Regional Annexes for the Prospects for the Global Economy

East Asia and Pacific regional prospects

Recent developments

GDP in the East Asia and Pacific region is estimated to have increased about [8.8] percent in 2005, down from [9.1] percent the year before (table A1.1). This robust growth masks divergent performance among individual countries, with economic activity in China having grown [9.9] percent, while output in other countries increased a more moderate [5.3] percent.

In China, domestic demand slowed markedly, following the implementation of administrative controls aimed at preventing economic overheating and excessive investment in specific sectors (most of the deceleration was concentrated in the first half of the year with spending rebounding again in the second half of the year). The impact on output, however, was limited. Weaker investment and domestic consumption saw import growth slow substantially (from [22.7] percent growth in 2004 to [13.5] percent), while exports growth remained relatively robust (easing [28.4] growth in 2004 to [22.0] percent). As a result, net exports made a 4 percentage point contribution to growth and GDP slowed hardly at all. Moreover, the combination of weak imports and still robust exports, caused the country's current account surplus to rise to some [$126] billion or [6.5] percent of GDP, despite substantially higher oil prices.

Outturns for other countries in the region were mixed. Among the larger countries, growth

Table A1.1 East Asia and Pacific forecast summary
(annual percent change unless indicated otherwise)

	90–00[1]	2003	2004	Est. 2005	Forecast 2006	2007	2008
GDP at market prices (2000 USD)[2]	8.4	8.8	9.1	8.8	8.3	8.2	8.1
GDP per capita (units in USD)	7.2	7.9	8.2	7.9	7.4	7.4	7.2
PPP GDP[3]	8.5	8.8	9.1	8.9	8.4	8.3	8.1
Private consumption	7.3	6.1	7.1	5.9	5.8	6.4	6.4
Public consumption	8.0	5.3	4.7	6.0	5.3	6.1	6.3
Fixed investment	10.1	17.1	8.7	5.4	9.7	9.7	8.5
Exports, GNFS[4]	11.7	18.0	22.2	16.2	13.9	13.6	13.5
Imports, GNFS[4]	11.3	17.1	20.5	11.7	13.6	14.3	13.4
Net exports, contribution to growth	0.3	1.0	1.7	2.8	1.2	0.9	1.2
Current account bal/GDP (%)	0.3	3.6	4.0	5.4	4.7	3.9	3.1
GDP deflator (median, LCU)	6.2	2.7	3.2	4.0	5.6	4.0	3.7
Fiscal balance/GDP (%)	–1.1	–2.4	–1.7	–1.5	–1.2	–0.9	–0.8
Memo items: GDP							
East Asia excluding China	4.7	5.5	6.0	5.3	5.5	5.8	5.4

Source: World Bank.
Notes: 1. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
2. GDP measured in constant 2000 U.S. dollars.
3. GDP measured at PPP exchange rates.
4. Exports and imports of goods and non-factor services.

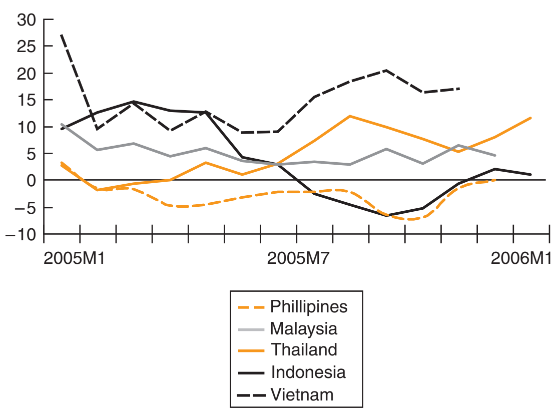
in oil producers like Vietnam and Indonesia accelerated somewhat reflecting both increased production and the spillover effects of higher revenues on domestic demand. For example, higher oil prices are estimated to have increased Indonesian GDP by 0.4 percent in 2005.

Growth among the smaller oil-importers decelerated from [6.4] to [4.8] percent, mainly reflecting a plateauing in the global high-tech cycle as well as reduced import demand from China. However, renewed strength in the high tech sector in late 2005 and a pickup in Chinese imports at the end of the year contributed to an acceleration in the exports of these countries during late 2005, early 2006 (figure A1.1). Investment in the developing economies (outside China) grew [8.4] percent, down only a bit from 2004. However, it has been relatively volatile among those developing countries most affected by the crisis, tending to pickup and decline with exports.

While higher oil prices have cut into incomes and doubtless contributed to the slowing of private consumption, the region has been surprisingly resilient to the shock. The regional current account balance actually improved, mainly reflecting reduced imports in China and increased Vietnamese and Indonesian oil revenues. China, Indonesia and Malaysia continue to enjoy current account surpluses. Of the larger countries in the region only Thailand saw its current account balance deteriorate significantly (by more than 3 percent of GDP). However, at –0.9 percent of GDP it is not a source of immediate concern.

Figure A1.1 Signs of a recovery in export growth

3-month moving average of monthly growth in merchandise export volumes, selected countries



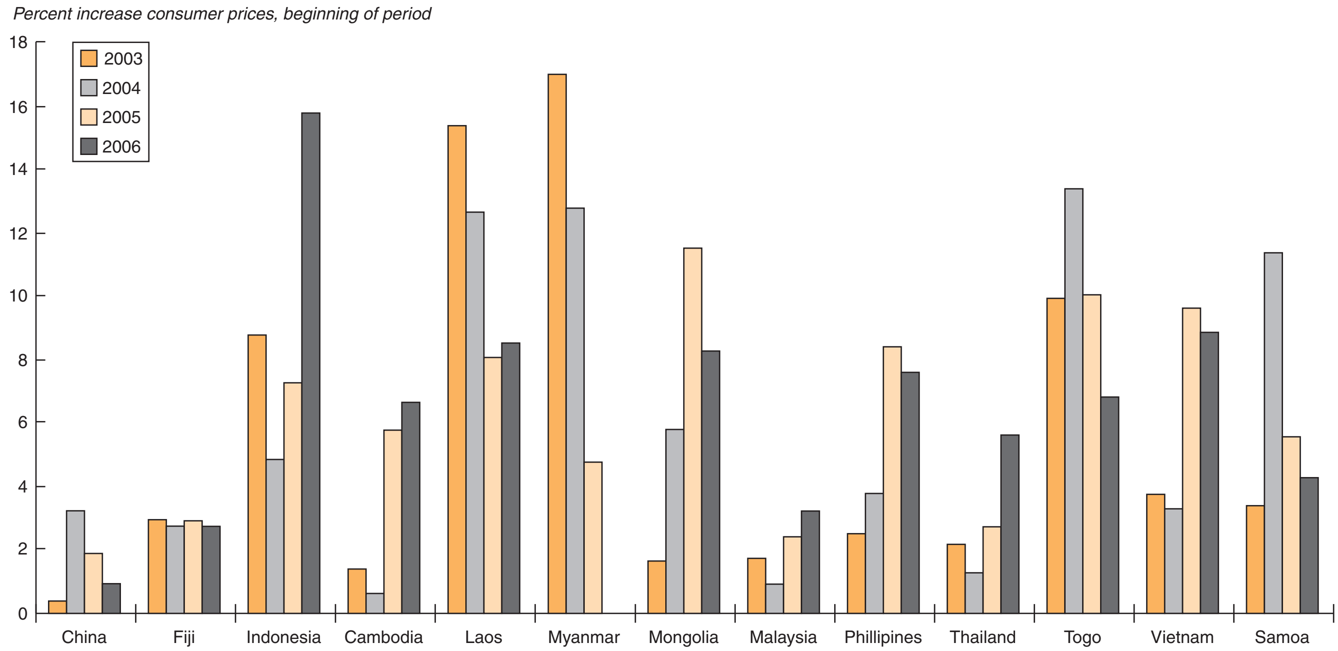
Source: World Bank.

Despite higher oil prices, aggregate inflation in the region remains stable and actually declined somewhat in the course of 2005 and the first quarter of 2006. However, inflation has gained momentum in several countries, including Cambodia, Indonesia, Mongolia, the Philippines and Vietnam (Figure A1.2). As a result, many countries in the region moved to tighten monetary policy in 2005. In the case of Indonesia, a decision in early 2005 to reduce the extent of costly fuel subsidies contributed to a fillip to inflation. However, it should pay dividends by reducing economic distortions and strengthening the government's fiscal position. Moreover, encouraging consumers and firms to adapt to a world of more costly oil prices should improve macroeconomic stability and growth in the medium term.

International bank-lending to the region and short term capital inflows declined sharply in 2005, reflecting a narrowing in interest rate spreads between East Asia and the United States and movements towards greater exchange rate flexibility in China and Malaysia. These last two measures in particular reduced short term speculative capital inflows that had been banking on large capital gains from a revaluation of these currencies. Vietnam successfully completed its first international bond issuance in October 2005, raising 750 million United States dollars at some 250 basis points above the comparable US ten-year treasuries. Although this spread is higher than that of China or Malaysia, it is lower than that of Indonesia or the Philippines. The yield on the bonds is expected to serve as a benchmark for other Vietnamese corporations seeking to access international capital markets. Indonesia also floated a $2 billion international bond issue in March 2006, its largest ever.

The April 2006 decision by the Chinese authorities to partially liberalize its capital account,[1] coupled with the summer 2005 decision to appreciate against the dollar and to manage value of the renminbi with respect to a basket of goods are positive steps towards a more flexible exchange rate regime. Following the initial 2 percentage point appreciation vis-à-vis the dollar, the Chinese currency has appreciated a further [1.2] percent. Taken together these events reduce the risk of speculative 'bubbles' in developing Asian financial markets and the unsustainably large capital inflows that preceded the 1997–98 financial crisis.

Figure A1.2 An uptick in inflation in some countries



Source: World Bank.

Medium-term outlook

Output in the region is projected to slow only modesty over the next three years, from [8.8] percent in 2005 to about [8.2] percent in 2008. Most of the slowdown reflects an easing of China's very strongly export-led growth. Excluding China, regional GDP is actually projected to pick up a bit in 2006/7 before returning to around [4.4] percent in 2008.

