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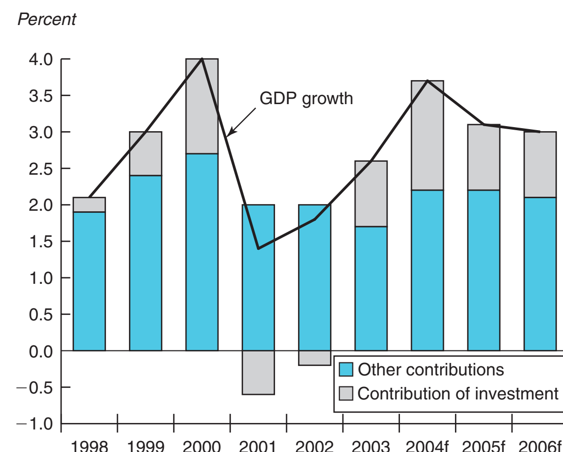
The Global Upturn and the Need for Adjustment

THE GLOBAL ECONOMIC environment affecting capital flows to developing countries improved appreciably in 2003. Global growth gained momentum in the second half of 2003 as the locus of economic activity shifted towards business investment spending. Renewed confidence in international financial markets led to a considerable decline in risk spreads in bond markets and fueled a strong rally in equity prices. Worldwide, GDP growth increased from 1.8 percent in 2002 to 2.6 percent during 2003; it is projected to rise to 3.7 percent in 2004 (table 1.1). Echoing the message of global recovery, key markets around the world rebounded. Nonenergy commodity prices in 2003 averaged 10 percent above their 2002 levels, while metal prices—traditionally a reliable leading indicator—surged at the end of 2003. A further 10 percent gain in commodity prices is expected this year. Global trade posted 4.5 percent growth in 2003 and should climb to 8.7 percent in 2004.

The recent global economic downturn—and now the recovery—has been strongly influenced by the business investment cycle. In response to the sharp drop in investment that followed the bursting of equity bubbles in mid-2000, governments in high-income countries quickly eased macroeconomic policies, and monetary policy drove global interest rates to historic lows. Firms started to work off excess capacity and cut costs. By 2003 profits began to rise, and with them so did investment. A step-up in capital spending, or in some countries a reduced rate of decline in investment, accounts more than all other factors for the acceleration of global GDP growth in 2003 (figure 1.1). The upturn in investment will likely gain strength in 2004 as recoveries in leading regional economies spread to lagging ones.

Another characteristic of the global recovery is that developing countries as a group are markedly outperforming the high-income countries. Developing countries' GDP grew 4.8 percent in 2003, compared to a 2.1 percent advance in the high-income countries. The low- and middle-income countries are on track this year to surpass the record 5.2 percent growth achieved in 2000, before the global slowdown. Trade performance, in particular, shows that developing countries have become an increasingly important pillar for global economic activity. In 2003 the volume of developing countries' imports and exports increased by 13.4 percent, more than five times the 2.5 percent

Figure 1.1 Contribution of investment to global GDP growth, 1998–2006



Note: *f* = forecast.
Source: World Bank.

Table 1.1 Global outlook in summary, 2002–2006

% change from previous year, except interest rates and oil price

						GEP 2004 forecasts	
	2002	2003e	2004f	2005f	2006f	2003	2004
Global conditions							
World trade volume[a]	3.5	4.6	8.7	7.9	7.1	4.6	7.9
Consumer prices							
G-7 countries[b,c]	1.3	2.0	1.4	1.7	1.9	1.4	0.9
United States	1.6	2.3	1.5	2.3	2.7	1.9	1.2
Commodity prices ($ terms)							
Non-oil commodities	5.1	10.0	10.4	−2.9	−2.8	6.9	1.0
Oil price (OPEC average)	24.9	28.9	26.0	23.0	20.0	26.5	22.0
Oil price (% change)	2.4	16.0	−10.0	−11.5	−13.0	6.3	−17.0
Manufactures unit export value[d]	−1.3	6.5	4.3	−1.7	−0.8	4.0	−0.4
Interest rates							
$, 6-month (%)	1.8	1.2	1.5	3.5	3.7	1.0	2.0
€, 6-month (%)	3.3	2.3	2.0	2.4	3.4	2.1	2.1
Real GDP growth[e]							
World	1.8	2.6	3.7	3.1	3.0	2.0	3.0
Memo item: World (PPP weights)[f]	2.9	3.7	4.6	4.1	3.9	3.1	3.9
High income	1.4	2.1	3.3	2.6	2.5	1.5	2.5
OECD countries	1.4	2.0	3.1	2.6	2.4	1.5	2.5
Euro area	0.9	0.4	1.7	2.3	2.3	0.7	1.7
Japan	−0.3	2.7	3.1	1.4	1.2	0.8	1.3
United States	2.2	3.2	4.6	3.2	2.9	2.2	3.4
Non-OECD countries	2.3	2.6	5.0	4.5	4.2	2.1	4.1
Developing countries	3.4	4.8	5.4	5.2	5.0	4.0	4.9
East Asia and Pacific[g]	6.7	7.7	7.4	6.7	6.3	6.1	6.7
Europe and Central Asia	4.6	5.5	4.9	4.8	4.7	4.3	4.5
Latin America and the Caribbean	−0.6	1.3	3.8	3.7	3.5	1.8	3.7
Middle East and N. Africa	3.3	5.1	3.7	3.9	4.0	3.3	3.9
South Asia	4.3	6.5	7.2	6.7	6.5	5.4	5.4
Sub-Saharan Africa	3.3	2.4	3.4	4.2	3.9	2.8	3.5
Memo items:							
Developing countries							
excluding transition countries	3.3	4.6	5.5	5.2	5.0	3.9	4.9
excluding China and India	2.1	3.4	4.4	4.5	4.2	3.0	4.1

Note: PPP = purchasing power parity; GEP 2004 = *Global Economic Prospects and the Developing Countries,* World Bank, January 2004; *e* = estimate; *f* = forecast.
a. Goods and non-factor services.
b. Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
c. In local currency, aggregated using 1995 GDP weights.
d. Unit value index of manufactured exports from major economies, expressed in U.S. dollars.
e. GDP in 1995 constant dollars; 1995 prices and market exchange rates.
f. GDP measured at 1995 PPP weights.
g. Now excludes the Republic of Korea, which has been reclassified as high-income OECD.
Source: World Bank data and staff estimates.

increase for high-income countries. The important role that the official foreign-exchange reserve assets of countries, such as China, are now playing in the financing of the U.S. current account deficit is yet another example of the growing role of developing countries in the global economy. And strong growth performance underscores the fact that many structural improvements in developing countries over the last decade are paying off.

But the global economy is emerging from the pervasive slowdown of recent years facing major macroeconomic challenges, which could have a critical bearing on the outlook for developing countries and the availability of external capital to finance their development. A growing share of the large and persistent current account deficit in the United States has been financed by the investment of foreign reserves that foreign central banks—particularly from Asia—have accumulated as a result of their trade and exchange-rate-management policies. Policy adjustments will be required—in high-income countries, to ensure an

orderly resolution of imbalances—and in developing countries, to guard against potential downside risks. Moreover, an end to the generalized easing in monetary policies—which has played some role in the recent strength of capital flows to developing countries—is likely. Policy challenges in two main areas are identified in this chapter:

- Macroeconomic policies in high-income countries—including fiscal adjustment in the United States, easier monetary policy in Europe, and flexible exchange-rate-management policies—could contribute to an orderly adjustment of current account imbalances. Fiscal adjustment is also necessary if real interest rates are not to rise, potentially crowding out the availability of capital to finance development.
- Developing countries should recognize the threat that these imbalances pose to the sustainability of the recent strengthening of capital flows and the risk of continuing fluctuations in the availability of external finance. Stronger inflows can help lay the foundation for sustained growth and poverty reduction if used effectively, but developing countries should be cautious of accumulating excessive debt, particularly short-term. And they should take the opportunity to manage their external liabilities, consolidate fiscal positions, and intensify ongoing reform efforts—including efforts to mobilize domestic savings—to further reduce their vulnerability to adverse financial shocks.

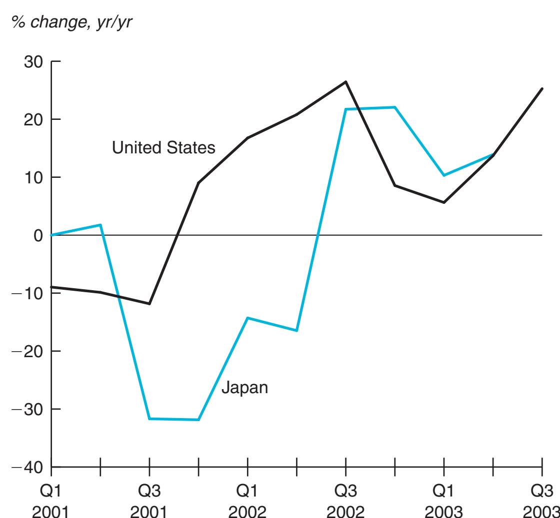
Adjustment, recovery, and imbalances in the high-income countries

After three years of below-potential growth, GDP in the high-income countries is likely to expand at a rate of 3.3 percent in 2004, well above the 1990s annual average of 2.5 percent. The shape of the recovery reflects the character of the slowdown that started in 2000, the macro policy stimulus that immediately followed the slowdown, and the adjustments made by the private sector in the last three years.

An investment-led recovery

The global economic slowdown of 2001 came after a decade of exuberant expectations and overinvestment—especially in high-tech markets. After equity markets collapsed, and investors reassessed the long-term profitability of new—often Internet-related—activities, the magnitude of excess capacity became apparent. Adjustment in the private sector was needed to reverse the sharp decline in capital spending.

Figure 1.2 Corporate profits in Japan and the United States, 2001–04



Note: The measure used in the United States is based on national accounts adjusted for industry valuation and capital consumption.
Sources: U.S. Department of Commerce and Japan ESRI.

