' local currency debt markets. In addition, portfolio investment by Japanese investor interest in developing countries tends to be geographically diverse, with a significant presence in Brazil, Mexico, and Turkey.

Should the momentum in capital flows to developing countries increase in the coming months, some countries may face challenges in managing the impact of these flows on their economies.

Prospects

Following a strong start to 2013 (figure FIN.16 and table FIN.1), net capital flows to the developing world are expected to increase to \$1.3 trillion, up from \$1.2 trillion in 2012, with another record level of bond flows, rebounding bank lending, and robust FDI inflows. As a share of developing countries' aggregate GDP, however, inflows appear set to ease slightly, from 4.9 percent to 4.7 percent.

While the prospects for capital flows to developing countries remain positive in the medium term, some of the factors that have been in play over the last few years are expected to weaken. For example, while developing economies will continue to grow

relatively faster than developed economies and their credit quality has improved, the growth differential is expected to narrow as growth in high-income countries picks up. Perceptions of the riskiness of high-income country investments have also declined, which should lead to a portfolio shift in their favor over the medium term.

In addition, the uniformly accommodative stance of monetary policy in high-income countries may begin to diverge as the United States looks toward scaling back on quantitative easing and Japan expands it. A gradual transition toward U.S. monetary policy tightening is likely to increase the cost of capital for developing countries; expectations of such a move may lead to an easing of flows even earlier. The shift in U.S. policy stance may be partially offset by quantitative easing in Japan, however, if investors there substantially increase their demand for developing country assets. The overall effect is likely to be tighter external financial conditions with considerable implications for developing countries.

Tighter external financial conditions can be expected to impact bond flows to developing countries—both international issuance within the countries and foreign investment into local currency bond markets. After reaching record highs in 2012 and 2013, bond flows are expected to fall gradually in 2014 and 2015.

Bank lending, on the other hand, is expected to rise, particularly now that intense deleveraging pressures have eased—although the extent of the bounce-back may be limited by an increasingly strict regulatory environment.

FDI inflows to developing countries are projected to increase through the forecast period, reaching \$758 billion (2.4 percent of GDP) by 2015. Despite considerable real-side uncertainties in the short term, multinational corporations continue to be attracted to developing countries' medium-term growth prospects, large and growing consumer base, natural resources, and still low labor costs. In addition, many developing countries are removing barriers to foreign investment. For example, following its recent World Trade Organization accession, Russia has committed to reducing restrictions on foreign investors in a number of service industries. Other countries in Eastern Europe have been pursuing services sector privatization. Similarly, India may attract an influx

Fig FIN.16 Net private capital flows are set to rise in nominal terms

Source: World Bank.

of investment in the coming years now that the cap on foreign ownership in multi-brand retail and aviation businesses has been raised. As long as Japanese monetary easing reduces the cost of capital for its multinationals, it should also support FDI flows to Asian economies, particularly Thailand and Vietnam in the short term.

While China continues to be the predominant destination of FDI flows among developing countries, FDI inflows to the country are expected to ease over the medium term. The Chinese economy is in the midst of significant structural adjustments, among these rising wages and production costs, which will continue to limit the efficiency-seeking FDI. The decline will be partly

offset, though, by the market-seeking FDI flows by multinationals interested in serving China's growing middle-income population.

Despite the expectation that private capital flows to developing countries will increase, the outlook is subject to significant downside risks. First, despite the recent progress towards a resolution of the Euro Area debt crisis, considerable uncertainties remain and, as highlighted by the Cyprus bailout, event risk persists. Any major setback could lead to a renewed crisis of confidence. Similarly, lack of progress in dealing with fiscal challenges in the United States has a similar potential to diminish confidence.

Table FIN1. Net capital flows to developing countries (\$ billions)