A decline in the transitional boost to trade associated with China's accession to the World Trade Organization is expected to moderate export growth in China even as import demand accelerates following a very weak year 2005, largely on the basis of rising consumer demand and investment. The combination of weaker exports and strong imports should be reflected in a gradual but significant reduction in China's current account surplus. Stronger Chinese exports, plus a projected upturn in world demand for the region's exports, notably high-tech goods,[2] are expected to boost export growth among smaller countries in the region. In addition, Vietnam's expected adhesion to the WTO in 2006 should provide a further fillip to regional export growth. Already regional exports exceed $1.3 trillion (almost $500 million excluding China) and the region's share of trade in GDP is the highest in the world.

Because of this strong export performance the current account balances countries in the region other than China are projected to improve by about 0.2 percent of GDP by 2008—despite even higher oil prices. While high oil prices are expected to increase regional inflation to around [5.2] percent in 2006, prudent monetary policy, flexible markets, productivity increases, and the continued migration of workers from the farm to the factory setting should keep wages and inflation in check.

Risks and policy challenges

This relatively benign outlook is subject to significant risks. Critical among these are global imbalances, both the potential consequences if these resolve themselves in a disorderly fashion but also the possibility that failure to resolve them results in a build-up of protectionist sentiment. In this regard, recent steps towards increased exchange rate flexibility and stimulate domestic demand in China are helpful. However, more may need to be done to ensure that China is seen as contributing to a resolution of these imbalances, especially in the light of its very large [6.5] percent of GDP current account surplus in 2005.

Managing China's very fast growth represents a further challenge both for China and the region. As the market plays an ever increasing role in developments in the Chinese economy, the authorities will need to increasingly rely upon market mechanisms for its control. The large oscillations in investment and import demand observed during 2005 (and their consequences for countries elsewhere in the region) are indicative of the limitations of administrative techniques.

Over the longer term, developments in the region will continue to be dominated by countries' domestic reform efforts and the regions emergence as the world's light-manufactures workshop. While associated improvements in resource allocation are already visible, the large changes involved will place important strains on most regional economies. Chief among these will be high job turnover and increasing urbanization, as economies adapt to new export opportunities and changing comparative advantage. Unfortunately, most countries in the region lack unemployment insurance or reliable minimum safety nets, and infrastructure remains in short supply. For example, in a recent investment climate survey, more than 1300 firms in Thailand indicated that infrastructure services, regulatory burden, and skills are the main factors inhibiting investment and productivity growth in the country.

While China has seen an impressive boom in investment, investment (and growth) among those countries affected by the dotcom crash has been relatively volatile and sluggish. Here, structural reforms that improve the investment climate by increasing the transparency and predictability of government policies, by simplifying business regulations, by improving cost effective delivery of infrastructure and logistics services, and by strengthening institutions that upgrade worker skills are key. Financial market instruments such as local government bonds, corporate debt, asset securitization, and venture capital funds have seen strong growth since the crisis. These could be further fostered by reforms that strengthen market infrastructure, raise accounting and auditing standards, and rationalize the policy, legal, and regulatory frameworks for these types of markets. Ongoing efforts to strengthen insolvency laws and foreclosure practices remain particularly important. Reforms to strengthen public-sector governance could significantly improve the state's ability to deliver key public goods and services.

Europe and Central Asia regional prospects

Recent developments

GDP in Europe and Central Asia expanded [5.5] percent in 2005, the fourth consecutive year since 2002 that regional growth exceeded 5 percent (table A1.2). Regional oil-exporters led the way, growing [7.1]

Table A1.2 Europe and Central Asia forecast summary
(annual percent change unless indicated otherwise)

	90–00[1]	2003	2004	Est.2005	Forecast 2006	Forecast 2007	Forecast 2008
GDP at market prices (2000 USD)[2]	–0.9	5.9	7.2	5.7	5.5	5.4	5.1
GDP per capita (units in USD)	–1.0	6.0	7.3	5.7	5.5	5.4	5.1
PPP GDP[3]	–1.9	6.3	7.4	5.7	5.5	5.4	5.1
Private consumption	0.5	6.2	8.3	7.4	6.8	6.5	6.4
Public consumption	0.0	2.0	2.3	2.8	2.8	2.9	2.8
Fixed investment	–6.2	9.1	12.7	10.1	8.9	9.3	8.6
Exports, GNFS[4]	1.5	11.6	13.4	8.6	9.2	9.1	9.2
Imports, GNFS[4]	–0.9	14.6	17.7	10.8	11.2	11.2	11.2
Net exports, contribution to growth	0.9	–0.8	–1.6	–1.0	–1.1	–1.3	–1.4
Current account bal/GDP (%)	–1.1	–0.1	0.3	1.2	1.9	1.4	0.6
GDP deflator (median, LCU)	129.7	3.6	5.1	5.7	5.7	4.7	4.4
Fiscal balance/GDP (%)	–6.1	–2.8	–1.8	0.5	0.0	–0.6	–1.3
Memo items: GDP							
Transition countries	1.8	4.7	6.7	5.0	5.0	4.9	4.8
Central and Eastern Europe	1.0	4.2	5.6	4.5	4.9	4.9	4.7
Commonwealth of Independent States	–4.4	7.8	8.0	6.7	6.3	6.0	5.4

Source: World Bank.
Notes: 1. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
2. GDP measured in constant 2000 U.S. dollars.
3. GDP measured at PPP exchange rates.
4. Exports and imports of goods and non-factor services.

percent, almost as fast as in 2004. In contrast, output in oil-importers expanded a more modest [4.9] percent, significantly slower than the [7.1] percent increase they recorded in 2004. The expansion slowed in the Central Eastern Europe sub-region from [6.0] to [4.5] percent, and in the Commonwealth of Independent States from [8.5] to [6.4] percent.

Growth among regional oil exporters reflected very strong domestic demand as high oil revenues boosted private consumption, public spending and investment. In Russia, domestic demand expanded by more than [10] percent for the second year in a row. Output increased less rapidly ([6.2] percent), because capacity constraints in the oil sector slowed export volumes, while imports grew rapidly as domestic supply could not keep up with domestic demand. Demand followed a similar profile in Kazakhstan, with economic activity expanding [9.4] percent. GDP increased [26] percent in Azerbaijan driven by oil-related investments and exports. Overall, import volumes increased twice as quickly as exports. As a result, despite a [41] percent increase in oil prices, the current account surplus of regional oil exporters improved only marginally reaching [10.1] percent of GDP.

Overall, macroeconomic policy contributed to strong demand. Government spending increased substantially, although because oil-related revenues also increased rapidly government balances in these countries improved further. Some steps have been taken to tighten monetary policy, including efforts by Russian authorities to sterilize oil revenues in excess of $28 a barrel. Nevertheless, inflation picked up, averaging 12.7 percent in Russia and 7.9 percent in Kazakhstan in 2005 before easing somewhat early in 2006.

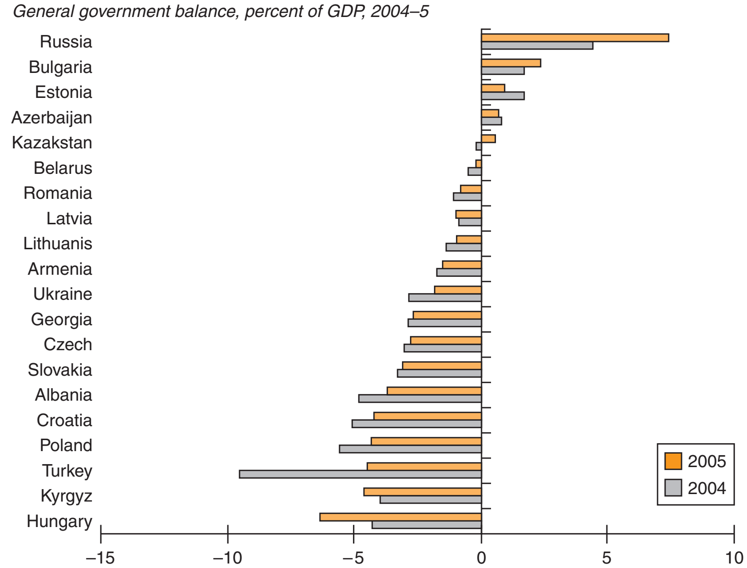
Among regional oil-importers, robust demand from regional oil exporters, favorable credit conditions, and continued integration with the economies of western Europe[3] helped to offset the negative impacts of higher oil prices. Nevertheless, growth slowed from [7.1] percent in 2004 to [4.9] percent. Much of this slowdown reflects a sharp slowdown in three of the largest economies in this grouping (Poland, Turkey and the Ukraine). Weaker consumption growth in the case of Poland and slower investment growth in Turkey saw output growth decline by slipped by more than two percentage points in each country. Political uncertainty in the Ukraine led to a deceleration in investment growth. This, coupled with a decline in export earnings, following the collapse in world steel in 2005 (due to an increase in the supply of steel from China) resulted in a sharp deceleration in growth from [11.5] percent in 2004 to [1.3] percent in 2005. Growth among the smaller oil-importers (excluding these three countries) slowed only somewhat last year, with double-digit export growth offsetting a more marked decline in domestic demand growth. In Kyrgyz Republic, economic disruption tied to political upheaval led to a deceleration in growth in 2005 to an estimated [3.4] percent from 7.1 percent in 2004.

Some progress has been made towards fiscal consolidation, notably in Turkey, where the government deficit declined from [9.5] percent of GDP in 2004 to [4.5] percent in 2005 (figure A1.3). However, seven countries (Albania, Croatia, Hungary, Kyrgyz Republic, Poland, Slovakia, and Turkey) in the region have fiscal deficits that exceed 3 percent of GDP, and, in the Baltics and Hungary, fiscal positions deteriorated in 2005, contributing to strong demand but also risks—especially among those countries that combine large fiscal and current account deficits.