Corporate profits have gradually improved in the high-income countries (figure 1.2) as firms have worked off many of the financial imbalances accumulated in the late 1990s—notably excess capacity and large inventories. In the late 1990s, the run-up in asset values was accompanied by overinvestment in key global industries—among them telecommunications, power, and information technology—which aggravated and extended the slump in global investment in 2001–02. During the last three years, however, businesses in the countries of the Organisation for Economic Cooperation and Development (OECD) restructured their balance sheets, cut back on operational expenses (including labor costs), and reduced capacity (World Bank 2003a). In adjusting, corporations took advantage of low interest rates to restructure debt and cut debt-service payments. These rationalizations enhanced price/earnings ratios and fueled a rise in equity prices. By the end of 2003, equity prices in high-income countries were some 25 percent above their level of a year earlier—in developing countries they had risen by

40 percent (see chapter 3)—suggesting a return of investor confidence.

The pickup in investment is likely to gain strength in 2004, as recovery in leading regional economies spreads to other countries. Europe is following the United States and Japan with a lag of approximately six months, mirroring conditions at the beginning of the slowdown, when investment declined first in the United States and Japan—the locus of many high-tech activities—and later in Europe.

The upturn in investment is likely to bring both Japan and the United States above their long-term potential growth in 2004. The GDP growth forecast of 4.6 percent for the United States and of 3.1 percent for Japan is in both cases more than 1 percentage point above the average growth rate of the last 10 years. Although it is impossible to determine potential growth exactly, and the prediction of turning points is similarly difficult, it is likely—as forecast—that growth will slow after 2004 in these two large economies. Japanese growth is increasingly tied to import demand in China and other developing countries in the region. As Chinese imports grew at an annualized rate of 40 percent in the last quarter of 2003, Japanese GDP was estimated to have advanced at an annualized rate of 7 percent, the highest since 1990. An expected return to more sustainable rates of trade expansion in the region in 2005 adds to the expected moderation of Japanese growth. For the Euro area, the picture is different. Entering recovery later, and constrained by the strong euro, GDP growth (expected to be 1.7 percent) is likely to remain below potential in 2004, before accelerating in subsequent years.

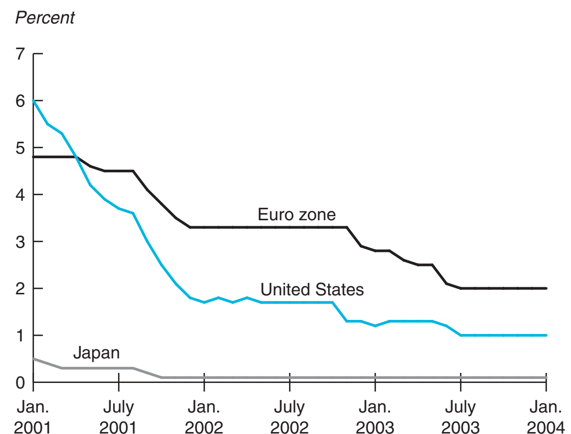
This growth pattern, combined with a gradual narrowing of budget deficits and some further weakening of the U.S. dollar, would allow a reduction of the U.S. current account deficit in the coming years. However, the key risks to the outlook lie precisely in these areas. Large budget deficits tend to persist long after fiscal stimulus has done its job of boosting growth in the economy. If the deterioration is not reversed, higher interest rates become more probable, and policymakers lack a key weapon to use against potential new shocks to the economy. Global current account imbalances generate risk, because it is unclear how long—and under what conditions—international investors will remain willing to finance the shortfalls. In some circumstances, an abrupt change in that willingness may trigger disorderly currency fluctuations.

Macroeconomic policies were instrumental in reinvigorating growth

Policymakers in the advanced economies have pursued expansive fiscal and monetary policies in recent years as they have sought to reverse the slowdown in economic activity that followed the correction in global equity markets in mid-2000. Even in Japan, which entered a recession with a fiscal deficit exceeding 6 percent of GDP and policy interest rates at 0.5 percent—and so had limited room for further traditional measures—efforts have been made to stimulate the economy through monetary ease. The United States, in particular, eased monetary policy very aggressively; the federal funds rate was reduced 13 times from the end of 2000 to mid-2003, from 6.5 percent to 1 percent (figure 1.3). The reductions buoyed consumer spending and housing-related activity. The European Central Bank (ECB), fearing inflation, was more cautious than the U.S. Federal Reserve at the outset of the crisis. Even so, it reduced its repurchase rate from 4.75 percent in late 2000 to 2 percent in early 2004.

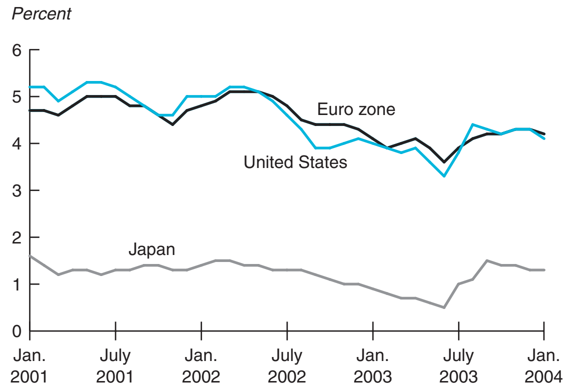
Long-term interest rates fell noticeably as the global economy slowed, but they have rebounded somewhat from their lows of mid-2003 as fears of deflation have receded. In early 2004, 10-year

Figure 1.3 Short-term interest rates in the Euro zone, Japan, and the United States, 2001–04



Source: Datastream.

Figure 1.4 Long-term interest rates (10-year government bond yields) in the Euro zone, Japan, and the United States, 2001–04



Source: Datastream.

government bond rates in Europe and the United States stood at 4.1 percent, compared with 3.6 percent and 3.3 percent in mid-2003 (figure 1.4). As a consequence of the turnaround in interest rates, the substantial boost to consumption that resulted from the wave of mortgage refinancing in the United States has apparently begun to wane.

As the global economy recovers, the phase of generalized easing of monetary policy appears to be coming to an end. The Bank of England and Reserve Bank of Australia recently increased interest rates and indicated that further rises were likely. The U.S. Federal Reserve has suggested that it will, in time, return to a more neutral monetary stance, although the disappointing rate of new job creation still causes worry. Further easing is possible in some countries and regions. Most notably, the recent strength of the euro against the dollar amid continuing sluggish domestic conditions in the Euro area, as well as the easing of inflation in the zone to rates below central bank targets, may give the ECB some room to reduce interest rates.

Fiscal deficits in high-income countries have widened every year since 2000—from 0.1 percent of GDP to 3.7 percent of GDP in 2003. The shift has been most pronounced in the United States, where the budget moved from a surplus of 1.6 percent of GDP in 2000 to a 4.6 percent deficit in 2003. But fiscal relaxation was the rule elsewhere as well. Fiscal deficits in the Euro area averaged 2.8 percent in 2003 compared to an average balanced budget in 2000, with France and Germany breaching the deficit limit of 3 percent of GDP set by the EU Stability and Growth Pact. In Japan the deficit was nearly 8 percent of GDP in 2003, 1.5 percentage points worse than in 2000. The budget gaps are not wholly the result of recession-induced declines in revenue.

Countercyclical fiscal policies helped prevent the recession from deepening, but they have created substantial medium-term challenges. Growing deficits in the United States foreshadow higher long-term real interest rates, as U.S. government borrowing competes for available finance with borrowers not only from the private sector, but also from developing countries. Recent simulations by the International Monetary Fund (Muhleisen and Towe 2004) suggest that, without corrective policies, a possible 15 percent increase in the ratio of U.S. public debt to GDP could eventually cause average real interest rates in the industrialized countries to increase by 50 to 100 basis points.

Financing of the U.S. current account deficit is a key vulnerability

On current trends, the U.S. current account deficit is likely to widen to about $590 billion—5 percent of GDP—in 2004, the fifth consecutive year in which the deficit has exceeded the previous high of 3.4 percent of GDP reached in the late 1980s. The deterioration in the U.S. fiscal balance since 2000 (6 percentage points of GDP) has played an important role in widening the country's current account deficit, more than offsetting an adjustment in the balance of private sector saving and investment equivalent to 5 percentage points of GDP. Once the financing of the U.S. external shortfall became more difficult, the current account deficit came to represent a substantial global imbalance.

Beginning in late 2002, demand began to falter among private overseas investors for dollar-denominated assets—at least at the prevailing exchange rate. Since then the dollar has fallen against nearly all major currencies, depreciating 30 percent against the euro and 20 percent against the yen by early 2004. The dollar's decline has reduced the competitiveness of European and Japanese exporters, while stimulating U.S. trade. The third quarter of 2003 saw a substantial fall in foreign private investment in U.S. assets, although this was largely offset by a reversal in the rate at which U.S. private investors accumulated assets abroad (table 1.2). Foreign demand for U.S. assets rebounded during the fourth quarter, however, as net

Table 1.2 Financing of U.S. current account deficit, 1999–2003
$ billions

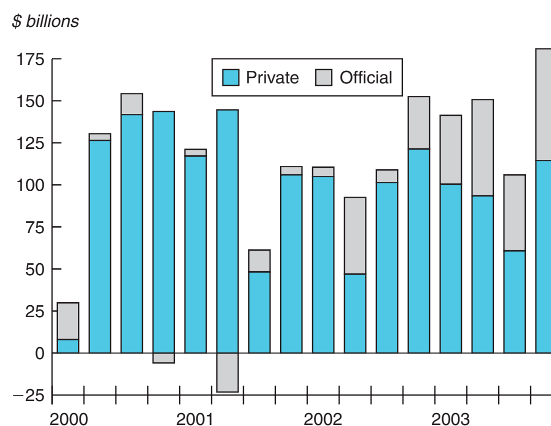
	1999	2000	2001	2002	2003
Current account balance	−290.8	−411.5	−393.7	−480.9	−541.8
Financing requirement	**282.1**	**411.8**	**398.7**	**484.5**	**540.3**
Net foreign official assets	**43.5**	**37.7**	**5.1**	**94.9**	**207.7**
As share of financing requirement	*15.4*	*9.2*	*1.3*	*19.6*	*38.4*
Net flows in FDI and Banking	**42.5**	**131.1**	**15.0**	**−28.4**	**−3.0**
Net flows in FDI	64.5	162.1	31.6	−98.2	−72.8
Net flows in banking	−22.0	−31.0	−16.6	69.8	69.8
As share of financing requirement	*15.1*	*31.7*	*3.7*	*−5.9*	*−0.5*
Net flows in portfolio assets	**178.3**	**302.0**	**326.8**	**419.2**	**339.3**
Corporate bonds	140.9	151.2	226.5	193.5	276.7
Corporate equities	−1.4	85.8	10.4	37.5	−54.1
Other long-term securities	43.1	96.4	85.2	76.3	−48.1
U.S. government securities	−4.3	−31.4	4.7	111.9	164.8
As share of financing requirement	*63.2*	*73.3*	*82.0*	*86.5*	*62.8*
Other (including statistical discrepancy)	17.8	−59.0	51.9	−1.2	−3.7

Source: U.S. Department of Commerce and World Bank staff estimates.

flows into U.S. private assets increased by some $115 billion.

