

IFC STRATEGIC DIRECTIONS: IMPLEMENTATION UPDATE AND FY06-FY08 OUTLOOK

SECTION I. THE EXTERNAL CONTEXT

1.1 **Strong Economic Growth for Developing Countries.** Developing countries enjoyed strong growth in 2004 with GDP increasing in aggregate by 6.5 percent (*See Table 1.1*). Macroeconomic conditions in many emerging economies were relatively stable, with reduced levels of external debt, fiscal policy management, and some structural reforms aimed at improving the investment climate. Trade volumes, chiefly driven by China, increased, oil-producing countries benefited from very strong oil revenues and EU accession countries experienced rapid growth as they began their integration process. With higher levels of economic growth, the number of IFC's frontier countries shrank to 94 in 2004 with an aggregate GDP of \$1,545 billion, equivalent to the GDP of China.¹ Global growth is expected to moderate in 2005, as illustrated in the table below.

Table 1.1. Real GDP Growth

(%)	2001	2002	2003	2004 (e)	2005 (f)
World	1.4	1.7	2.5	3.9	3.2
High Income Countries	1.1	1.3	1.8	3.2	2.6
Developing Countries	3.0	3.6	5.3	6.5	5.6
East Asia & Pacific	5.6	6.9	8.0	8.2	7.5
Europe & Central Asia	2.4	4.6	5.9	6.6	5.2
Latin America & Caribbean	0.3	-0.6	2.0	5.5	4.2
Middle East & North Africa	4.0	4.5	5.2	5.1	5.0
South-Asia	4.7	4.6	7.5	6.6	6.1
Sub-Saharan Africa	3.1	3.1	3.4	3.6	3.8

Source: Global Economic Prospects, Global Development Finance 2005 Executive Board Draft.

1.2 **Private Capital Flows Continue to Recover, Concentration in Larger Economies.** Net private capital flows to developing countries showed further recovery during 2004 after rising in 2003 (*See Chart 1.1 on page 2*). The total private flow was \$248 billion in 2004, almost reaching the peak level of \$276 billion attained in 1997. The continued recovery in the total capital flows was largely driven by net debt flows and a modest increase in foreign direct investment (FDI) inflows, while portfolio equity flows stabilized. Most of the capital flows went to relatively few large economies. About 90 percent of the increase in FDI inflows were to Brazil, Russia, India, China and Mexico. About 85 percent of the net medium to long-term debt flow to developing countries in 2004 went to financing sovereigns and public sector entities.

1.3 Gross private bank syndications to the private sector were very selective in terms of countries and projects. Increased flows in 2004 went primarily to non-frontier countries (*See Chart 1.2A on page 2*), mirroring the concentration of FDI flows noted above. About 60 percent of the international bank loans of longer maturities (over 5 years) were provided with IFI support. Of the remaining 40 percent without

¹From a base of 103 countries defined as low income countries and/or high risk (Institutional Investor Biannual Rating is less than 30) in 1999 when IFC established its frontier strategy. GDP is measured by current US dollars. The 13 countries that exited the frontier category during the period include: Algeria, Belize, China, Grenada, Guatemala, Iran, Jamaica, Kazakhstan, Libya, Romania, Russia, Ukraine, and Vanuatu. The four countries that entered the frontier category include: Argentina, Lebanon, Papua New Guinea, and Paraguay.

IFI support, two-thirds were for financing projects with majority foreign ownership or a few very large domestic groups. In addition, for international bank syndication with very long maturities (over 7 years) there has been very little growth in volume over the past five years (See Chart 1.2B).