Several countries have taken advantage of low international interest rates and ample liquidity to restructure their debt. As a result, external debt as a share of GDP has declined from [54] in 2000 to an estimated [43] percent in 2005 (debt relief to

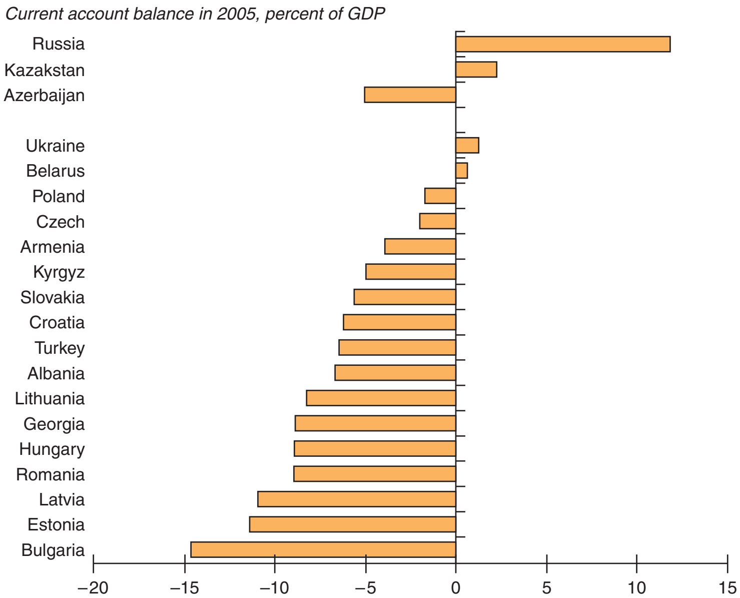
Figure A1.3 High but declining government deficits

General government balance, percent of GDP, 2004–5



Source: World Bank.

Figure A1.4 Large current account deficits



Source: World Bank.

Tajikistan in 2005 also played a role). In particular, Russia has used oil rents to prepay debt ($15bn to Paris Club and $3.3 bn to IMF in 2005).[4] In contrast, external debt / export revenues have deteriorated in a number of oil-importing countries, notably Estonia, Hungary and Latvia, where this ratio is estimated to have increased by one or more percentage points.

Generally lenient fiscal policies and strong capital inflows, including foreign direct investment attracted by privatization and market opportunities as prospects that more countries in the region joining the EU solidified, contributed to strong domestic demand and rapidly growing imports in the region. This, plus higher oil prices and increased in the prices paid for natural gas led to widening current account deficits in many of the region's oil-importing economies. Over half reported current account deficits of 5 or more percent of GDP in 2005 (figure A1.4). Overall, inflation has remained subdued among oil importers. A relatively modest pickup was, however, recorded in the Baltics, Croatia, Georgia, Kyrgyz Republic and the Ukraine.

Medium-term outlook

Regional GDP growth is projected to remain broadly stable at [5 $^{1}/_{2}$] percent through to 2007, before slowing somewhat in 2008.

Growth among oil-exporting countries in the region is projected to slow from [7.1] percent in 2005 to a still robust [5.5] percent in 2008. Rapid credit expansion and large increases in wages and pensions are projected to continue fueling double-digit growth in private consumption demand. However, a limited supply response, reflecting relatively low past investment rates and oil-sector capacity constraints, is expected to limit GDP growth. As a result, import demand is projected to outstrip exports by a wide margin, with net exports reducing GDP growth by between 2 and 2 $^{1}/_{2}$ percentage points. Moreover, these countries' aggregate current account surplus should shrink from 11 percent of GDP in 2005 to around [6] percent in 2008.

Growth in central and eastern European countries is projected to pick up somewhat in 2006, mainly reflecting a recovery in domestic demand in Poland in response to a recent easing of monetary policy. Growth elsewhere in the sub-region is projected to remain strong, buoyed by very strong credit expansion and reform efforts in the Baltics and an expected further firming of western European export demand. Rising EU transfers to new member states (expected to reach between [2.5] and [4] percent of GDP depending on the country), and continuing strong FDI inflows to countries seeking to accede to the EU are projected to partially offset a gradual decline in export demand from regional exporters. While inflation remains subdued in most countries in the sub-region, very strong domestic demand and emerging capacity constraints in the Baltics and a number of Southern European countries are expected to require a further tightening of policies.

Among oil-importing members of the Commonwealth of Independent States, growth is projected to remain broadly stable and strong at around [7] percent. The Ukraine, the largest country within this group, is expected to grow only slowly in 2006 before picking up moderately in 2007 and 2008, while output in the remaining countries is projected to slow from about [7.6] percent in 2005 to a more sustainable [5.6] percent in 2008 as the one-off effects of good harvests in Armenia and Georgia and an oil-related pickup in remittance flows ease.

Risks and policy challenges

A number of countries in the region are experiencing substantial accession-related stress that could resolve itself in a disorderly fashion. Turkey, Bulgaria and Romania have experienced strong capital inflows (initially in the form of FDI), a rapid expansion in domestic credit, rising inflation and a real effective appreciation. Monetary institutions have reacted by raising interest rates, which have somewhat counter-productively attracted additional capital inflows. While authorities have also tightened fiscal policies (substantially in some cases) more may be required to avoid a rapid correction.

Although foreign direct investment inflows are generally considered a more stable source of financing and less susceptible to reversal than financial flows that have been attracted by high interest rates, experience among other EU accession countries demonstrates that FDI flows can stop. Moreover, short-term debt inflows to these countries are large (representing [37] percent of inflows to Turkey for example). A significant change in investor sentiment towards these countries, either brought upon by concerns over the sustainability of inflated currency valuations, or some external event, such as a disorderly resolution to global imbalances (see main text), would likely provoke a significant and rapid depreciation of these currencies, temporarily raising interest rates even further, with large negative consequences for growth.

Other countries with high current account deficits, especially those new member states with large fiscal deficits, may also be at risk. To minimize the likelihood of such a turn of events authorities should tighten fiscal policy and strengthen the financial sector's ability to deal with the kind of rapid changes that might arise.

More generally, substantial current account deficits make a number of countries in the region vulnerable to higher than anticipated oil prices, or a sudden retrenchment by international investors. Risks are magnified for countries like Croatia, Estonia, Kazakhstan and Latvia, which have relatively large exposures to interest-sensitive debt. In these countries, a 200 basis point increase in U.S. interest rates and in developing country risk premia, could see their debt-servicing costs rise by as much as [3] percent of GDP.

Latin America and Caribbean regional prospects

Recent developments

GDP in Latin American and the Caribbean increased an estimated [4.4] percent in 2005, down substantially from the [6] percent growth recorded in 2004. The slowdown mainly reflects decelerations in a few large countries. In Brazil growth slowed from [4.9] to [2.3] percent in response to tight monetary policy, while in Mexico both tight monetary policy and strong competition in export markets brought GDP growth down to [2.9] percent from [4.4] in 2004. The regional slowdown also reflected sharp decelerations in Uruguay and Venezuela. Following unsustainably rapid growth in 2004 of [12.3] and [17.9] percent respectively, output in each country slowed to a still very fast [6.2] and [9.4] percent pace, respectively. Excluding these four countries, economic activity in the region picked up slightly expanding [6.7] percent.

The expansion showed signs of maturing. Strong commodity-related revenues and improved business confidence have increased the contribution of domestic demand to growth in most countries in the region. Elevated commodity prices were a particular factor in Peru's robust expansion (growth accelerated to [6.7] percent from [4.8] percent), while growth in Colombia continued to benefit from improved confidence and recent reforms. Growth in Argentina remained very strong ([9.1] percent), driven by expanding credit, negative real interest rates and strong public spending on infrastructure projects.

Somewhat surprisingly, both oil importing and oil-exporting countries in the region decelerated by about 1.5 percentage points. The strength of oil importers reflects in part the supportive role that other commodity prices have played. For Central American and Caribbean economies, higher oil prices represented a negative terms of trade shock of about 2.6 percent of their GDP (Table A1.3), but this was more than completely offset by favorable developments in the prices of their own exports. In addition, a considerable counter-cyclical increase in remittance flows towards central American countries further helped offset the negative income effect of higher oil prices.

This recent pick up in growth contrasts with the very weak aggregate performance of the region between 1998–2003, when growth averaged only [1.1] percent (figure A1.5). In part it reflects the recovery of several large countries (Argentina, Uruguay, Venezuela) from earlier crises and the emergence of an extremely favorable external environment, comprised of rapidly growing demand for the regions exports (especially oil, metals and

Table A1.3 Latin America and Caribbean forecast summary
(annual percent change unless indicated otherwise)

	90–00[1]	2003	2004	Est. 2005	Forecast 2006	2007	2008
GDP at market prices (2000 USD)[2]	3.4	2.0	6.0	4.4	4.6	4.0	3.7
GDP per capita (units in USD)	1.6	0.5	4.5	3.0	3.2	2.6	2.4
PPP GDP[3]	3.3	2.1	5.6	4.2	4.5	3.9	3.7
Private consumption	3.4	1.2	5.9	4.5	4.9	3.8	3.4
Public consumption	1.6	5.9	1.4	3.9	3.8	2.5	1.8
Fixed investment	4.6	–0.3	13.3	10.0	6.9	7.3	7.6
Exports, GNFS[4]	8.1	2.7	12.2	6.2	6.6	6.3	5.7
Imports, GNFS[4]	10.7	1.9	14.4	10.4	8.8	7.7	7.2
Net exports, contribution to growth	–0.3	0.2	–0.2	–0.9	–0.5	–0.4	–0.4
Current account bal/GDP (%)	–2.8	0.5	0.9	1.5	1.3	0.7	0.3
GDP deflator (median, LCU)	12.0	8.0	8.1	8.0	7.1	5.7	6.4
Fiscal balance/GDP (%)	..	0.0	0.2	0.0	–0.3	–1.2	–1.5
Memo items: GDP							
LAC excluding Argentina	3.2	1.0	5.5	3.6	4.0	3.8	3.7
Central America	4.5	3.6	3.7	3.7	3.4	3.3	3.0
Caribbean	4.0	3.3	2.9	6.6	5.7	5.0	4.5

Source: World Bank.
Notes: 1. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
2. GDP measured in constant 2000 U.S. dollars.
3. GDP measured at PPP exchange rates.
4. Exports and imports of goods and non-factor services.

minerals), high commodity prices and abundant liquidity in international financial markets.