With the decline in demand for U.S. assets among private investors, a growing share of the burden of financing the U.S. current account deficit has been shouldered by official institutions in developing countries that have invested reserves accumulated through good trade performance, effective exchange-rate management, and the strengthening in capital flows (see figure 1.5 and box 1.1). Inflows of foreign official assets to the United States amounted to $208 billion during 2003, compared with $95 billion for the whole of 2002, financing almost 40 percent of the U.S. current account deficit. Foreign official institutions purchased a net $150 billion of U.S. long-term securities in 2003, compared with $40 billion in 2002. Traditionally invested chiefly in Treasury

Figure 1.5 Net financial flows to the United States, 2000–03



Sources: U.S. Department of Commerce and World Bank staff estimates.

Box 1.1 Reserve accumulation in developing countries

The rate of reserve accumulation in the developing countries surged to $276 billion in 2003 from $173 billion in 2002 and $78 billion in 2001. Reserves in China increased by $117 billion to reach $403 billion in 2003. Other countries also saw notable increases in reserves: India's rose by $26 billion to $97 billion; Russia's by $30 billion to $73 billion; and Brazil's by $12 billion to $49 billion. Developing countries have been steadily building reserves in reaction to the costly crises of the 1990s—precautionary motives may therefore explain some of the increase, particularly in countries such as Brazil and Turkey, which are emerging from crises. However, the

Box 1.1 *(continued)*

recent acceleration in reserve accumulation is above what would be expected based on precaution alone.

In some countries, including those with the largest accumulations, the rise in reserves is the result of exchange-rate-management policies operating in a context of strong trade performance and high capital inflows. The reserves of some advanced economies—particularly in Asia—also increased strongly for similar reasons. Japan's reserves rose by about $200 billion over 2003 to stand at $650 billion, as a result of intervention to limit the appreciation of the yen against the dollar, and Korea's reserves also increased significantly.

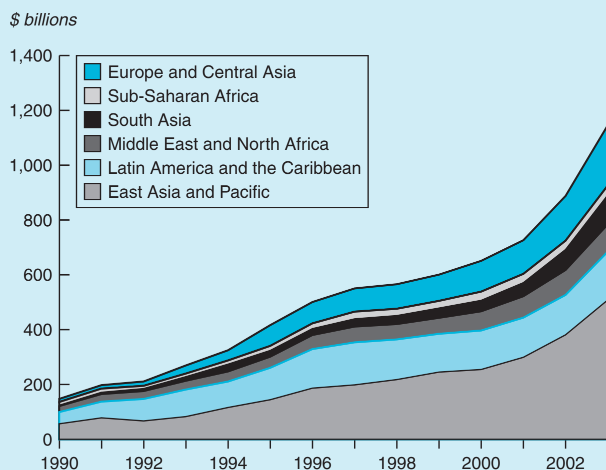
Although just a few countries account for the bulk of the increase in reserves, most have seen some rise in recent years. In aggregate, developing countries' total reserves were approximately $1.2 trillion at the end of 2003, 75 percent above the level of three years ago. Since 2000, reserves have risen in all six World Bank regions. Of the 132 developing countries that reported data for 2003, 102 increased reserves.

The rise in international reserves is substantial relative to indicators typically used to measure the adequacy of reserves. The ratio of reserves to imports of goods and nonfactor services for developing countries as a group rose from 42 percent in 2000 to 59 percent in 2003. Over the same period, developing countries' reserves increased from twice to almost four times the size of short-term debt.

Higher reserves come at a cost. Reserves are typically invested in liquid, low-risk instruments that are easily converted into cash at a known value. Some three-quarters of global foreign exchange reserves are held in U.S. dollars, with a large share in Treasury securities (McCauley and Fung 2003). In many countries, the monetary authorities have issued securities in an effort to sterilize the impact of rising reserves on domestic monetary conditions; they pay interest on those securities at rates that are sometimes much higher than those they earn on their reserves. Moreover, instead of holding reserves, governments could reduce their debt in international capital markets (at spreads that may be several hundred basis points above LIBOR). Thailand has indicated that it will repay public external debt over the coming year rather than increase reserves. In December 2003, China used $45 billion of its foreign-exchange reserves in the recapitalization of the Bank of China and China Construction Bank. Other countries may seek to limit the cost of holding reserves by choosing to hold a portion in higher yielding assets, accepting some increase in risk.

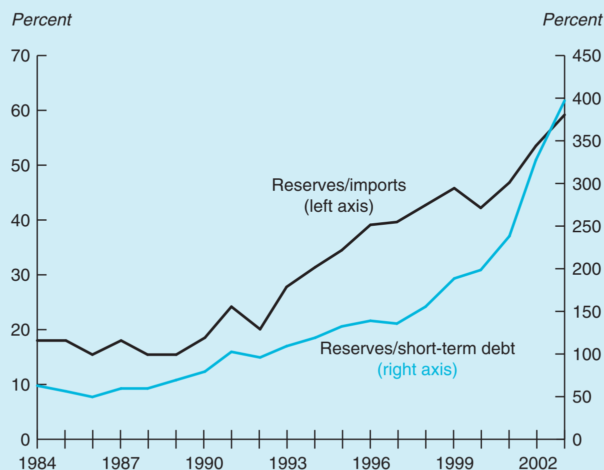
Given the critical role that foreign official assets are playing in financing the U.S. current account deficit and in the market for U.S. securities, the portfolio choices of reserve managers in developing countries could have a significant impact on these markets. Portfolio managers may need to balance their desire for higher returns against the risk of triggering shifts in asset prices, including exchange rates.

International reserves in developing countries, 1990–2003



Note: Estimates for 2003 refer to end-December for most countries. Where not, the most recent available data are used.
Source: International Financial Statistics.

Ratios of reserves to imports and reserves to short-term debt, 1984–2003

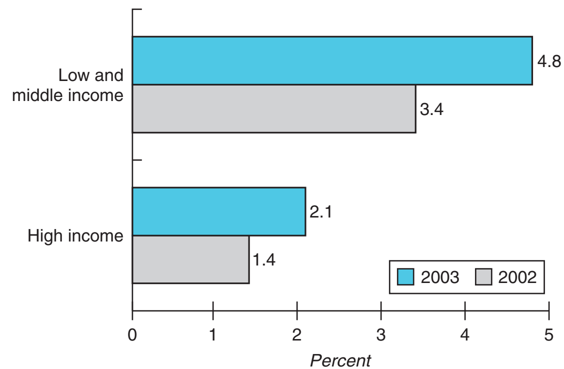


Source: World Bank data.

securities, a growing share of U.S.-dollar reserves has been invested in other securities, particularly bonds of U.S. government agencies, as reserve managers have sought to increase returns and limit quasi-fiscal losses. For example, as of December 2003, the U.S. Federal Reserve was holding $232 billion of government agency bonds on behalf of foreign central banks. Heavy purchases of such securities by central banks, especially from Asia, have helped keep Treasury bond yields relatively low, particularly for securities of relatively short maturity.

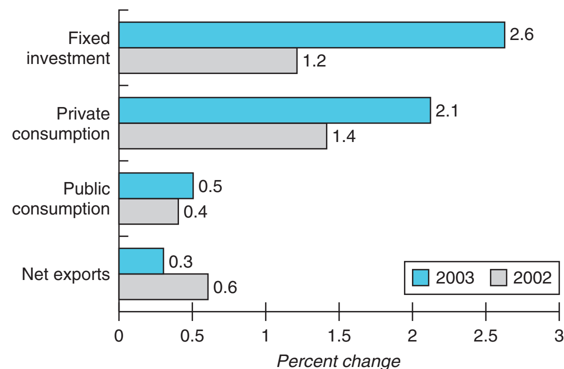
The timing and extent of any future adjustment in the U.S. current account remains highly uncertain. Equally uncertain is how foreign investors' appetite for U.S. assets will respond to exchange-rate changes and developments in the real economy and asset markets in the United States and elsewhere. But the critical role of foreign official assets, including those of developing countries such as China, in the financing of the U.S. current account deficit and in the market for U.S. government securities underlines the interdependence of developed and developing countries and their common interest in resolving existing imbalances. As the current configuration of financing is unlikely to be sustained indefinitely, a combination of dollar depreciation and slower growth in U.S. domestic demand relative to the growth of demand abroad will be required. A gradual tightening of U.S. fiscal policy could reduce the possibility of a severe and abrupt correction brought about by market forces.

Figure 1.6 GDP growth in low- and middle-income and high-income countries, 2002–03



Source: World Bank.

Figure 1.7 Contributors to GDP growth in developing countries by demand component, 2002–03



Note: Excludes statistical discrepancies.
Source: World Bank.

Developing countries: a favorable outlook, but risks remain

As a group, developing countries grew much faster than the industrial countries in 2003, although the accomplishments of individual economies varied widely. GDP per capita in the low- and middle-income countries increased by 3.5 percent during the year, compared with a 1.6 percent advance in the high-income group. With faster population growth in the developing world, the differential in real GDP growth was larger: 4.8 percent versus 2.1 percent (figure 1.6). Developing-country growth is likely to pick up to 5.4 percent in 2004—the strongest in two decades—before easing back toward 5 percent gains over 2005–06. In East Asia, which is leading the global cycle, economies may begin to cool somewhat sooner than in other regions.