	2008	2009	2010	2011	2012e	2013f	2014f	2015f
Current account balance	409.4	233.0	173.3	129.6	-16.7	-74.9	-108.2	-126.3
Capital Inflows	812.7	701.0	1,218.8	1,175.0	1,192.4	1,260.9	1,297.4	1,394.8
<i>Private inflows, net</i>	782.3	620.0	1,145.6	1,145.1	1,178.3	1,250.2	1,290.7	1,391.7
Equity Inflows, net	583.4	541.3	710.5	710.4	758.1	791.1	803.5	863.5
Net FDI inflows	637.0	427.1	582.3	701.5	670.0	719.3	715.7	758.2
Net portfolio equity inflows	-53.6	114.2	128.2	8.9	88.1	71.8	87.8	105.3
Private creditors, Net	198.8	78.7	435.1	434.6	420.2	459.1	487.2	528.2
Bonds	-8.6	61.0	129.7	123.8	190.3	187.3	164.4	151.9
Banks	223.3	-11.9	37.2	108.2	82.0	104.7	125.3	146.9
Short-term debt flows	-17.1	17.8	257.6	189.3	141.0	158.5	188.2	221.1
Other private	1.3	11.7	10.7	13.3	7.1	9.2	10.4	9.8
Official inflows, net	30.4	81.0	73.2	30.0	14.1	10.7	6.7	3.1
World Bank	7.2	18.3	22.4	6.6	4.6			
IMF	10.8	26.8	13.8	0.5	-3.9			
Other official	12.4	35.9	36.9	22.8	13.4			
Capital outflows	-321.2	-175.2	-314.1	-284.7	-365.4	-371.3	-416.3	-464.4
FDI outflows	-211.8	-144.3	-213.9	-198.0	-238.0	-275.0	-325.0	-370.0
Portfolio equity outflows	-32.1	-75.9	-50.6	4.3	-12.4	-17.3	-24.3	-29.4
Private debt outflows	-78.3	50.7	-57.3	-81.0	-103.0	-72.0	-61.0	-56.0
Other outflows	1.0	-5.7	7.7	-10.0	-12.0	-7.0	-6.0	-9.0
Net capital flows (inflows + outflows)	491.5	525.8	904.7	890.4	827.1	889.6	881.1	930.4
Net unidentified Flows/a	-82.1	-292.8	-731.3	-760.8	-843.8	-964.5	-989.3	-1,056.7

Source: The World Bank

Note: e = estimate, f = forecast

/a Combination of errors and omissions. unidentified capital inflows to and outflows from developing countries

Another factor that might generate volatility in global financial markets is the process of unwinding of monetary easing in the United States. As discussed earlier, expectations related to a possible easing in the pace of quantitative easing recently led to an increase in U.S. 10-year Treasury yields, accompanied by a widening of spreads. A rapid shift in expectations related to monetary policy in the coming months could generate sharp adjustments in financial markets and capital flows to developing countries.

In such a scenario, vulnerabilities that have built up during periods of sustained low borrowing costs may be exposed. In this respect, 18 developing countries have private external debt exposures in excess of 30 percent of GDP (figure FIN.17). Three-quarters of these are in developing Europe and Central Asia, reflecting strong banking and inter-company linkages with high-income Europe. In the case of Seychelles and Papua New Guinea, the gross private sector debt reflects a thriving offshore-banking system. Though the presence of offshore banking changes the nature of the associated risk, it does not eliminate it, as the recent experiences of Cyprus, Iceland, and Ireland illustrate.

Fig FIN.17 Net private capital flows are set to rise in nominal terms

Note 1: External private debt include private nonguaranteed external debt with short- and long-term maturity.

Note 2: Orange bars indicate low income countries.

Source: World Bank.

Notes

1. Argentina defaulted a record \$95 billion in sovereign debt in 2001. Although the country managed to restructure 92 percent of the debt in 2005 and 2010, Argentina remained in a drawn-out legal battle with bondholders who did not enter into the debt swaps. In the fall of 2012, a U.S. court ruled that Argentina was obliged to repay the unstructured debt, prompting fears that the country may default once again. As of mid-2013 the issue remains unresolved. A recent IMF (2013b) report indicates that ongoing litigation against Argentina could have significant implications for future sovereign debt restructurings by increasing the leverage of holdout creditors.
2. Since January 2013, the sovereign ratings of 11 developing countries have been upgraded, while only five have been downgraded.
3. According to the April ECB report, net tightening of credit standards declined for loans to businesses in the Euro area. Net tightening for firms is now below its historical average. Credit standards also declined for households, although they remain higher than the historical average.
4. Historical FDI data has been revised given that several countries have started reporting according to the Balance of Payments and International Investment Position Manual (BPM6).
5. FDI flows to Russia surged in the first quarter of 2013 as the deal between Rosneft and BP around the TNK-BP sale eventually resulted in the acquisition of 18.5 percent of Rosneft, worth almost \$15 billion, was closed. Adjusted for this one-off event, FDI inflows to Russia remained fairly stable during the first quarter of 2013.

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