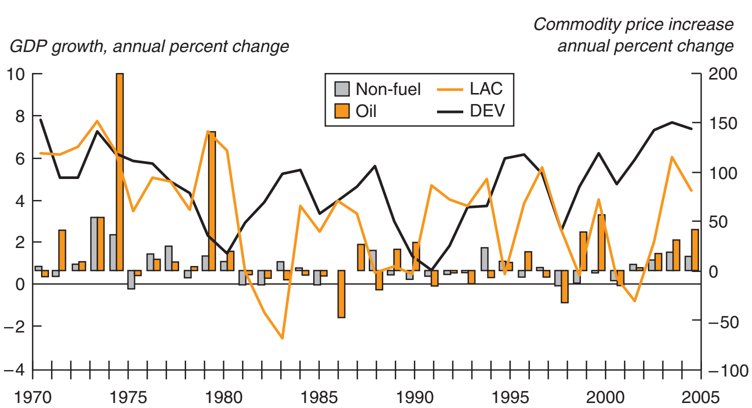
Improved macroeconomic, monetary and microeconomic policies also played a role. Lower government deficits, lower inflation, lower external debt to export ratios, and a substantially improved regional current account position have contributed, along with ample liquidity and record oil prices to reduce the sovereign risk premia and domestic interest rates in the region. In contrast to the risk premium on US 'BB' rated corporate bonds, which has increased [60] basis points since December 2004, the risk premia on Latin American 'BB' bonds has fallen 27 basis points.

Governments in the region have taken advantage of low interest rates to restructure their liabilities, retiring more expensive debts, stretching maturities and pre-financing future borrowing requirements (see Chapter 3 in the main text). The latest of these initiatives include a February 2006 announcement by Brazil, Colombia, Mexico and Venezuela to buy back about $33 billion in external debt.[5] Simultaneously countries in the region have increased the amount of debt issued in local currencies, reducing the exchange rate risk associated with their debt. Overall, the regional external debt to export ratio has declined from 195 percent in 2002 to 112 percent in 2005, further reducing countries' vulnerability to foreign exchange shocks.

Reduced perceived sovereign risk, sounder monetary and fiscal policy, and international investors' search for yield have also attracted investors towards Latin American equities (table A1.4). Several stock markets in the region have registered record returns.

Much of the improvement in fiscal balances within the region reflects windfall gains from high commodity prices and reduced debt-servicing charges due to low interest rates, debt restructuring and debt repayments. In addition, more classical cyclical factors are at play as rapid growth has

Figure A1.5 Growth in Latin America & Caribbean remains volatile



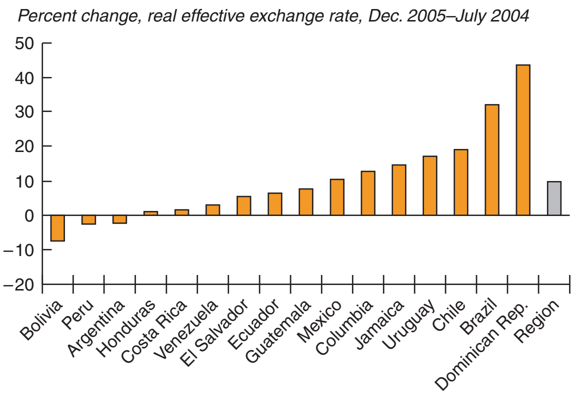
Source: World Bank.

Table A1.4 Stock market total return in dollar terms

	Percent increase (2003/5)
Colombia	741.4
Brazil	449.1
Peru	355
Argentina	322.5
Chile	255.2
Mexico	266.6
Venezuela	165.8

Source: World Bank.

Figure A1.6 Most currencies have appreciated



Source: World Bank.

contributed to rising tax revenues. Encouragingly, improved revenues have not led to an expansion in public spending to the same degree as during past boom periods. As a result, structural deficits are estimated to have improved in several countries—even though many countries have increased primary (net of interest charges) spending. Venezuela represents a notable exception. Taking spending by the state oil company into account, public spending has been strongly pro-cyclical and is estimated to have reached more than 30 percent of GDP.

Regional inflation developments are mixed. The median inflation rate for countries in the region as measured by the GDP deflator remained stable at [8] percent in 2005, while a weighted average of consumer price inflation suggested that after declining from [7.1] percent in 2003 to [4.5] percent in 2004, inflation in the region rose in 2005 reaching [5.4] percent. However, the pickup in inflation was limited to a few countries, notably Argentina where consumer prices inflation increased from [4.4] to [9.6] percent. Inflation also picked up, by one or more percentage points in Chile, Costa Rica, Guatemala, Jamaica and Paraguay. In the remaining countries inflation eased or rose only modestly. Excluding Argentina from the regional aggregate, inflation was broadly stable at about 5 percent.

The good inflation performance of most countries reflects important changes on the stance of monetary policy over the last decade. Many countries have adopted flexible exchange rates and inflation targeting. Monetary policy has been broadly accomodative, with low but positive real interest rates. Argentina and Venezuela stand out as exceptions, having pursued very loose policies, wit negative real interest rates, to boost short term growth. The resulting excess liquidity, combined with higher oil prices, has contributed to a rise of inflation of more than 10 percent in both countries.

High commodity prices (and solid export volume growth) ensured that the region's current account position improved once again in 2005, recording a [1.5] percent of GDP surplus. Even among poorer oil-dependent Central American and Caribbean countries, current account positions showed no serious deterioration (Jamaica, forming a notable exception)—in part because of increased remittance flows and strong prices for non-oil commodities, in particular sugar (see table A1.4).

This strong external performance, combined with sounder macroeconomic policies in many countries, has caused regional currencies to strengthen. Since mid 2004, virtually all regional currencies, particularly those of Brazil, Chile, Colombia and the Dominican Republic, have appreciated against a weighted average of the inflation-adjusted currencies of their trading partners (figure A1.6) without, however, appearing to affect external competitiveness adversely. Unlike past episodes of appreciation in the region, which were driven by surging capital inflows, countries have maintained and even improved their current account positions (the region as a whole is in surplus) as export revenues (and volumes) continue to grow strongly. Given this aggregate surplus, central banks have used net capital inflows to build reserves. As a result, reserves to short-term debt ratios are at historically high levels and constitute a significant buffer should there be a future retrenchment in capital flows.

Outlook

Prospects for Latin America and the Caribbean are good in historical perspective. Strong global growth is expected to maintain demand for the region's exports and keep commodity prices high, boosting incomes and domestic demand. However, a return to more sustainable growth rates in Argentina and Venezuela, capacity constraints in extractive sectors and rising international interest rates are projected to moderate the expansion in the years ahead. For 2006, these forces should be offset by a relaxation of monetary policies in Brazil and Mexico. As a result, regional growth is projected to remain broadly stable this year, before slowing towards [3.5] percent in 2008.

Stronger domestic demand fueled by high commodity prices is projected to maintain import growth even as export revenues cease rising as rapidly. As a consequence, the region's current account is projected to deteriorate, moving from a [1.5] percent of GDP surplus in the past year to a small deficit by 2008. Region-wide inflation is projected to ease further, although strong inflationary pressures pose serious challenges in several countries, notably Argentina and Venezuela, and needs to be monitored in Costa Rica, Jamaica, and Paraguay.

While measures to impose price controls and limit exports of food may reduce short-term inflationary pressures in Argentina, they are unlikely to be successful over the long term and will likely hurt the agro-industrial sector, which until now has played an important role in the country's recovery. Similar efforts in Venezuela to intervene in the economy and fix prices have increased market distortions, weakened private property rights and are likely to undermine longer-term growth potential.

Presidential elections in seven countries in 2006 are not expected to result in a significant change in macroeconomic policy, either because the existing government is expected to be returned to power or because of a general consensus over current policies. Less certainty surrounds the outcomes and economic policy consequences of elections in Peru, Ecuador and Nicaragua, where popular dissatisfaction with existing policies may have a substantial influence on political outcomes.

Risks and policy challenges

This is a relatively benign scenario for the Latin American and Caribbean region. However, there is no room for complacency. The recovery is too recent to indicate a change in long term trends, particularly as the current conjuncture is highly favorable—both in terms of high commodity prices and liquid capital markets. These conditions will almost certainly deteriorate. Improvement on the recent good performance will require substantial further reforms: improve the investment climate, consolidate public finances and ensure a more equitable distribution of the fruits of higher growth.

The recent signing of the Dominican Republic–Central American Free Trade agreement with the United States represents an important step towards improved performance, not just because the United States is these countries' major trading partner. The agreement also holds the potential of increasing trade and investment within and between countries in the region, which may be key to lifting economic growth. Peru and Colombia have also recently finished negotiations for an FTA with the United States. However, to reap the full benefits major obstacles need to be removed including improving electricity supply, road quality, port and customs efficiency, boosting financial depth, improving the quality and coverage of education, as well as strengthening institutions.

Although, significantly less prevalent than in the past, pro-cyclical fiscal policy and inflexible entitlement spending continues to pose a risk for the region. Authorities should be especially careful that government spending (whether or not pre-electoral in nature) does not contribute to an overheating of local economies. Domestic demand is already growing very rapidly and an additional impetus from the public sector may be sufficient to spark inflationary pressures, forcing monetary authorities to react by raising interest rates and slowing growth. More generally, policy makers should follow a prudent path as concerns new spending programs, ensuring that additional expenditures are consistent with growth prospects in a less benign external environment characterized by higher interest rates and lower commodity prices.

Uncertainty caused by global imbalances forms a further risk for the region. In the event of a sharp slowing of external demand, commodity prices could be expected to decline and interest rates to rise, presenting the region with a triple threat. Such a shock would likely result in a substantial increase in U.S. interest rates, but also in risk premia as investors seek shelter from uncertainty. As in past episodes, the sudden drying up of international liquidity would likely have serious consequences on regional growth, simultaneously increasing debt-servicing costs and reducing rev-

Table A1.5 Middle East and North Africa forecast summary
(annual percent change unless indicated otherwise)

					Forecast		
	90–00[1]	2003	2004	Est. 2005	2006	2007	2008
GDP at market prices (2000 USD)[2]	3.8	4.8	4.7	4.8	5.3	5.2	5.1
GDP per capita (units in USD)	1.7	3.1	3.0	2.9	3.4	3.3	3.3
PPP GDP[3]	4.1	3.7	4.3	4.0	5.1	5.1	5.2
Private consumption	2.3	4.2	4.4	4.9	8.0	6.7	5.7
Public consumption	1.2	3.5	5.6	12.6	7.4	9.4	6.2
Fixed investment	3.0	5.5	11.4	8.0	8.6	8.3	10.2
Exports, GNFS[4]	3.8	4.7	8.6	7.6	3.3	3.5	4.0
Imports, GNFS[4]	–0.9	4.1	16.1	13.2	11.2	10.2	9.0
Net exports, contribution to growth	1.4	0.2	–2.2	–1.9	–2.8	–2.6	–2.2
Current account bal/GDP (%)	–0.3	6.7	8.7	13.4	14.2	9.3	5.6
GDP deflator (median, LCU)	7.4	3.8	8.6	14.1	9.0	4.4	4.7
Fiscal balance/GDP (%)	–3.6	–0.3	0.3	3.7	5.0	3.8	2.9
Memo items: GDP							
MENA Geographic Region[5]	3.4	6.0	5.0	5.6	5.7	5.2	4.8
Resource poor–Labor abundant[6]	4.1	4.0	4.4	4.2	5.3	5.3	5.5
Resource rich–Labor abundant[7]	3.4	5.9	5.1	5.4	5.2	5.0	4.8
Resource rich–Labor importing[8]	2.9	7.5	5.4	6.6	6.2	5.3	4.3

Source: World Bank.
Notes: 1. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
2. GDP measured in constant 2000 U.S. dollars.
3. GDP measured at PPP exchange rates.
4. Exports and imports of goods and non-factor services.
5. Geographic region includes high-income countries: Bahrain, Kuwait and Saudi Arabia.
6. Egypt, Jordan, Morocco and Tunisia.
7. Algeria, Iran, Syria and Yemen.
8. Bahrain, Kuwait, Oman and Saudi Arabia.

enues—likely forcing a pro-cyclical cut in government spending. While recent steps to reduce financial market exposure in the region will reduce the amplitude of these effects as compared with what they would have been, countries in the region remain vulnerable.