Capital spending is driving growth

Developing countries have not missed out on the revival of global investment, with capital spending accelerating broadly from 4.9 percent growth in 2002 to 10.8 percent in 2003. The acceleration more than doubled investment's contribution to output, making it the principal driving force for growth (figure 1.7). Capital spending has been spurred by the boom in China, where investment increased by 23 percent in 2003; by an 11.7 percent surge in South Asian spending, where foreign direct investors eye India's growth potential; by a rebound in the EU accession countries of Central

Europe (5.9 percent growth in 2003), which are already reaping positive effects from their imminent integration; and by strong capital outlays among oil-exporting countries following several years of elevated oil prices. Oil exporters in the Middle East and North Africa saw growth of 13.5 percent; and in the Commonwealth of Independent States, 14.2 percent. Latin American investment outlays continued to contract during 2003, but the 1 percent decline was less sharp than the 7 percent fall in 2002. Indeed, the bottoming out of capital-stock adjustments has contributed to a pickup in GDP growth in the region, while signaling nascent recovery in fixed investment. Sub-Saharan Africa appears not to have shared fully in the acceleration of investment, with capital spending near 6 percent growth in 2002–03, although recent observations are insufficient to justify firm conclusions.

Public sector spending grew steadily across developing countries—in line with GDP. In addition to reflecting the more prudent macroeconomic policies of recent years, the steady growth also suggests that fiscal policy, on average, is not as cyclically influenced as in the high-income group (box 1.2). Improved fiscal policies have helped to avoid further widening of budget and current account deficits, while supporting local currencies and muting inflationary tendencies. Despite the strong cyclical rebound in economic activity, median local-currency inflation (GDP deflator) for developing countries as a group dropped to 4.2 percent in 2003, much better than the average of 5.5 percent over the last three years and 8.9 percent over the last decade.

Box 1.2 The fiscal response of low- and middle-income countries to the downturn

The 2001 recession prompted countercyclical fiscal action in many industrial countries but in just a few of the low- and middle-income groups. As a result of automatic stabilizers (increased social benefits and reduced tax payments) and active policies (tax cuts and additional spending, especially in the United States), the fiscal balance in high-income countries as a group shifted from a surplus of 0.1 percent of GDP in 2000 to a deficit of 3.7 percent in 2003. Over the same period the fiscal deficit of low- and middle-income countries together slipped by less than half a percentage point (see figure).

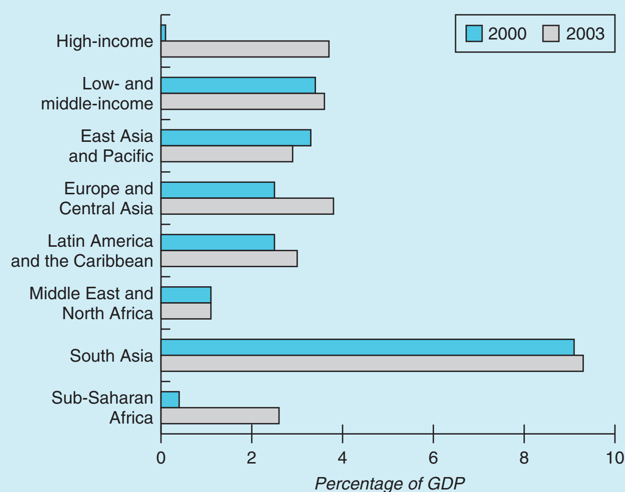
Why are developing countries less likely to adopt countercyclical fiscal policies?

- Automatic fiscal stabilizers such as a progressive tax system and social safety nets are not as common in low- and middle-income countries as in high-income ones. Some social policies in developing countries (for example, consumer subsidies when global commodity prices are high) are even procyclical.
- Fiscal stimulus often kicks in too late to make countercyclical policies effective (often true in high-income countries as well).
- Many developing countries entered the slowdown with higher public debt and deficits than high-income countries, and are more vulnerable to loss of confidence in financial markets.
- Numerous governments depend on external financing, and capital inflows into developing countries tend to be procyclical.

In view of the cautious fiscal policies of developing countries, the rebound of domestic demand is all the more encouraging.

Sources: IMF 2003 and Talvi 2000.

Fiscal deficits in high-income and developing countries as a percentage of GDP, 2000 and 2003



Sources: IMF and World Bank.

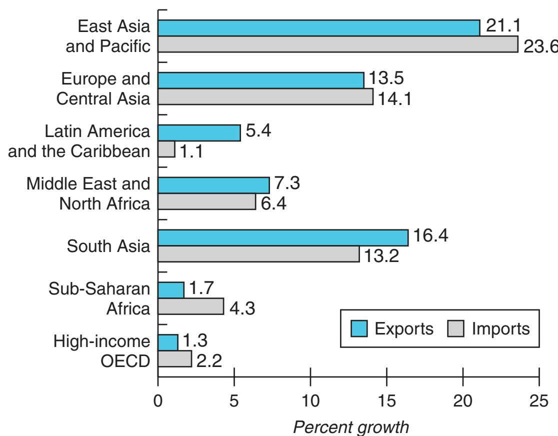
Rapid growth of developing-country trade

The performance differential between the low- and middle-income countries and their high-income counterparts was even greater in international trade than in output growth. This was true for developing countries in Asia and Europe particularly, which experienced double-digit growth in both export and import volumes (goods and services), against 1.8 percent growth for high-income OECD countries (figure 1.8).

In 2003, growth in import demand of developing countries (13.3 percent) matched growth in exports (13.5 percent)—implying that the expansion in foreign markets did not come at the cost of high-income countries. In other words, increased competition from developing-country exports was offset by the developing countries' increased demand for imports. Import demand in East Asia, in particular, spurred Japanese export growth to 10 percent in 2003. And within East Asia, China has emerged as a powerhouse for trade, with a surge of 40 percent in import volumes in 2003, suggesting that accession to the World Trade Organization was more than just an administrative change. Although trade developments during 2003 did not contribute significantly to developing-country GDP growth—in an accounting sense—the continued rapid integration of developing countries into global markets is likely to spur long-term productivity by improving allocative efficiency and stimulating competition and innovation. It is worth noting that while developing countries accounted for some 24 percent of world trade in 2003, their import demand was responsible for more than half of the year's growth in trade volumes (figure 1.9).

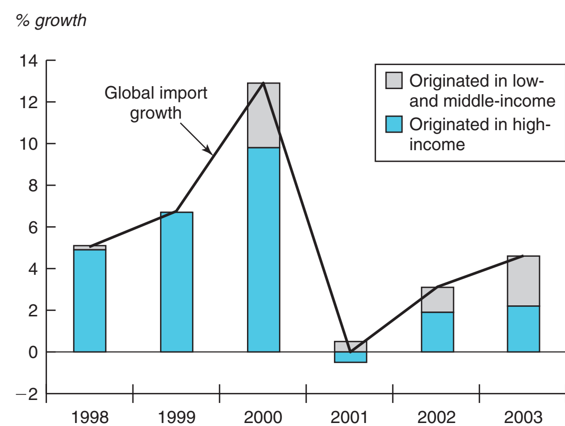
For commodity exporters, recovery has meant more than larger trade volumes: substantial gains in prices have multiplied export revenues (table 1.3). During 2003, energy and nonenergy commodity prices (in U.S. dollar terms) advanced

Figure 1.8 Growth in imports and exports of goods and nonfactor services, 2003



Source: World Bank.

Figure 1.9 Global import growth and developing countries' contribution, 1998–2003



Source: World Bank data and projections.

Table 1.3 Export revenues of developing countries, 2000–06

% growth in U.S.-dollar revenues

	2000	2001	2002	2003	2004f	2005f	2006f
Low- and middle-income	20.9	−0.1	8.1	18.6	14.3	10.6	10.0
East Asia and Pacific	21.9	−1.7	13.8	22.0	18.8	17.2	14.3
Europe and Central Asia	20.0	4.9	9.5	27.1	17.4	7.1	6.3
Latin America and the Caribbean	19.2	−3.6	0.3	7.0	8.6	8.7	8.7
Middle East and North Africa	28.6	4.7	0.2	11.6	8.1	3.3	7.4
South Asia	18.0	1.9	14.5	19.2	14.7	8.0	8.7
Sub-Saharan Africa	17.8	−4.6	7.3	15.5	−0.1	0.9	4.7

Note: f = forecast.
Source: World Bank staff estimates.

by 16 and 10 percent above 2002 levels. The strongest gains were seen for metals, the most cyclical of all commodities, which gained 28 percent over the year. In large measure, the dollar price increases of 2003 reflected the weakening of base currencies, and commodity prices rose only slightly relative to domestic prices of other goods for buyers and sellers around the world (box 1.3). However, further gains in 2004 are expected to translate into genuinely stronger real commodity prices in many importing and exporting countries.

Other factors underpinning the recovery

For 2004 and beyond, the outlook for developing countries is positive. Further improvement in the external environment is likely to combine with increasingly favorable domestic conditions. The main risk to this propitious scenario is the possibility of a sudden rise in international interest rates, which, as discussed earlier, could result from a disorderly unwinding of current account imbalances and associated volatile movements in exchange rates. The challenge for policymakers in developing countries is to be prepared for the contingency of higher rates in the short to medium terms. Pursuing prudent fiscal policies and avoiding overexposure to short-term external debt could reduce overall vulnerability to such potential shocks.

Improvements in the external environment are expected in the form of stronger import demand in

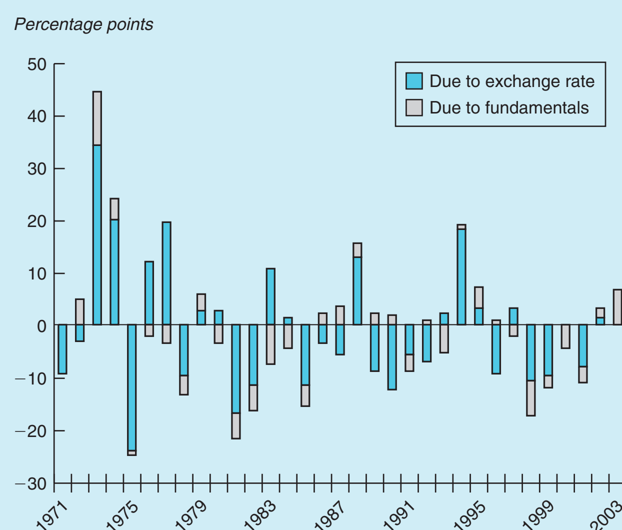
Box 1.3. Commodity prices and exchange rates

Primary commodity prices are notoriously volatile, reflecting a barrage of supply and demand shocks. From 1995 to 2001, the World Bank's index of dollar-denominated commodity prices fell by more than 35 percent, before rebounding by 14 percent over the next two years. In real terms (deflated by the U.S. GDP deflator), the downturn was an even steeper 42 percent. However, these price swings reflect not only market forces, but also the arbitrary choice of the dollar as the currency in which prices are expressed. What part of the price volatility reflects demand and supply factors and what part the chosen currency?