Chart 1.1. Net Private Capital Flows to Developing Countries

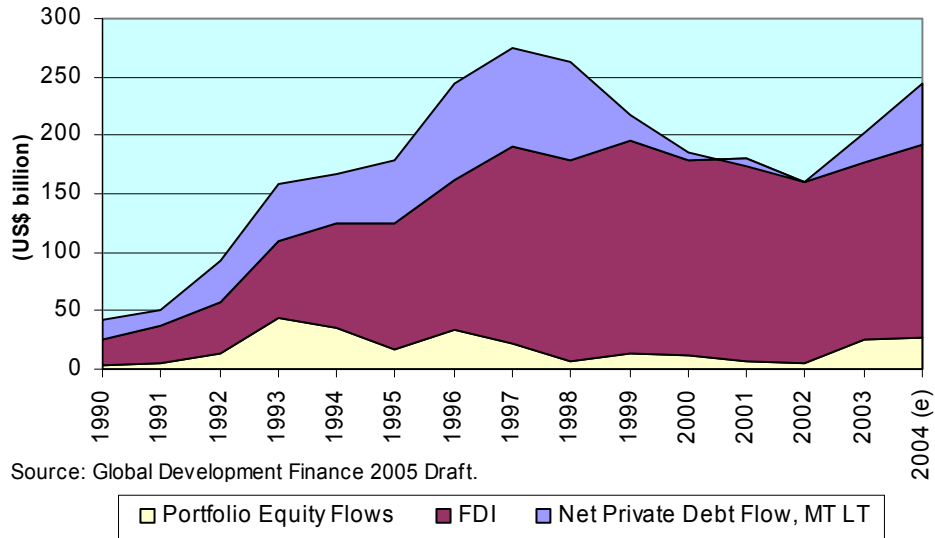


Chart 1.2A

Gross Private Bank Syndications to the private sector in Developing Countries, by Frontier/Non-Frontier >1 year

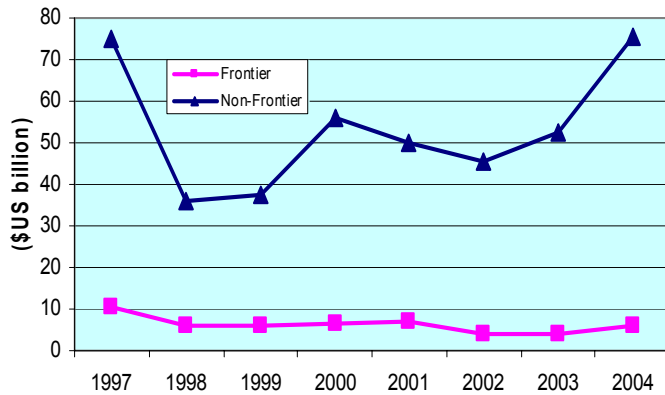
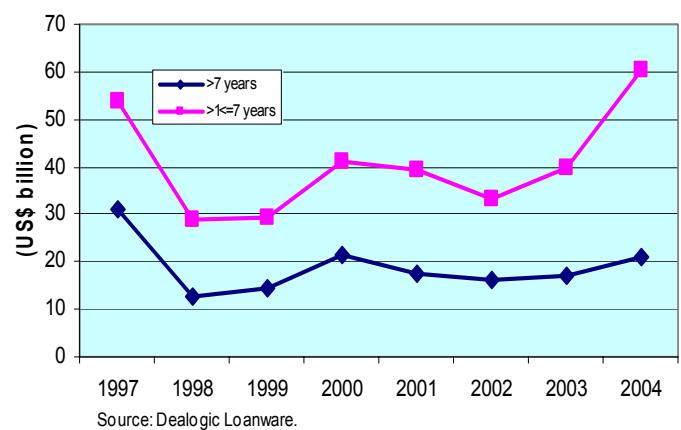
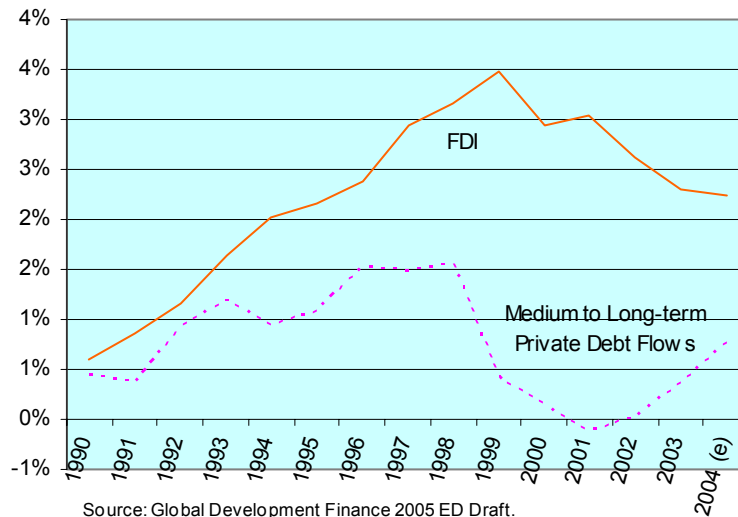