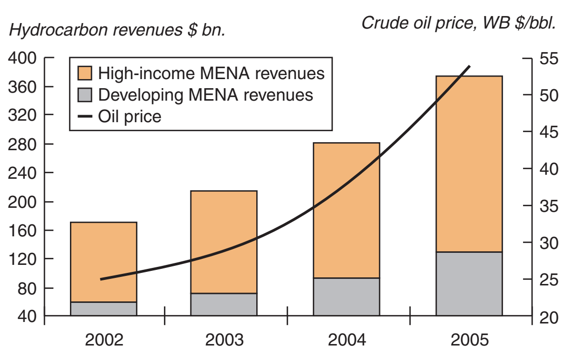
Middle East and North Africa regional prospects

Recent developments

GDP for developing economies in the Middle East and North Africa region increased [4.9] percent in 2005, up moderately from [4.7] percent the year before (table A1.5). At the same time, output growth for the broader geographic region,[6] which includes the group of high-income oil exporting countries located in the area, advanced at a robust [5.7] percent, up [0.6] points of growth from 2005, powered by a continued surge in hydrocarbon revenues.

Among developing oil exporters, GDP growth accelerated from [4.9] to [5.5] percent, boosted by a [17] percent increase in fiscal spending that spilled over to consumption, construction and other private activity. Economic activity in Algeria expanded [5.5] percent on the back of strong export growth, while Iran advanced [5.7] percent, spurred by public spending. Since 2003, crude oil prices have risen more than [85] percent and related revenues of developing oil exporters have increased by [80] percent, reaching $[130] billion or [33] percent of collective GDP (figure A1.7). Revenues of the high-income exporters are also highlighted in the figure. These amounted to

Figure A1.7 A surge in oil revenues



Source: Comtrade, EIU, Haver, IMF, World Bank.

a substantial $[245] billion, carrying the total for the broader region to $[375] billion.

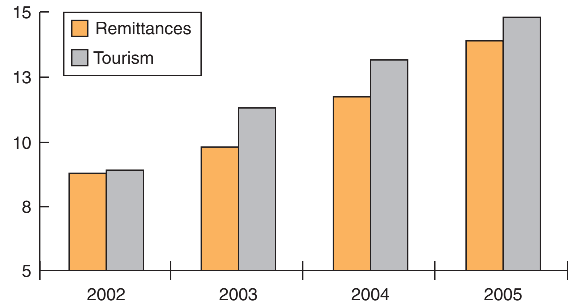
In contrast with earlier oil price booms, most regional oil exporters have pursued a relatively prudent fiscal policy. Despite a [33] percent increase in revenues during 2005, oil exporters (both high-income and developing) have raised current spending by a relatively moderate [12] percent, and capital spending by [16] percent. Importantly, countries have taken substantial steps to pay down debt. On balance, oil-exporting governments are projected to generate a $[140] billion fiscal surplus, representing [15] percent of the group's GDP. In contrast, a number of oil-importing countries in the region have failed to pass-through higher oil prices to consumers. As a result, fiscal positions in several countries deteriorated sharply.

Growth among the group of oil importers/ diversified economies eased in the year to [4.2] from [4.4] percent in 2004. GDP in Morocco was restrained by significant drought; in contrast, output in Egypt picked-up to [5.6] percent on the back of strong revenue gains from remittances, tourism and Suez Canal dues. Economic activity in Jordan continued to benefit from strong investment (notably real estate), construction spending and Gulf-war related outlays. But higher oil prices contributed to substantial deterioration in oil importer trade positions—from deficit of $[12.7] billion in 2003 to $[27.8] billion in 2005—the decline equivalent to [7] percentage points of GDP. However, remittances and tourism revenues rose to $[29] billion in the year, especially vibrant in Egypt. Improvements in the non-goods balance led the group to record a small current account surplus for the year. Remittances to Morocco, Tunisia, Egypt and Jordan as a group increased [19] percent (following [18] percent gains the year before). Tourism revenues, increasingly of an intra-regional nature, reached $[15] billion in 2005, up [13] percent in the year and following on strong [17] percent gains during 2004 (figure A1.8).

Use of energy-price subsidies is widespread in the region, both for importing and oil-exporting economies. While this has eased the impact of higher prices on households, it has increased fiscal deficits in a number of countries, including importers Morocco and Tunisia. Among oil-importers, the largest impact was Jordan, where at fuel subsidies accounted for [3.3] percent of GDP in 2004.

Figure A1.8 Fast rising tourism and remittance flows

Tourism and remittances: Morocco, Tunisia, Egypt, Jordan, $bn



Source: National agencies, IMF, and World Bank.

Oil revenues have also financed investment boom in the region, resulting in significant asset price inflation in the Gulf States.[7] Regional equity markets (including those of high-income oil exporters) are now valued at $[1.3] trillion, almost as much as those in developing Asia, and much higher as a percent of GDP. As a complement to investment in equities and other financial instruments, FDI and large-scale project capital are now flowing from the Gulf States into neighboring countries, principally to industrial sectors in Egypt, Jordan and Syria (e.g. cement, oil refineries). Inroads are also being made in the financial sector, tourism infrastructure and real estate. For the latter, Jordan is viewed as a key destination for funds, with planned residential-, urban-regeneration and other offerings on the table, amounting to some $2.5 billion. Though precise data are difficult to come by, FDI—and portfolio investment on the order of $[5–$10] billion appears to have been committed over the last year—substantial for the scope of industry in the Mashreq.

A sizable portion of the boost to the region's oil revenues has been invested abroad. Some $[80] billion (60 percent of the total) can be traced to extra-regional investments, which have been placed over a wider geographical base than in the past and allocated across a broader set of assets.[8] This amount likely understates actual outflows, as State Agencies are reported to make heavy use of third-party agencies when making foreign placements.[9] And very-large private equity placements are filling out the investment portfolio—for example, Dubai's $1 billion share in Daimler-Chrysler and $5.2 billion purchase of P&O.

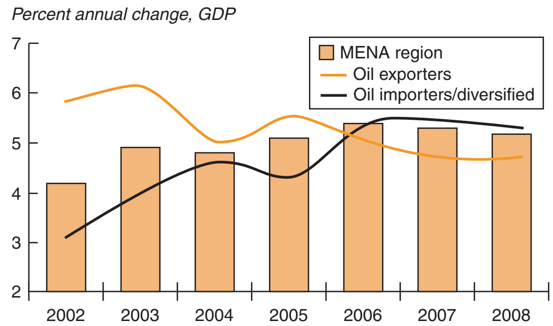
Medium-term outlook

GDP growth for developing MENA is projected to accelerate in 2006, reaching [5.3] percent from [4.9] percent during 2005, before easing somewhat in 2007–08. The broader pattern of growth reflects a pick up in activity among oil importers (from [4.2] to [5.3] percent) and a gradual slowdown among oil exporters from [5.5] percent in 2005 to [4.8] percent by 2008 (figure A1.9). For the broader MENA geographic region, GDP gains are anticipated to ease into 2006, to [5.3] from [5.7] percent, in large measure as activity in the oil dominant economies including Saudi Arabia, the UAE and Qatar, begins to cool as capacity constraints bind tightly, and initial impetus from fiscal outlays beings to diminish.

For developing exporters, this relatively strong projection mainly reflects continued gains in hydrocarbon revenues and increased absorption of cumulative windfalls. Oil prices are projected to ease only moderately from $[63]/bbl on average in 2006 to around $[59]/bbl by 2008 due to limited excess capacity and the short-term inelasticity of both energy demand and energy supply. Though exporters' revenues will no longer be growing rapidly, demand should remain strong as government expenditure continues to grow faster than production and the additional revenues find their way into domestic demand. Because domestic supply can respond only slowly to increased demand and additional investment, imports should continue growing rapidly even as export volumes and GDP growth moderate. As a result, the contribution to growth of the external sector is projected to turn negative and the current account surpluses of oil-exporters ease to about [3] percent of GDP by 2008 from a peak [17.5] percent in 2005. The massive In-Salah and In-Amenas gas projects in Algeria are expected to increase deliveries by a wide margin in 2006 and 2007. In Iran, Oman, and Syria declining yields are expected to slow output of crude oil, with expanded natural gas, LNG and NGL in Oman and Qatar providing only a partial offset.

Prospects for the oil importing/diversified economies of the region are projected to improve following the 2005 slowdown linked to poor export performance across the Maghreb and drought in Morocco. Anticipated recovery in European demand will be a key external factor, as will the eventual easing of oil prices, which should diminish pressure on fiscal balances of those countries that

Figure A1.9 Regional growth prospects



Source: World Bank and DECPG projections.

have not passed through higher oil prices. Tunisia and Jordan may benefit from the resurgence in European demand, but will face stiff new competition in textiles and clothing following the removal of ATC in January 2005. Economic activity in Jordan should continue to benefit from spending related to reconstruction efforts in Iraq. And Egypt's improving track record of reforms, together with revival of growth in European demand for goods and tourism services should underpin a further pickup of growth in that economy.