Sellers and buyers of commodities base their actions on relative prices (commodity prices deflated by a domestic deflator). Yet outside the United States those real prices are not necessarily the deflated dollar prices. German construction firms pay for copper and wood with euros; cocoa farmers in Côte d'Ivoire receive CFA francs. For these agents, dollar prices may be quite misleading. For instance, in 2001 the price of gold fell by 2.9 percent in dollars but rose 35 percent in South African rands. Prices expressed in a basket of currencies weighted with country shares in world trade would give a better indication of the experience of typical commodity buyers and sellers. Changes in such a weighted index of real commodity prices may be interpreted as the impact of demand or supply shocks.

The figure at right decomposes changes in real, dollar-denominated commodity prices into real exchange-rate effects of the dollar against a commodity-trade-weighted basket of currencies and a residual reflecting market forces (which is relevant for typical buyers and sellers). The sharp declines in dollar prices in the late 1990s

Decomposition of changes in real U.S.-dollar commodity prices, 1971–2003



Source: World Bank staff estimates.

following the Asian crisis are seen to be mainly due to market forces (that is, real declines for the average seller and buyer), and to a lesser extent to the weakening of the dollar. By contrast, the rebound in dollar prices in recent years barely compensated for the weakening of the dollar and did not translate into higher real prices for the average seller and buyer. The real commodity price index was unchanged in 2003, compared to an average 0.6 percent decline historically.

high-income countries, additional firming of non-oil commodity prices, and continued rise in capital flows to developing countries. Imports of goods and services by high-income countries are projected to accelerate from a 2.7 percent rate of growth in 2003 to 6.8 percent in 2004. As GDP growth within this group converges over the coming years, and as current account positions reverse gradually, import demand in Europe and Japan is likely to outpace that of the United States—from 2005 onward.

Building on the robust 10 percent advance of 2003, the rally in non-oil commodity prices is anticipated to continue, with an additional 10.4 percent gain in 2004. Firming demand, relatively tight supplies, low stocks levels, and continued weakness of the dollar are key supporting factors. The combination of these factors and improving external demand should lead to continued robust growth in nominal export revenues (see table 1.3). Agricultural prices are projected to increase by 5.1 percent, with the strongest rise in fat and oil prices due to tight supplies and robust demand in East Asia. Beverage prices remain at extremely modest levels by historic standards, as supplies from new low-cost coffee producers, notably Vietnam and Brazil, cut short a cycle of sharply rising prices. Metal prices, in contrast, are anticipated to surge nearly 26 percent during 2004—double the increase of 2003. Many markets already have moved into deficit due to declining stocks, earlier supply cuts, and broadening of demand growth in areas outside China. Non-oil commodity prices are likely to peak in 2004, before declining by around 3 percent in 2005, as higher prices bring on new supplies and, in the case of metals, reactivation of idled capacity.

Oil prices are anticipated to average $26 a barrel in 2004, down from about $29 in 2003, assuming that OPEC manages production sufficiently to keep its prices in the upper half of its target band. Oil prices began 2004 above $30 a barrel, due to very low stocks and strong investment-fund demand. Some of the major OPEC producers justify higher prices because the decline in the U.S. dollar has eroded their purchasing power, which may have prompted the organization's decision in February to cut production quotas further. Oil prices are expected to decline in 2005 and beyond, as large non-OPEC supplies come on stream—from the Caspian, the Russian Federation, and West Africa—and as many OPEC countries, including Iraq, develop new capacity. Price risks remain if OPEC maintains its resolve to keep oil prices high—or to move its band higher because of the dollar—even in the face of declining market share.

For the immediate future, the global recovery in economic activity, the high degree of liquidity in international capital markets resulting from stimulative monetary policies, and the general improvement in perceived credit quality in developing countries appear to be sufficiently strong to support robust capital flows to developing countries. Aided by the relaxation of foreign-ownership restrictions in China, India, and elsewhere, flows of foreign direct investment (FDI) are expected to reverse their decline of the last two years. Moreover, the strengthening of domestic demand in many developing countries is likely to increase demand for external finance. Firm oil prices will likely increase the external financing requirements of oil importers.

Against the background of the improving external environment, GDP growth for all low- and middle-income countries is likely to accelerate from 4.8 percent in 2003 to 5.4 percent in 2004 (table 1.4). If it does, it will exceed the 20-year record of 5.2 percent set in 2000. Growth of capital

Table 1.4 Developing-country growth, 1991–2006

Percentage growth rates, points, ratios

	1991–2000	2000	2001	2002	2003e	2004f	2005f	2006f
Real GDP growth	3.4	5.2	3.0	3.4	4.8	5.4	5.2	5.0
Contribution to growth (points)								
Private consumption	2.1	2.6	1.8	1.4	2.1	2.9	3.0	2.8
Fixed investment	0.6	1.7	0.8	1.1	2.6	2.3	1.8	1.8
Net foreign balance	0.4	−0.2	0.2	0.6	0.3	−0.3	−0.1	0.2
Current account balance (share of GDP)	−1.4	1.0	0.4	1.3	1.1	0.5	0.1	0.1
Fiscal balance (share of GDP)	−7.1	−3.4	−3.6	−4.0	−3.6	−3.4	−3.3	−3.1

Note: e = estimate; *f* = forecast.
Source: World Bank data and staff estimates.

spending in the developing countries is likely to have peaked at 10.8 percent in 2003; it should now slow to single-digit gains, easing the pace of GDP growth to still robust advances of 5 percent over 2005–06. Such growth performance should enable a further narrowing of fiscal deficits from the peak levels of 2002. As part of the global rebalancing of external positions, current account surpluses—one percentage point of GDP in 2003—should dissipate gradually over the next few years.

Regional prospects

EU accession and oil shape the outlook for Europe and Central Asia

The economies of the Europe and Central Asia region grew by 5.5 percent in 2003, up from 4.6 percent the year before. As was the case for many regions, the pickup in growth was led by a firming of capital spending. Investment's contribution to GDP growth tripled to 1.8 percentage points in 2003 from 0.6 points in 2002 (table 1.5). Determinants of growth in the region have differed notably between Central and Eastern Europe, where links with the Euro area are growing closer, and the Commonwealth of Independent States (CIS), where trends in the oil and gas sector predominate. Despite sluggish activity in the Euro area, growth in Central and Eastern Europe (excluding Turkey) accelerated from 3 percent in 2002 to 4.1 percent in 2003, as several countries increased export-market shares in the European Union as part of the broader integration process. Shipments to the European Union, for example, now account for 30–33 percent of the national incomes of Hungary and the Czech Republic. Growth in the Baltic States continued on a robust track, with a GDP advance of 7 percent, up from 6.3 percent in 2002. Investment was a key driving factor in this outturn, rising by 13.2 percent in the year. Fiscal stimulus also played a broader role in the upturn in Central European demand. The Russian Federation and other countries of the CIS expanded from growth of 4.7 percent in 2002 to 6.6 percent in 2003, powered by a 8.6 percent advance in consumer spending and investment growth of 12.5 percent. The underpinnings for domestic growth continue to be strong oil revenues. For the Russian Federation, this yielded a fiscal surplus in 2003—for the fourth year in succession—amounting to 1.4 percent of GDP, and a massive current account surplus of $42 billion, or 9.9 percent of GDP.

The outlook for 2004 and beyond is for continued robust growth in the region as a whole, again characterized by distinct driving forces, risks, and policy challenges in the major country groups. Growth in Central and Eastern Europe is expected to approach 4.5 percent, as effective implementation of EU-related structural reforms provides a stronger foundation for expansion. Net FDI inflows declined from 3 percent of GDP in 2002 to 2.1 percent in 2003, as the privatization process in several accession countries neared completion. But large stocks of FDI accumulated over recent years, together with the EU accession process, should offer favorable conditions for productivity growth (box 1.4). The main risks and policy challenges are mounting fiscal deficits and

Table 1.5 Growth in Europe and Central Asia, 1991–2006

Percentage growth rates, points, ratios

	1991–2000	2000	2001	2002	2003e	2004f	2005f	2006f
Real GDP growth	−1.4	6.8	2.4	4.6	5.5	4.9	4.8	4.7
Contribution to growth (points)								
Private consumption	0.0	2.9	2.0	3.2	3.7	3.3	3.1	2.9
Fixed investment	−2.2	2.5	−0.7	0.6	1.8	1.6	1.7	1.7
Net foreign balance	1.3	−1.4	1.1	−1.2	−0.1	−0.5	−0.6	−0.4
Current account balance (share of GDP)	−0.7	1.9	1.9	0.8	0.7	−0.4	−0.8	−0.9
Fiscal balance, share of GDP	−11.4	−2.5	−3.7	−3.7	−3.8	−3.5	−3.4	−3.2
Memo items: real GDP growth								
Central and Eastern Europe	1.7	4.8	−0.4	4.4	4.4	4.5	4.6	4.4
Excluding Turkey	0.9	3.6	3.0	3.0	4.1	4.3	4.6	4.5
Commonwealth of Independent States	−3.9	9.2	5.7	4.7	6.6	5.4	5.1	5.1

Note: e = estimate; *f* = forecast.
Source: World Bank staff estimates.

Box 1.4 The integration dividend in Central Europe

The European Union will expand dramatically in May 2004, when eight transition countries—Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia—along with Cyprus and Malta, come into the fold. Per capita income in 2002 in the accession countries, measured in purchasing power parity, ranged from 36 percent of the EU average in Latvia to 71 percent in Slovenia (see first box figure). How quickly, and to what extent, will the new members narrow the gap with EU living standards?