Chart 1.2B

Gross Private Bank Syndications to the private sector in Developing Countries, by Maturity



1.4 Slower Growth of Flows as a Percentage of GDP. While total private capital flows have increased over the past two years, net flows have not kept pace with economic activity in emerging markets. Chart 1.3 on page 3 shows FDI and medium to long term debt as a percentage of GDP. In relation to the size of the economies in developing countries, 2004 capital flows are still significantly lower than levels of the mid-90s.

Chart 1.3 Net Private Capital Flows to Developing Countries as Percent of GDP

1.5 Strengthened Domestic Financial Markets and Lower Spreads. Inter-bank credits from major international banks and domestic deposit growth helped domestic banks expand their lending in 2004. Improvements were also seen in capital positions, asset quality, and earnings². Domestic banks are now offering medium and long-term resources to private sector clients in a select number of countries, such as Russia, Romania, China, Indonesia, South Africa, Pakistan and India. Credit quality among developing countries' sovereigns also showed improvement during 2004. S&P, Moody's and Fitch combined upgraded 32 countries during the year³ compared to 24 countries in 2002. This helped lower sovereign spreads to 343 basis points by the end of 2004⁴, about a 400 basis point drop from two years ago.

1.6 Growth of South-South Opportunities. An important new trend that has come with the expansion of emerging market economies is the rise in South-South investment. Companies in large emerging markets are expanding their operations to developing countries at accelerating rates. The level of FDI outflows from developing countries amounted to over \$40 billion in 2004, up from about \$16 billion in 2002. These FDI outflows not only went to high income countries but also to other developing countries. This growing trend of South-South FDI was estimated at 28 percent of total FDI inflows to developing countries for 2001, compared to 17 percent in 1995.

1.7 Risks Remain. While the external environment was positive in 2004, caution is in order. Emerging markets have experienced a great deal of volatility in the past, with sharp economic downturns or country crises creating domino effects across an entire region. Many countries and companies in emerging markets are still in vulnerable positions. There is already a concern in some markets that low levels of spreads may be leading to increased risk taking and investing in search of yield. A rise in global interest rates could burden those countries with higher external debt. The potential volatility of the emerging markets reinforces the need for IFC to remain engaged with clients through all business cycles to manage risks and to be prepared to assume a counter-cyclical role if the external environment deteriorates.

1.8 Support for the Private Sector Development Agenda Continues to Be Strong. The importance of private sector development for growth and poverty alleviation is accepted now by a

² IMF Global Financial Stability Report.

³ For foreign currency sovereign ratings. Source: SFRCR.

⁴ J.P. Morgan Chase EMBI Global Index.

alliances (e.g. FMO and DEG cooperation agreements), European-wide cooperation, and ties to EIB. In this environment, IFC must continue to differentiate itself by capitalizing on its strengths as a global institution, leveraging its world-wide financial, industry and technical assistance expertise, its sustainability competencies as well as its regional knowledge and presence.