Risks and policy challenges

Notwithstanding the current period of relatively strong growth, the region faces a daunting list of structural reform issues related to economic policy, as well as governance, gender, and resources (e.g. water), against a background of geopolitical tensions that remain a central concern for policymakers.[10]

The key challenge facing oil exporters is to leverage oil revenues so as to generate job growth that will be necessary to meet the booming demographic pressures faced by all countries in the region. This requires striking a balance between domestic investment outlays that enhance capacity, and extranational financial management of windfall revenues so as to avoid an excessive appreciation of the currency, domestic overheating and inflation.

The challenge for oil-importing and labor abundant countries will be to improve the investment climate both in order to attract investment, but also to improve the effectiveness of those investments that are made. It appears however, that, except in Egypt, relatively little progress has been made since 2004. Earlier positive steps in Morocco and Tunisia included reforms to improve the business and investment climate, and Morocco's

Free Trade Agreement with the United States (that came into force this year and offers some promise of increased exports and higher FDI). Morocco's labor law remains only partially implemented; and Tunisia's investment in higher valued added industry and services is lagging. Egypt has made recent progress in the areas of tax and customs, banking and examination of bureaucratic restraints to growth. Such reforms need to be sustained, extended to other countries in the region, and accelerated. If achieved, a shift from public-sector led to more rapid private-sector-led growth could take shape over the next several years.

A concern regarding oil exporters is that windfall oil revenues tend to diminish reform momentum. Oil windfalls should be viewed at least partially as temporary, and should be used to finance necessary structural reform. Failure to do so would ultimately increase oil exporters' dependence upon oil and reduce future growth prospects. Moreover, while capacity-enhancing investments in infrastructure, education, and healthcare will likely yield long-term dividends, care must be taken to avoid creating long-term entitlements that cannot be respected when revenues decline.

But, the main economic risks and uncertainties for the region stem from the future price of oil and the strength of the European recovery.

The outlook for oil prices remains uncertain. Both higher- and lower-than projected prices are possible. For oil exporters, a much higher-than-projected oil price would add revenue and stimulate both investment and consumption over the projection period. But over the longer term higher prices would likely accelerate supply and demand responses, provoking a faster-than-projected decline in oil prices. As long as oil prices do not fall back to the $20 range, a more rapid than projected decline in oil prices is unlikely to have major consequences for demand because oil exporters have budgeted oil prices in a prudent fashion. Challenges facing policy markers include continuing cautious management of the windfall to avoid domestic overheating and inflationary consequences; and importantly, to avoid the tendency for high revenues to cloud the need for structural change.

For oil importers, higher oil prices would likely cut into growth, rendering subsidization policies clearly unsustainable. Lower prices would ease fiscal pressures. However, the positive impact they would have on domestic incomes would have to be tempered by the potential for reduced remittances, tourism and investment inflows from oil exporters.

While slower-than-projected growth in Europe would likely have a smaller impact on regional prospects than higher oil prices, it could accentuate the current account and fiscal difficulties of the region's oil-importing/diversified economies. The region's external performance will also depend on the extent to which local manufacturers can adapt to lower quotas in the clothing and textile sector. In the baseline, countries' market shares are expected to stabilize, but this will require firms to find niches that they can continue to serve. Generally, industry must respond flexibly to increased competition from the new member states of the EU as well as developing Asia. Over-inflated asset prices also pose a risk (particularly among the GCC), should they deflate rapidly—especially as there are indications that the banking sector may becoming over exposed (IMF, 2006).

South Asia regional prospects

Recent developments

Regional GDP growth for 2005 accelerated to an estimated [7.7 percent], driven by very strong growth in Afghanistan [13.8 percent], Bhutan [8] percent, India [8.0 percent], and Pakistan [7.8 percent] (table A1.6).

In both India and Pakistan, the two largest economies in the region, growth was consumption-led, reflecting higher farm incomes on the one hand and a relaxation of fiscal policy in Pakistan, plus an already lax fiscal and monetary policy stance in India (figure A1.10). The boost to private consumption represented almost three quarters of the increase in Indian GDP and more than all of the increase in Pakistan. In India, investment and exports continued to grow rapidly, but in Pakistan investment grew an anemic [1.5] percent and exports were up [7.8] percent. The acceleration of domestic demand in Pakistan was not met by domestic production and, as a result, imports rose by much more than exports. Even in India, industrial production growth slowed from [8.5] percent in 2004 to [7.8] percent and import growth outstripped exports by a significant margin—suggesting that supply was unable to keep up with demand.

Among smaller economies, GDP growth in Sri Lanka slowed to [4.1] percent, as strong service

Table A1.6 South Asia forecast summary

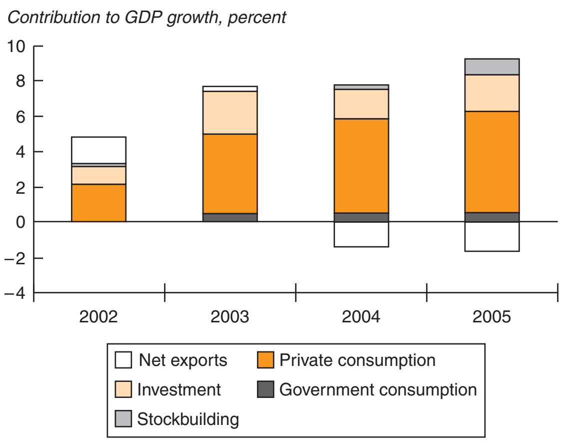
(annual percent change unless indicated otherwise)

					Forecast		
	90–00[1]	2003	2004	Est. 2005	2006	2007	2008
GDP at market prices (2000 USD)[2]	5.2	7.8	6.7	7.7	6.8	6.5	6.2
GDP per capita (units in USD)	3.2	6.1	5.0	6.1	5.3	5.0	4.7
PPP GDP[3]	5.3	8.0	6.8	7.7	6.8	6.5	6.2
Private consumption	4.0	6.7	8.1	9.4	7.4	6.8	5.8
Public consumption	5.0	4.6	4.6	5.8	5.1	4.8	4.0
Fixed investment	5.8	11.5	8.0	8.6	9.1	9.0	7.8
Exports, GNFS[4]	10.7	11.5	10.7	11.5	12.5	12.6	12.6
Imports, GNFS[4]	9.9	11.3	18.7	17.4	15.5	14.5	11.3
Net exports, contribution to growth	–0.1	0.1	–1.3	–1.2	–0.9	–0.8	–0.1
Current account bal/GDP (%)	–1.6	1.4	–0.6	–2.6	–3.5	–3.3	–2.5
GDP deflator (median, LCU)	8.3	4.4	4.3	6.8	7.5	6.8	5.8
Fiscal balance/GDP (%)	–7.6	–7.7	–7.5	–7.5	–7.3	–7.1	–7.3
Memo items: GDP							
South Asia excluding India	4.4	5.1	6.1	6.6	6.2	6.0	5.5

Source: World Bank

Notes: 1. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
2. GDP measured in constant 2000 U.S. dollars.
3. GDP measured at PPP exchange rates.
4. Exports and imports of goods and non-factor services.

Figure A1.10 Demand-led growth



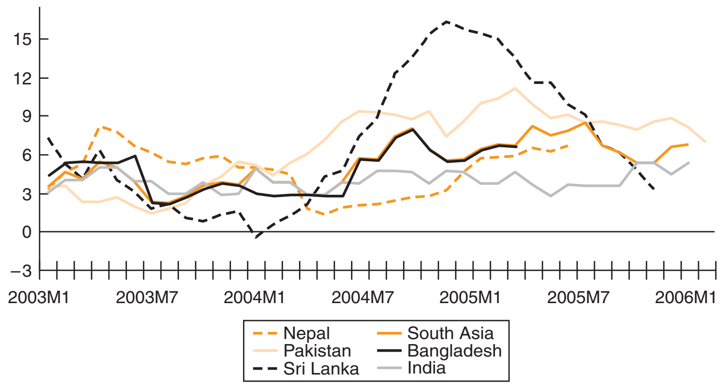
Source: World Bank.

sector growth failed to completely offset the negative impact of the December 2004 Tsunami. Slower growth in Bangladesh was tied to flooding, while political strife in Nepal cut into tourism, slowing GDP growth to [2.5] percent.

Notwithstanding double-digit growth in export volumes, the combination of higher oil prices and very strong consumption demand generated a [2.0] percent of GDP deterioration in the regional current account balance. The deterioration would have been worse, but the region has benefited from the removal of textile and clothing quotas, gaining market share. While the clothing and textile imports of Bangladesh, India, Pakistan, and Sri Lanka picked up, producers in Nepal and the Maldives lost market share. In Bangladesh and Pakistan, large remittance inflows—in part stemming from the oil boom in the Arabian Gulf oil-exporting countries, where many South Asian migrant workers are based—also helped to offset the deterioration in the trade balance, while booming capital inflows have contributed significantly to meeting the financing requirement.

Reflecting very rapid increases in domestic demand, rising oil prices and bad monsoons in 2004, inflation in the region surged (figure A1.11), rising from an average of [3.6] percent in 2003 to [9.1] percent in 2005. Most recently, better harvests have exercised some downward pressure on prices, but year-over-year inflation for the region as a whole remains high at [6.7] percent in February 2006. Much of the increase in inflation stems from changes in food prices, with good harvests in Afghanistan, India and Pakistan leading to some easing or containment of pressures, while poor harvests in Bangladesh and Nepal created the opposite effect. These adverse trends are especially notable given that countries have yet to fully pass-through to the domestic market all of the rise in international fuel prices—implying a backlog in inflationary pressures. The monetary authorities in Bangladesh, India, Pakistan and Sri Lanka have re-

Figure A1.11 Inflation has picked up



Source: World Bank.

acted by raising policy rates, but real interest rates remain low (near zero in India).

Medium-term outlook

Economic activity in the region is projected to slow in 2006 through to 2008 as private consumption demand eases to a more sustainable pace in response to a tightening of monetary and fiscal policies. Weaker global demand is projected to slow export growth and although consumer demand is expected to decelerate, continued robust investment demand should keep imports expanding faster than exports. This, plus an only limited decline in oil prices, is projected to lead to a further deterioration in the regional current account deficit to some [3.8] percent of GDP in 2008. While financing should not be a concern, expected declines in global liquidity are likely to be reflected in rising borrowing costs and higher debt-servicing charges.