Lessons from Portugal, Spain, and Greece point to policies as key—
The accession experiences of three recently joined members suggest that market access alone will not narrow the income gap. Instead, the pace of convergence will largely depend on the policy environment. In the first five years after joining the European Union in 1986, Portugal and Spain consolidated their budget deficits, introduced new value-added taxes, and tightened money growth, triggering significant increases in FDI inflows. In contrast, in the first five years following its accession in 1981, Greece's budget deficit rose sharply and money growth remained expansionary, at nearly 25 percent a year. After rising markedly just before accession, FDI inflows to Greece shrank in the first five years of membership. The culmination of these developments led to a narrowing of the income gap in Portugal and Spain but to a widening of the gap in Greece (box table).

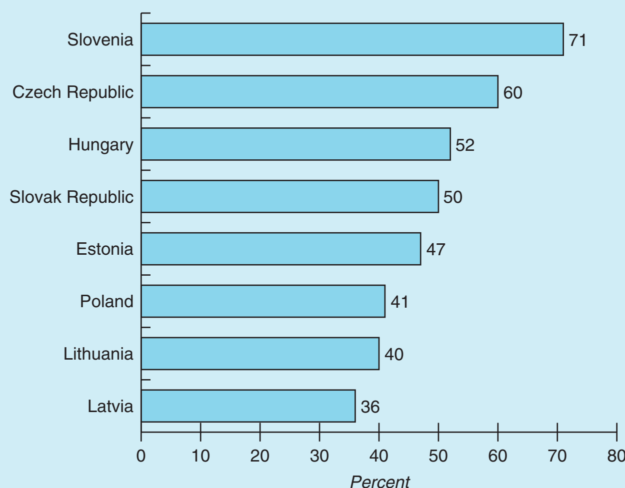
Per capita GDP for Greece, Portugal, and Spain as a share of the European Union average, various years
Percentage

	Accession year	5 years after accession	15 years after accession
Greece	77	72	65
Portugal	58	66	71
Spain	73	78	82

Source: World Bank staff estimates.

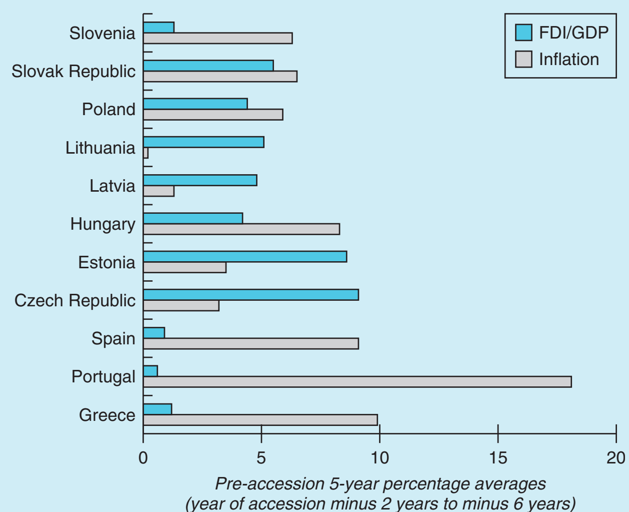
The eight transition countries are more oriented toward the European Union than were their three southern European counterparts at a similar stage in the accession process. The eight, for example, have already witnessed a massive reorientation in trade to EU markets, as a group, and to a country have been receiving more significant inflows of FDI as a share of GDP and have narrower inflation differentials to the present European Union than did the three earlier candidates (box second figure). In addition, the eight already have adopted much of the *acquis communautaire* (EU body of law). On the other hand, once the new members enter the union, they can expect significantly lower EU aid flows (from cohesion and structural funds) as a share of GDP than those received by Greece, Portugal, and Spain, which amounted to 2–3 percent of GDP.

Per capita GDP for accession countries as a share of the European Union average, 2002



Source: World Bank.

CPI inflation differential (vs Germany) and FDI as a share of GDP



Source: World Bank.

Box 1.4 *(continued)*

—and prospects for catching up are promising
While these factors are not readily quantifiable, the outlook for convergence between the present European Union and its newest members is good. Significant FDI inflows are expected to continue—fueled by falling trade and transactions costs, coupled with a positive policy environment, attractive relative labor costs, and reduced risk. The only likely countervailing factor is likely to be slower growth related to privatization. The timing of accession in mid-2004 is auspicious, given an expected upward trend in growth in the core EU countries. The accession could well turn out to enhance the prospects for the European Union as a whole, especially as transitional restrictions on labor movement—set to last seven years after accession—are lifted.

vulnerability to increases in global interest rates. Fiscal deficits increased in a number of countries—notably in Poland and Hungary, to 6 and 9.4 percent of GDP in 2003, respectively—reflecting countercyclical policies and structural increases in outlays for civil service wages, healthcare, and pensions. Fiscal adjustment in the accession countries will become an increasing challenge, as EU resources will only partially fund the spending requirements of the new members. To benefit more fully from the accession process, governments should rein in fiscal deficits, while avoiding spikes in short-term debt flows. For the region as a whole, short-term debt increased sharply from $1.5 billion in 2002 to $17 billion in 2003.

In the CIS, growth is projected to ease from the 6.6 percent registered in 2003 toward 5 percent by 2005–06, due in large measure to moderating oil prices and lower tax revenues. For the Russian Federation principally (but also for Azerbaijan, Kazakhstan, and Turkmenistan), high oil prices since 2000 helped shore up fiscal balances, reduced interest-rate risk, and, combined with structural reforms, notably in the Russian Federation, improved business sentiment. For example, rising investor confidence resulted in a doubling of international lending flows to the Russian corporate sector during 2003. The primary policy challenge for the oil-rich countries of the CIS is to broaden the capacity and efficiency of sectors outside of oil and gas, and to prepare for lower oil prices in the future. Although the medium-term outlook suggests relatively high oil prices—$26 a barrel in 2004 and $23 in 2005—the secular trend in price remains downward, and sudden sharp declines will remain a risk factor.

Strong growth in South Asia with intensified financial links

Led by buoyant growth in India (accounting for 75 percent of regional GDP), South Asia achieved a GDP advance of 6.5 percent in 2003, a sharp pickup from the 4.3 percent registered in 2002 (table 1.6). Domestic demand provided the impetus for growth during the year—with the contribution of consumption to regional GDP growth ratcheting

Table 1.6 Growth in South Asia, 1991–2006
Percentage growth rates, points, ratios

	1991–2000	2000	2001	2002	2003e	2004f	2005f	2006f
Real GDP growth	5.2	4.2	4.7	4.3	6.5	7.2	6.7	6.5
Contribution to growth (points)								
Private consumption	2.9	1.9	3.2	2.4	4.0	4.0	3.7	3.6
Fixed investment	1.3	1.1	0.8	1.9	2.7	2.7	2.6	2.5
Net foreign balance	−0.1	1.7	0.6	1.7	0.8	0.2	0.1	0.3
Current account balance (share of GDP)	−1.5	−0.7	0.5	1.4	0.7	0.5	0.3	0.3
Fiscal balance (share of GDP)	−11.0	−9.1	−8.5	−9.7	−9.3	−9.1	−8.9	−8.6
Memo items: real GDP growth								
South Asia excluding India	4.4	5.1	3.1	3.4	5.4	5.9	5.8	5.7

Note: e = estimate; f = forecast.
Source: World Bank staff estimates.

up from 2.4 percentage points in 2002 to 4 points in 2003, and that of fixed investment from 1.9 to 2.7 points. In Pakistan, government consumption was sustained at low double-digit rates supported by foreign assistance flows. Relief from drought was an important element in the region's growth picture during the year, as rural incomes and consumption rebounded sharply. Yet acceleration in domestic demand was also tied to intensified inflows of international funds. Workers' remittances to the region—which increased from $13 billion in 2001 to $17 billion during 2002, and further to $18.2 billion in 2003—have been key contributors to the vibrancy of private consumption. FDI, still negligible a decade ago, increased to $5.1 billion in 2003 from $4.1 billion the preceding year. And portfolio equity flows jumped to $7 billion from $1 billion in 2002. These signs of increased international confidence—India, for the first time, was upgraded to investment-grade status—provided support for recovery in domestic investment. And South Asia's exports of goods and services—led by a 25 percent rise in Pakistan, in part due to an expansion of textile exports—continued the double-digit gains begun in 2002, enabling countries to import at a similar pace without substantial deterioration of external balances.

Sources of growth for South Asia are likely to become more diversified—with burgeoning services exports from locations such as Bangalore, India, and the growing practice of outsourcing from the OECD economies. Peace talks between India and Pakistan, coupled with the regional trade initiatives of the South Asian Association for Regional Cooperation may further boost international confidence. Grounded in these developments, the strength of the South Asian economy is anticipated to endure, with output rising to peak growth of 7.2 percent in 2004, followed by a degree of moderation. To maintain an accelerated pace of growth, however, policymakers face several challenges. Inflexibility in labor markets, weak bankruptcy frameworks, and infrastructure bottlenecks remain a constraint to economic performance and international competitiveness. And the impending phaseout of the international multifiber arrangement in 2005 poses a challenge, especially for the smaller countries of South Asia. But the principal policy challenge is India's large general government deficit of more than 10 percent of GDP, which threatens to push up interest rates while crowding out private investment and limiting policy options. Fiscal consolidation has reduced deficits in Sri Lanka, while Bangladesh, Nepal, and Pakistan have considerably smaller deficits—though in these countries as well, further consolidation would protect the economies from potential downside risks.

Growth in East Asia propelled by China and the high-tech upturn

The developing countries of East Asia and the Pacific are leading the global turnaround in investment, with an 18.6 percent advance in capital spending in 2003 (table 1.7). Capital formation has underpinned GDP growth, which accelerated to 7.7 percent last year, up from 6.7 percent in 2002 and 5.6 percent the year before. Healthy investment spending was supported by sanguine financial-market sentiment, which translated into lower interest-rate spreads and a partial revival of portfolio flows. FDI flows, on the other hand, have been slow to rebound, except in China. East

Table 1.7 Growth in East Asia and Pacific, 1991–2006

Percentage growth rates, points, ratios

	1991–2000	2000	2001	2002	2003e	2004f	2005f	2006f
Real GDP growth	7.8	7.2	5.6	6.7	7.7	7.4	6.7	6.3
Contribution to growth (points)								
Private consumption	3.6	3.5	2.5	2.7	3.1	3.0	3.7	3.5
Fixed investment	2.9	3.2	3.2	4.3	6.4	4.3	2.5	3.0
Net foreign balance	0.3	−0.2	−0.5	0.8	−0.1	−1.0	−0.5	0.2
Current account balance (share of GDP)	0.4	3.4	2.5	3.6	2.7	2.0	1.4	1.4
Fiscal balance (share of GDP)	−1.0	−3.3	−3.3	−3.4	−2.9	−3.1	−2.9	−2.7
Memo items: real GDP growth								
East Asia & Pacific excluding China	4.7	5.8	2.4	4.4	5.0	5.9	6.5	4.9

Note: e = estimate; *f* = forecast.
Source: World Bank staff estimates.