In India and Pakistan, more restrictive macropolicies, combined with tighter international credit conditions, and an easing of external demand (in the US), are projected to slow growth by about [1] percentage point in 2006. India is expected to continue benefiting from strong services sector growth, including foreign demand for IT services, and rising private investment, given improving business confidence and progress in market reforms. The government's recently announced four-year 'Build India' infrastructure program (equivalent to a total package of about 5 percent of GDP) will provide an additional fillip to growth starting in 2006. Growth in Pakistan is projected to become more balanced as consumer demand slows to more sustainable rates. A continued supportive external environment and expansion of Pakistan's textile and other manufacturing sectors should maintain export growth, while investment is expected to rise, due in part to the reconstruction efforts following the October 2005 earthquake in Kashmir.

Prospects for growth in the rest of the region are mixed. In Bhutan, growth is projected to expand rapidly into double digit rates over the forecast period with the coming on-stream of new hydroelectric power, which will significantly boost capacity. In Sri Lanka growth is forecast to expand in 2006, as the aid-assisted, post-Tsunami, recovery takes hold, and in Bangladesh, growth is forecast to remain broadly stable. Foreign assistance for reconstruction in Afghanistan is expected to remain a key factor to growth over the near-term. In Nepal, growth is forecast to continue to be constrained to low rates, as political instability and the insurgency undermine economic activity, including tourist travel.

Given that domestic demand is still strong and that most of the hike in international oil prices has yet to be passed through to domestic prices, some increase in inflationary pressures is projected in Bangladesh, India and Nepal in 2006 before easing back down over the forecast horizon. Tighter monetary policy in Pakistan and Sri Lanka is expected to stem increases in their inflation rates.

Risks and policy challenges

Managing the very strong growth of the past few years and ensuring that an inflationary spiral does not develop, represents a serious challenge for the region. While large swings in food prices have contributed to the upswing in regional inflation, rapid increases in domestic demand (notably consumption) and low interest rates likely played a role. In the current context, and especially with significant portions of high oil prices yet to be passed through consumer prices, a tightening of monetary and fiscal policy is in order, if overheating and a hard landing are to be avoided.

Although several countries have taken steps to pass on higher oil prices, explicit and implicit subsidies (through state oil companies) are imposing a heavy burden on the government purse. They have increased government deficits by as much as 0.5 percent of GDP in Pakistan and 0.7 percent of GDP in India between 2002 and 2005. In India, subsidies appear to have crowded out other development spending on health and education (Devarajan and Ghani 2006). In addition to the fiscal cost, by preventing relative prices from adjusting, these policies eliminate private incentives to conserve fuel, and thereby contribute to high current account deficits.

Pursuing a prudent fiscal policy and enhanced financial sector supervision will be important to achieving a soft-landing, as monetary policy options are limited; higher rates would likely draw higher foreign capital inflows, and lower rates would stimulate higher banking sector lending.

Finally, continued political tensions in the region, notably in Nepal and Sri Lanka, pose threats to growth. While such instability tends to reduce investment and slow growth, an escalation would have dire consequences—potentially leading to a drop in output and a serious aggravation of poverty.

Sub Saharan Africa regional prospects

Recent developments

GDP in Sub-Saharan Africa, bolstered by strong world demand and rising commodity prices, increased [5.2] percent in 2005, marking the second year in a row that regional growth exceeded 5 percent (table A1.7). The pace of economic expansion was particularly strong for oil-exporters, which grew on average by [6.4] percent, but the expansion among oil importers was also robust at [4.7] percent.

Although growth in oil-exporting economies was down from the [6.7] percent recorded in 2004, it remained well above trend. GDP in Nigeria (the second largest economy in Sub-Saharan Africa) slowed a bit to a nevertheless robust [5.8] percent, as socio-political tensions and attacks on oil-sector infrastructure cut into oil-sector growth. Strong domestic demand, fueled by oil revenues and government spending, combined with a rebound in agricultural output to boost growth in the non-oil sector by [8.2] percent. Ample oil revenues also fueled demand in other oil exporting countries. The oil sector *per se* was the main driver of growth in Angola and Chad, and played an essential role in the acceleration of output in Sudan. In Equatorial Guinea, growth came to a near standstill as oil production stabilized following a [32] percent expansion the year before.

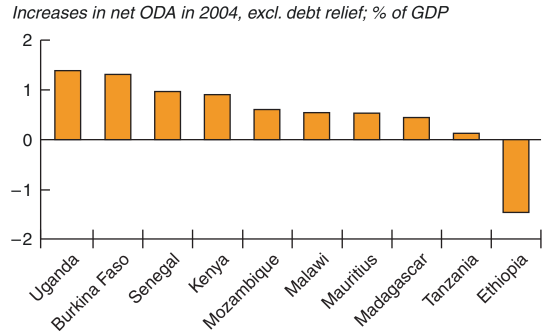
In spite of high oil prices most oil importing economies performed well, with growth inching up to 4.7 percent last year, from 4.6 percent the previous year. High metals prices, lower taxes and low interest rates boosted domestic demand in South Africa to [5.9] percent and GDP growth to

Table A1.7 Sub-Saharan Africa forecast summary
(annual percent change unless indicated otherwise)

					Forecast		
	90–00[1]	2003	2004	Est. 2005	2006	2007	2008
GDP at market prices (2000 USD)[2]	2.4	4.0	5.2	5.2	5.4	4.9	5.4
GDP per capita (units in USD)	–0.2	1.7	2.9	3.2	3.5	3.0	3.4
PPP GDP[3]	2.5	3.6	5.3	5.2	5.7	5.0	5.5
Private consumption	2.1	0.3	4.6	5.2	5.1	4.8	4.9
Public consumption	2.9	7.3	4.4	5.1	6.0	6.5	6.5
Fixed investment	3.7	7.8	11.5	9.6	8.9	9.1	7.1
Exports, GNFS[4]	4.5	7.1	5.7	6.0	8.0	5.3	7.1
Imports, GNFS[4]	4.6	7.4	8.9	8.3	9.7	8.3	7.5
Net exports, contribution to growth	0.0	–0.2	–1.2	–1.0	–0.9	–1.3	–0.5
Current account bal/GDP (%)	–1.9	0.5	0.0	–0.6	0.0	–0.7	–1.1
GDP deflator (median, LCU)	9.7	6.0	6.8	6.0	4.6	3.4	3.4
Fiscal balance/GDP (%)	–4.3	–1.9	–0.3	0.8	0.4	–0.4	–0.8
Memo items: GDP							
SSA excluding South Africa	2.8	4.9	5.7	5.4	6.0	5.2	5.7
Oil exporters	2.7	6.7	6.7	6.4	7.5	6.0	6.6
Oil importers	2.3	2.9	4.6	4.7	4.5	4.4	4.8
CFA countries	2.6	3.5	5.1	3.5	3.8	3.5	3.9

Source: World Bank
Notes: 1. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
2. GDP measured in constant 2000 U.S. dollars.
3. GDP measured at PPP exchange rates.
4. Exports and imports of goods and non-factor services.

Figure A1.12 Increased aid in Sub Saharan Africa



Source: OECD, World Bank.

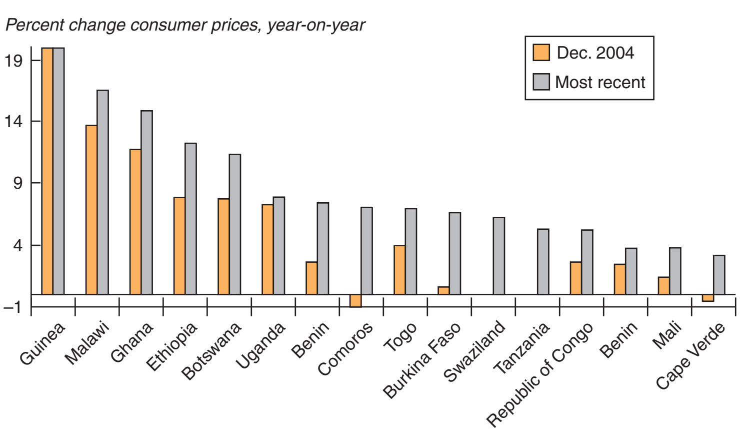
[4.9] percent—the fastest growth that country has recorded in more than two decades. In West Africa, continued rapid growth was supported by better crop yields and improved agricultural income. In addition, incomes and domestic demand in the regional also benefited from strong non-oil commodity prices, the notable exception being cotton. Even in Ghana, one of the region's most oil-dependent economies, real sector indicators such as manufacturing sales, credit to the private sector, and imports depict an increase in economic activity. In Eastern Africa good harvests also boosted economic performance, with growth in many economies exceeding 5.0 percent. Indeed growth in Ethiopia surpassed 7 percent, in Uganda neared 6.0 percent, while in Kenya it topped 5.0 percent.

Fiscal policy among oil-importers appears to have been moderately expansionary. In the case of South Africa, government spending has outstripped GDP over the past several years—although a cyclical upswing in tax revenues has allowed the overall deficit to decline. Fiscal balances among smaller oil importers have deteriorated by about 2 percentage points since 2002, despite record high growth rates. Their government deficits stood at an estimated [5.5] percent of GDP in 2005. In contrast, the general government balance of oil exporters has moved into a [5.9] percent of GDP surplus—suggesting that for the moment authorities in these countries are treating at least part of the additional oil revenues as temporary windfall gains not to be spent right away. Overall, government balances in the region have moved into a small surplus of [0.5] percent of GDP from [–2.6] percent of GDP in 2002.

Growth in the region also benefited from increased official development assistance (ODA) (figure A1.12). ODA, excluding debt relief, topped $24 billion in 2004 (the last year for which data are available). It rose by 1.0 or more percent of GDP in a number of countries, helping to fund domestic investment projects and providing much needed foreign currency. Debt relief also increased significantly, reaching $5 billion in 2004, up from $1.2 billion in 2000.

Sub-Saharan Africa, together with South Asia is one of only two regions in the world where headline inflation has been rising (see Chapter 1, main text). A combination of currency depreciation, pass-through of higher oil prices onto consumers, rising transportation costs and higher foods prices due to drought-related supply disruptions has led to a pick up in inflationary pressures in Botswana, Guinea, Malawi, Zambia and Zimbabwe (figure A1.13). In West Africa's CFA franc countries large increases in food prices have pushed inflation rates well above the rate targeted by the regional central bank, although better crops this year should ease the inflationary pressures.