Asian industrial production and export growth—up 20 percent for the year—benefited smartly from the upturn in global demand for high-tech products.

The engine of regional growth continues to be China, both through its direct impact on aggregate GDP (amounting to two-thirds of the region) and, increasingly, as an important export market for other regional economies. China's output grew by 9.1 percent in 2003, with capital spending up 23 percent and trade flows rising 35–40 percent. It is likely that during 2003, exports from the rest of East Asia to China overtook—for the first time—exports from these economies to Japan. This development is offsetting some concerns among East Asian countries about competitive pressures from Chinese exports in third markets.

Robust near-term momentum in world high-tech demand, healthy gains in East Asian rural incomes due to higher prices for agricultural commodities, and improving balance sheets of banks and corporations in several postcrisis economies should prove sufficient to sustain stronger growth (74 percent) in 2004. Yet output gains are forecast to moderate over the period to 2006, as cyclical highs may indeed have been reached in late 2003. And there are further risks to the generally buoyant view. On the domestic front, the ability to restrain credit creation, to monitor developments in specific sectors in danger of overheating, and to foster improved political stability could prove challenging for policymakers. In the international context, risks stemming from efforts to reverse the U.S. current account deficit, volatile exchange-rate movements, and rising protectionist tendencies could adversely affect the region's prospects. Capital inflows are contributing to a substantial accumulation of foreign reserves above conventional benchmarks, and in turn to a strong expansion of domestic credit, with implications for potential overheating in already fast-growing economies. Strengthened financial-sector regulation and supervision, in addition to greater exchange-rate flexibility, among other responses, could help mitigate risks from credit expansion and runaway growth. Against this background, and with robust GDP outturns, policymakers in China are seeking to prevent overheating and to engineer a soft landing from the current investment boom.

Sub-Saharan Africa—continuing to lag

In contrast with accelerating growth in other developing regions, GDP growth in Sub-Saharan Africa slowed to 2.4 percent in 2003 from 3.3 percent in 2002 (table 1.8). However, these aggregate developments mask divergent trends. The West African energy sector continued to boom, thanks to resilient oil prices and strong investor interest, although linkages to other sectors of these economies remain weak. With steady new discoveries of oil reserves, African oil accounts for a growing share of global production (figure 1.10). In many other countries, however, adverse weather conditions dampened agricultural production and slowed domestic demand, while a falloff in export growth, due to sluggish conditions in Europe, caused a compression of imports. In South Africa, export growth was further restrained by sharp appreciation of the rand in response to higher gold prices and tighter monetary policy to curb inflation. The

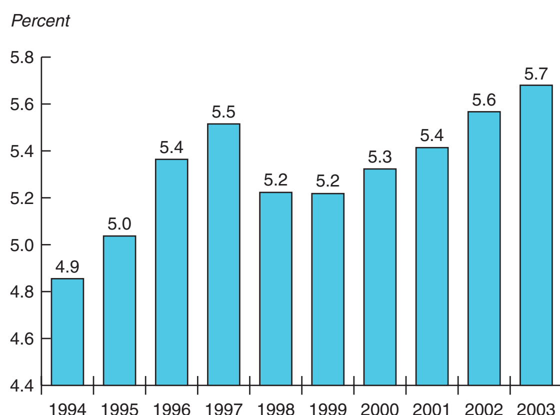
Table 1.8 Growth in Sub-Saharan Africa, 1991–2006

Percentage growth rates, points, ratios

	1991–2000	2000	2001	2002	2003e	2004f	2005f	2006f
Real GDP growth	2.2	3.1	3.1	3.3	2.4	3.4	4.2	3.9
Contribution to growth (points)								
Private consumption	1.3	0.4	2.2	2.3	1.5	1.9	2.1	2.3
Fixed investment	0.6	0.7	1.4	1.3	1.1	1.2	1.0	0.9
Net foreign balance	−0.3	0.5	−0.7	−0.9	−0.9	0.5	0.8	0.6
Current account balance (share of GDP)	−1.9	−0.1	−2.6	−2.5	−2.6	−3.8	−3.5	−3.0
Fiscal balance (share of GDP)	−3.7	−0.4	−1.3	−2.3	−2.6	−2.1	−1.9	−1.8
Memo items: real GDP growth								
Oil exporters	2.1	4.0	3.0	4.0	3.8	3.8	4.8	4.4
Excluding oil exporters & South Africa	3.0	2.0	3.8	2.7	2.5	4.6	4.7	4.5

Note: *e* = estimate; *f* = forecast.
Source: World Bank staff estimates.

Figure 1.10 Sub-Saharan African oil production as a share of world oil production, 1994–2003



Source: World Bank data.

volatility of domestic performance across Africa is reflected in international capital flows to the region, with the stock of debt fluctuating around $210 billion, roughly equivalent to two-thirds of GDP. Net flows of long-term debt, either negative or slightly positive over the 1998–2001 period, increased by 0.4 percent of GDP in 2002 and 1.5 percent in 2003. Portfolio equity contracted from a net inflow amounting to 2.8 percent of GDP in 1999, to a net outflow of 0.1 percent of GDP in 2002, before rallying somewhat in 2003. And FDI inflows appear to have narrowed slightly from 2.3 percent of GDP in 2002 to 2.1 percent in 2003.

Over the next two years, the region should be able to maintain GDP growth at over 4 percent. For non-oil-producing countries, currency realignments and increased demand should continue to support global commodity prices, while oil prices are expected to moderate but to remain at still high levels relatively. This would imply regional per capita income growth of 1.4 percent in 2004 and near 2 percent thereafter, compared to 0.5 percent per year for the previous 10 years. Significant structural reforms—in addition to good weather and greater political stability—are needed to achieve this potential. The downside risks to these projections are large and multiple. Intractable problems of disease and poor infrastructure will persist over the forecast period, and while policy is moving broadly in the right direction, investment risks remain high and business environments generally poor. Taxation, labor laws, and excessive regulation have been identified as particular problems (World Bank 2003b). Finally, despite genuine progress in resolving some of the region's most egregious civil conflicts (Angola and Liberia), the situation in the Democratic Republic of Congo, Somalia, Sudan, and Zimbabwe remains unstable.

Buoyant oil sector boosts growth in the Middle East and North Africa

Despite severe disruption in the Middle East and North Africa—tied in large measure to the Iraq conflict—GDP growth jumped from 3.3 percent in 2002 to 5.1 percent in 2003, the strongest economic performance since 1991 (table 1.9). Underpinning the advance was a sharp upturn in growth for the region's oil-exporting economies, to 5.7 percent from 3.6 percent during 2002. Higher

Table 1.9 Growth in the Middle East and North Africa, 1991–2006

Percentage growth rates, points, ratios

	1991–2000	2000	2001	2002	2003e	2004f	2005f	2006f
Real GDP growth	3.3	4.4	3.5	3.3	5.1	3.7	3.9	4.0
Contribution to growth (points)								
Private consumption	1.2	1.8	2.6	1.8	1.0	1.7	1.8	1.6
Fixed investment	0.8	0.7	1.3	0.2	2.3	0.9	1.2	1.0
Net foreign balance	1.1	1.6	−0.1	−1.2	0.6	0.6	0.2	1.3
Current account balance (share of GDP)	−1.7	7.1	4.4	4.6	4.2	2.6	2.0	2.8
Fiscal balance (share of GDP)	−1.5	−1.1	−1.9	−2.9	−1.1	−3.3	−3.3	−3.0
Memo items: real GDP growth								
Resource poor, labor abundant countries	3.8	3.8	4.5	2.9	4.2	3.9	4.2	4.3
Resource rich, labor abundant countries	3.5	4.4	4.0	5.7	5.9	5.0	4.8	5.0
Resource rich, labor importing countries	3.2	6.2	2.0	1.1	4.7	2.6	2.7	2.8

Note: e = estimate; f = forecast.
Source: World Bank staff estimates.

oil prices and a ramp-up in crude oil production provided substantial revenue gains, supporting increased public current and capital spending. A pickup in growth among the diversified exporters (from 3 to 3.9 percent in the year) reflected a rebound from severe drought in the Maghreb, including a strong 6.0 percent advance in Tunisia from 1.7 percent in 2002, which additionally reflected a pickup in its tourism. Other countries—the Arab Republic of Egypt, Jordan, and the Syrian Arab Republic—witnessed a stabilization or moderate slowing of output. Despite security tensions throughout the year, capital spending expanded by 10 percent, providing a 2.3 percentage point fillip to growth in 2003, up from 0.2 points during 2002. Robust advances were made in Algeria, the Islamic Republic of Iran, and Saudi Arabia, supported by rising petroleum revenues. Soaring oil receipts maintained the region's aggregate current account surplus near $25 billion, or 4.2 percent of regional GDP.

The regional outlook hinges on international and domestic developments affecting groups of countries in the heterogeneous region. As crude-oil production is scaled back once again (with OPEC quota reductions expected in 2004), growth among key oil exporters is expected to ease to 3.7 percent in 2004 and to maintain a similar pace of expansion through 2005. Current account surpluses should remain sizeable, however, providing resources that could be effectively channeled toward structural reforms. In the case of Iraq, however, the continued recovery in oil production will support the recovery in GDP growth, as the interim government focuses on building capacity for essential services, reconstruction, and job growth with the assistance of international donors. The softening of growth among the economies of the resource-rich and labor-importing countries (Gulf Cooperation Council), in particular, should be more than offset by firming activity among the more diversified economies, as well as continued strong growth among the resource-rich, labor-abundant countries of the region—notably Algeria and the Islamic Republic of Iran. Gradual recovery in Western Europe will be critical in stimulating exports from the Maghreb, as well as enhancing prospects for tourism and remittance revenues across the region. The balance of these factors suggests that regional growth should achieve 4 percent by 2006.