Figure A1.13 Accelerating Inflation



Source: Datastream, Afristat and World Bank.

Rising oil prices contributed to a dramatic improvement in current account balances in many oil exporters and together with strong domestic demand, to a sometimes worryingly large deterioration in the external balances of some oil-importing economies (figure A1.14). A total of [21] countries now have current account deficits in excess of 6 percent of GDP. Ghana, a particularly oil-intensive economy, saw its imported oil bill increase by 41 percent and its current account deficit more than double. Kenya, Rwanda, Seychelles, Uganda and

Tanzania's external balance also deteriorated markedly. Some countries were able to finance larger trade deficits through a combination of higher current transfers and higher remittances.

Medium-term outlook

Economic performance in Sub-Saharan Africa is projected to remain robust, supported by improved governance, increased integration in the global economy, robust external demand, and a more stable political environment.

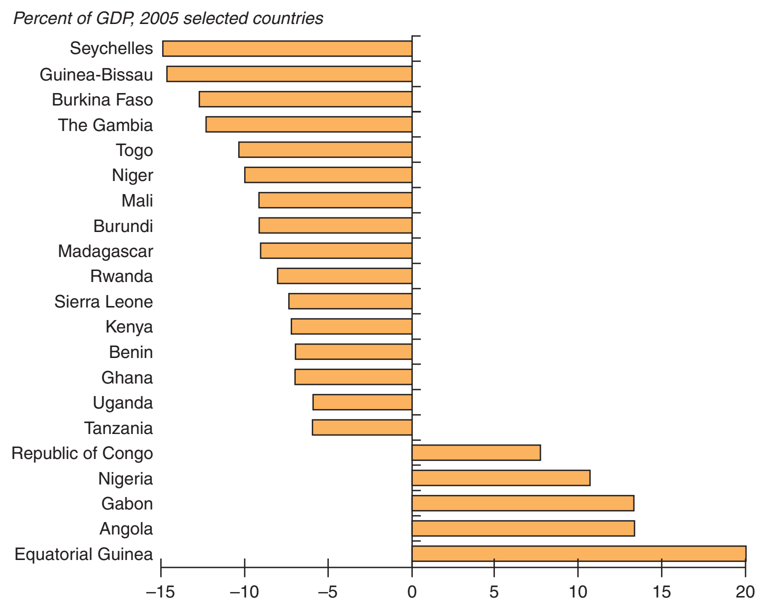
GDP growth in Sub-Saharan Africa is projected to remain very robust, averaging more than [5] percent over the next three years. The overall growth profile is expected to be somewhat bumpy reflecting the coming on line of new oil fields. Growth among oil exporters is projected to accelerate this year, weaken somewhat in 2007 and pickup once again, coming in at about [6.6] percent in 2008, as oil production growth in Mauritania and Sao Tome and Principe accelerates. Growth among oil importers is expected to continue to slow as adjustment to higher oil costs continues. However, these countries should benefit from rising aid inflows and a generally favorable international environment. As a result, their economies are projected to slow only a bit in 2006/7 before picking up in 2008.

An expected relaxation of fiscal policy in 2006/2007 and still high commodity prices are expected to maintain growth in South Africa, the region's largest economy, in excess of [4.5] percents. The Nigerian economy is expected to decelerate this year reflecting slower agriculture production following a bumper crop last year and continued delivery problems in the oil sector. Weak infrastructure and rising uncertainty surrounding the political transition continue to weigh on Nigeria's longer term growth prospects and are expected to keep growth below its potential.

In central Africa economic growth will remain robust and relatively balanced, albeit decelerating as oil sectors push against capacity. Two of the main engines of growth will continue to be private investment and consumption. Non-oil sectors are projected to grow by [5.0] percent in 2005 as compared with a more modest 3.0 percent for the oil sector.

Drought affecting vast areas in East Africa will take a toll on economic performance this year (industrial sectors are suffering from inadequate hydro-electrical production, and food prices are rising, eroding real incomes). Assuming more normal rainfalls patterns over the short term output should pick up in 2007 and 2008.

Figure A1.14 Current account balances



Source: World Bank.

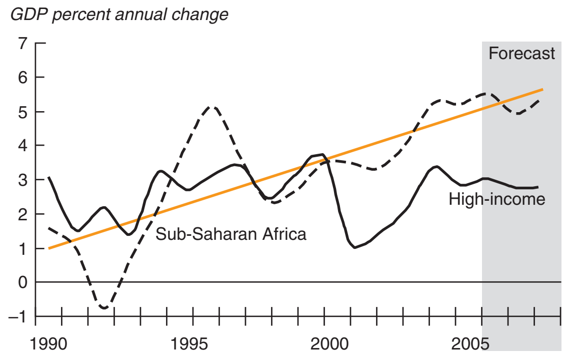
Growth in sugar and textile producers (Swaziland, Lesotho, Mauritius) will be hit by EU sugar policies reforms, and by strong competition from low-cost producers like China, following the removal of textile export quotas. Strong growth in South Africa will spill over in the satellite economies of the Southern Africa Development Community. Growth in Mozambique, Tanzania and Zambia is also expected to remain fairly strong, as they benefit from debt write-offs.

ODA is projected to increase even more rapidly in coming years, rising to some $130 billion in 2010, up from $79.5 billion in 2004. The recently approved Multilateral Debt Relief Initiative will also provide debt relief beyond the HIPC initiative.

Risks and policy challenges

Sub-Saharan Africa's performance over the past five years and in particular the resilience displayed by these economies in the face of higher oil prices, suggests that the sub-continent may have turned a corner. Indeed, this strong growth represents a continuation of a trend improvement in growth

Figure A1.15 Growth in Africa has been on an upward trend



Source: World Bank.

observed over the past 15 years (figure A1.15). Growth in the sub-continent has averaged 4.0 percent between 2000/5 as compared with less than 1 percent during the first half of the 1990s. Of particular note is the decline in growth volatility in the region. As a result, 22 countries have averaged 4 percent or better growth rates during the past 5 years as compared with only 8 in the first half of the 1990s.[11]

Africa's improved performance reflects a number of fundamental factors including: better governance, increased trade flows, and integration in the global economies. However, it is also reflects a very favorable external environment characterized by exceptionally strong commodity prices, low interest rates, rising aid flows and debt forgiveness. In addition, the past five years have been a relatively drought-free and peaceful period, with strong growth in a number of countries that have emerged from conflict contributing to overall performance.

The baseline scenario for Sub-Saharan Africa implies an unprecedented period of continuous strong growth for the region. However, prospects are fragile and downside risks predominate. The baseline is contingent on the external environment remaining supportive, including economic recovery in the EU, strong growth performance in South Africa, only a modest decline in commodity prices, a gradual rise in interest rates and continued strong Chinese demand for raw materials. Moreover, realizing the growth potential implicit in this forecast will require that substantial progress be made in addressing the significant weaknesses that continue to plague the region, including inadequate infrastructure, low investment rates, high costs, unfavorable business climates, limited financial intermediation, weak institutions, and poor governance.

In addition, countries have exhausted many of the buffers that allowed them to face the rise in oil prices relatively painlessly (see Chapter 1). As a result, they are now more vulnerable to external shocks. For poor oil importers, the most serious potential shocks include a further hike in oil prices following a supply shock, a decline in non-oil commodity prices and a fall in global demand. Shortfalls in both private and official transfers also constitute a risk, albeit a more moderate one given the commitments made by the international community and increased investors' interests in the region.

Other more risks include those of drought and a relapse into armed conflicts in countries that have just emerged from prolonged conflicts. Either of these would cause important contractions in output in the affected countries. Estimates suggest that, on average, conflicts reduce per capita growth by 2.2 percent for a 10 year period.[12] Currently, 5 countries are in conflict and about 8 are at risk of lapsing back into conflict. A number of political developments, including those in Chad, Ethiopia, Nigeria, and Somalia could contain the seeds of future conflicts that could be extremely destructive of growth, imposing a substantial reduction in the progress that is currently being made against extreme poverty in the sub-continent.

Notes

1. The liberalization allows domestic banks to convert client's local currency into dollars so as to purchase U.S. Treasuries and overseas fixed-income securities.

2. Recently, global demand for high-tech goods is on the upswing; exports of these products accelerated from Korea, Taiwan (China), Singapore, and Thailand in the third quarter.

3. Eight countries in the region (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia) acceded to the European Union in mid-2004. Bulgaria, Romania are scheduled to join January 1, 2007, while Croatia, Macedonia and Turkey are expected to join later.

4. Russia is planning to prepay another $28 bn to the Paris Club during 2006.

5. Brazil and Argentina have also paid back their debt to the IMF, while the region has reduced the amount of outstanding Brady bonds from $142 billion to $3.3 billion.

6. For the purposes of this report the Middle-East and North Africa region is restricted to the following developing countries within the geographic region: Algeria, Egypt, Jordan, Iran, Morocco, Syria, Tunisia; and Yemen. Data limitations prevent the inclusion of Djibouti, Iraq, Libya, and

Lebanon in the projections. Among high income countries in the geographic region include: Bahrain, Kuwait and Saudi Arabia. Data problems preclude the inclusion of Qatar and the United Arab Emirates in the high-income aggregates.

7. Initially revenues flowed into Gulf-state equity and real-estate markets. But during 2003, share prices rose 70 percent across the region and 2004 showed more spectacular increases—Saudi Arabia 80 percent, UAE 95 percent. Yet this kind of asset inflation is almost certainly unsustainable.

8. "Recycling of Petrodollars," Quarterly Review, Bank for International Settlements, December 2005.

9. This is due to the increasing use of National Oil Companies and Investment Trusts to manage the surplus funds. These entities in turn make greater use of offshore centers, hedge funds and other investment vehicles to place MENA assets abroad.

10. See MENA region reports on trade and investment, governance, gender, and employment, produced in 2003–04 which highlight fundamental challenges for the region at the start of the 21st century. http://publications.worldbank.org/ecommerce/catalog/product?item_id=2430578

11. Only three countries averaged 5 percent or better growth in 1990/5 as compared with 14 during 2000/5.

12. Collier, Paul "On the Economic Consequences of Civil War." *Oxford Economic Papers*. No. 51. 1999. pp. 168–83.