This outlook requires enduring efforts toward structural reform. Oil producers must manage volatile oil revenues (box 1.5). Others must reduce their reliance on the public sector. Many of the region's countries have initiated measures to support expansion of the private sector and trade in an effort to improve growth prospects. Investment reforms and gradual opening of economies to trade have been pursued to varying degrees in Jordan and Tunisia, two early reformers, and in the Arab Republic of Egypt and Morocco, as well as in the resource-based economies of Algeria and the Islamic Republic of Iran. Among other initiatives, countries have been pursuing strengthened trade ties with Europe through the Euro-Med trade agreements, while intraregion trade is being promoted through the Pan Arab Free Trade Area. While gains have been achieved, reforms targeted at the investment climate and at trade have lagged in comparison to other developing regions. Geopolitical tensions form the principal backdrop of risk to the outlook, which may threaten steps toward freer trade and constrain the free movement of labor and, in turn, worker remittances.

A return to growth in Latin America and the Caribbean

Growth recovery in the region has been slow, partly due to uneven performance across countries. Regional GDP advanced by 1.3 percent in 2003, following contraction of 0.6 percent during 2002. Excluding countries recovering from acute crises, such as Argentina, Uruguay, and República Bolivariana de Venezuela, the strongest performers were in the Andean group, where Chile, Colombia, and Peru recorded growth above 3 percent for the year.

Diverging patterns have also been recorded for the Caribbean and Central American country groups. Recent growth performance and prospects are below average for the former group, whereas a positive 3.1 percent growth rate was achieved by Central America in 2003 and, thanks to the recently signed CAFTA agreements, sustained economic growth in a 3 percent range is expected for the near future. In contrast with the situation in other developing regions, output gains in Latin America and the Caribbean relied more on stronger net exports in 2003, which contributed 1 percentage point to growth. Domestic demand provided a net drag on regional dynamics, as both

Box 1.5 The benefits and hazards of oil funds

Pitfalls of oil funds—

The ability of oil-and-gas-exporting economies to effectively use export revenues as catalysts for stronger economic growth and poverty reduction has been, at best, mixed. Several factors play a role:

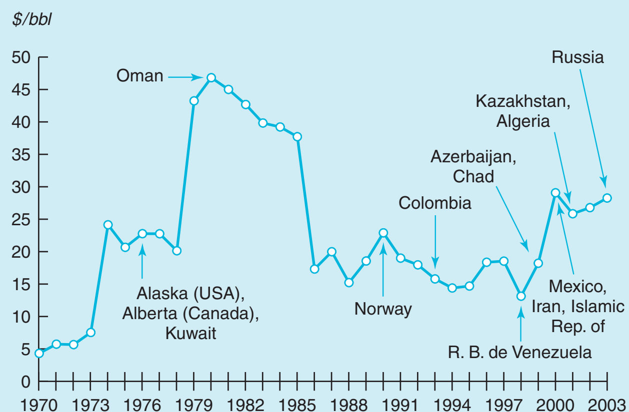
- Windfall profits and high export revenues in times of high oil prices damage prospects in other tradable sectors because of real exchange-rate appreciation: the so-called Dutch disease.
- Energy-based revenues are volatile and unpredictable. Because government budgets depend heavily on the oil revenues, such volatility can easily lead to fiscal instability.
- Energy resources will eventually become exhausted. The prospect does not create a natural investment climate for long-term sustainable development.

—can be managed

Oil funds, delinked from the current budget and invested abroad, potentially help alleviate these problems. Further, compared to the imbalances associated with petrodollar recycling during the 1970s, creation of oil funds suggests improvement in the management of oil rents. Delinking the volatile part of oil revenues from current budgets contributes to fiscal stability. By investing oil revenues abroad, instead of spending them domestically, the hazards of exchange-rate appreciation can be mitigated in the event of temporarily high oil prices. Long-term funds may help prepare a country for the depletion of resources. They are usually administered separately from other government accounts, and without the protections of adequate transparency, good governance, and institutional controls, these funds can be subject to the influence of the politically powerful. At the extreme, this can mean outright theft, but a more common danger is raiding the funds to finance current expenditures without necessary checks and balances. Therefore, complete transparency and clear rules guiding contributions and withdrawals are needed if the funds are to be a catalyst for long-term growth.

Given the potential benefits, an increasing number of oil exporters have created some form of oil fund, particularly since the 1990s. This trend partly reflects the relatively recent firming of oil prices since 1998 and the subsequent need to manage windfall revenues. Several countries have adopted oil funds as part of a broader effort to reorganize and revitalize their hydrocarbon sectors and to make the transition from centrally planned systems (figure), and new oil exporters are emerging, for example Kazakhstan.

Price of oil and the creation of oil funds in selected countries, 1970–2003



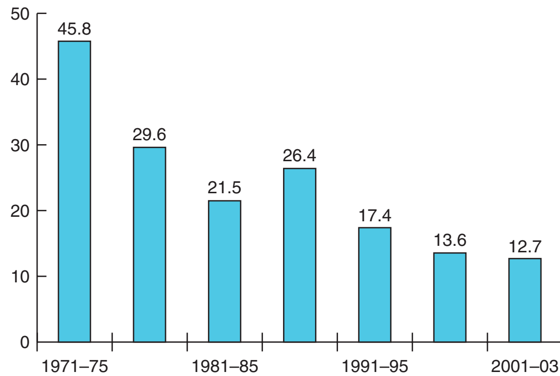
Source: Davis 2001.

private consumption and fixed investment sapped 0.2 percentage points from GDP growth. During the first three quarters of 2003, export growth outpaced that of imports for most countries, while trade surplus positions became common.

In the continuing process of adjustment after financial difficulties, Latin American domestic spending was dramatically curtailed, cutting the aggregate current account deficit from $53 billion in 2001 to $2.6 billion by 2003. In mirror image, net financial-resource flows into the region dropped sharply over the period from a peak of $138 billion in 1998 to $38 billion in 2002—or from 6.9 percent of GDP to 2.3 percent—the largest swing for any region. Flows stabilized at an estimated $46 billion in 2003. The evolution of financial flows reflects a weakening in FDI inflow from 5 percent of GDP in 1998 to just over 2 percent in 2003, due to the end of the privatization boom and the economic difficulties in Brazil and Argentina. Net flows of long-term debt declined from 3.2 percent of GDP in 1998 to an outflow

Figure 1.11 Volatility of export growth in Latin America and the Caribbean, 1971–2003

Standard deviation of monthly growth rates for five-year periods (%)



Source: World Bank staff estimates.

equivalent to 0.6 percent in 2002, before turning slightly positive again in 2003.

With recovery now seen to be broadening, especially after gaining traction in Brazil and Mexico during late 2003, GDP growth for the region is expected to advance by 3.8 percent in 2004 (table 1.10). As domestic demand revives, import growth is likely to grow in step. With prudent fiscal policies, significant deterioration of external accounts should be avoided. Fundamental underpinnings for recovery include improved macroeconomic management that has reined in inflation across the region; a decades-long pursuit of outward-oriented development strategies that has not only altered the level of trade flows but also reduced the volatility of export earnings; and more competitive and flexible exchange-rates (figure 1.11). The policy challenge is to target a sustainable pace of growth—especially by addressing the important structural issue of improving productivity growth—and to avoid temptations to overborrow in the context of the weaker dollar and lower interest-rate spreads. Indeed, the principal risk to the outlook for Latin America is a sudden rise in international interest rates.[1]

Advanced-economy policies and the outlook for development finance

There have been various forces behind the current global recovery. Rationalization and balance-sheet consolidation by the private sector have occurred against the backdrop of an acceleration of growth in Asia and technological advances that have underpinned high productivity gains. In addition, aggressive macroeconomic policy responses by high-income countries have been important in improving the external financing conditions of developing countries. However, the current macroeconomic policies in advanced economies are not sustainable in the long term, and there needs to be adjustment towards more balanced global economic growth and more sustainable financing of existing current account imbalances.

How the current imbalances are resolved will have a critical bearing on the availability of finance for developing countries. The nature and timing of this adjustment will depend on several related factors: the speed with which economic activity picks up in the rest of the world—particularly the Euro area; the success of policymakers in

Table 1.10 Growth in Latin America and the Caribbean, 1991–2006

Percentage growth rates, points, ratios

	1991–2000	2000	2001	2002	2003e	2004f	2005f	2006f
Real GDP growth	3.4	3.7	0.3	−0.6	1.3	3.8	3.7	3.5
Contribution to growth (points)								
Private consumption	2.7	2.5	0.4	−1.4	−0.1	2.4	2.4	2.1
Fixed investment	0.8	0.6	−0.5	−1.3	−0.2	1.3	1.2	0.9
Net foreign balance	−0.3	−0.7	0.4	1.9	1.0	−0.1	0.3	0.1
Current account balance (share of GDP)	−2.8	−2.3	−2.8	−0.9	−0.2	−0.5	−0.9	−1.0
Fiscal balance (share of GDP)	−8.6	−3.0	−2.9	−3.0	−2.4	−1.4	−1.1	−1.2
Memo items: real GDP growth								
Central America	4.5	3.2	1.9	2.0	3.1	3.1	3.0	2.9
Caribbean	4.3	5.8	2.7	3.0	0.5	0.8	2.9	3.0

Note: e = estimate; *f* = forecast.
Source: World Bank staff estimates.

facilitating orderly adjustments in exchange rates; the continued willingness of private investors—and official institutions—to finance existing current account imbalances without sharp adjustments in asset prices and exchange rates; and the willingness of policymakers to reevaluate stimulative policies as the recovery in activity gathers strength. A gradual tightening of fiscal policies in high-income countries—particularly in the United States—could contribute to an orderly resolution of the current imbalances and stability in the flows of capital to the developing world.

Note

1. When on January 27, 2004, the U.S. Federal Reserve Board noted that increases in interest-rate spreads had made many Latin American economies more vulnerable, currencies depreciated and stock markets fell, reversing the steady improvements of 2003.

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