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Prospects for Developing Countries

TURMOIL IN FINANCIAL MARKETS, slower growth in high-income countries, and rising inflation have all adversely affected growth prospects for developing countries over the near term. Most countries have shown impressive resilience in this turbulent environment, and growth for developing countries as a group is expected to moderate from 7.8 percent in 2007 to a still strong 6.5 percent in 2008 (table 1.1). However, vulnerable countries that depend on foreign capital flows are likely to experience a sharper slowdown. Moreover, despite strong production growth at the aggregate level, higher food and energy prices have caused real incomes to decline, significantly increasing the hardships faced by the very poor, particularly in urban centers.

Not all of the news is gloomy. In some respects, the slowing of the global economy is welcome, coming as it does on the heels of several years of very fast growth and increasing signs of overheating, as illustrated by a dramatic increase in international commodity prices and by excessive inflationary pressures in a number of countries. And the slowdown in U.S. domestic demand, along with the depreciation of the dollar, is helping to resolve long-standing global imbalances. The U.S. current account deficit narrowed from 6.2 percent of GDP in 2006 to 4.9 percent during the final quarter of 2007. These factors bode well for longer-term prospects, once the current cyclical adjustment—heightened by continuing financial turbulence—comes to closure.

But now, more than at any other time in recent years, the uncertainty surrounding the outlook is quite pronounced and tilted to the downside. The turmoil in financial markets has deepened since late 2007. Major banks, securities firms, and financial guarantors have announced sizable valuation losses on mortgages and other assets, which have strained their balance sheets. The ensuing tightening of credit conditions, and the disruption to the financial system more generally, have been felt most directly by high-income economies, particularly the United States, where the housing sector has borne the brunt of the fallout from the subprime crisis. The slowdown in the United States and in much of Europe appears to have intensified since the end of 2007, and GDP for the high-income members of the Organisation for Economic Co-operation and Development (OECD) is now projected to grow 1.5 percent in 2008, down a full percentage point from 2007. Growth in developing countries is projected to slow by 1.3 percentage points in 2008, but at an expected 6.5 percent, growth will remain well above the average gains of the 1980s (2.9 percent), the 1990s (3.8 percent), and even the more recent period 2000–05 (5.3 percent) (figure 1.1).

Moreover, the continued strength of domestic demand and imports in developing countries is helping to cushion the global effects of the slowdown in high-income countries. Developing-country imports have become an increasingly important driver of global growth. More than half of the growth in global import demand is now originating in developing countries. Partly as a result, U.S. and, to a lesser extent, European exports have been booming—helping to moderate the extent of decline in their GDP growth.

The continued strong growth of developing countries despite the financial turmoil and slowdown among OECD countries demonstrates their increased resilience to external shocks. Compared with earlier episodes of global financial turbulence, far fewer developing countries are currently

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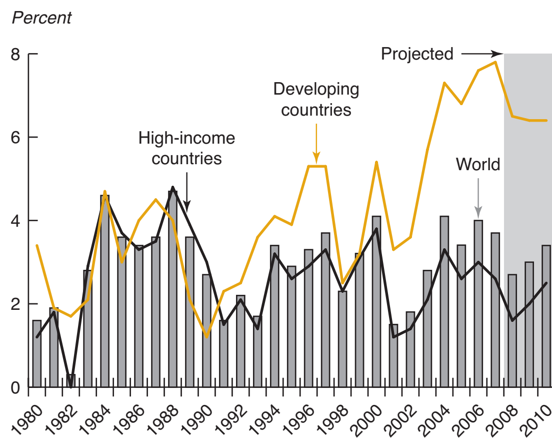
Table 1.1 The global outlook in summary

(percentage change from previous year unless noted)

Indicator	2006	2007e	2008f	2009f	2010f
Global conditions					
World trade volume	9.7	7.5	4.5	7.2	8.4
Consumer prices					
G-7 countries[a,b]	2.0	1.9	2.6	1.8	2.0
United States	3.2	2.9	3.9	2.3	2.5
Commodity prices (US$ terms)					
Non-oil commodities	29.1	17.0	24.1	−8.2	−9.0
Oil price (US$ per barrel)[c]	64.3	71.1	108.1	105.5	98.5
Oil price (percentage change)	20.4	10.6	52.1	−2.4	−6.7
Manufactures unit export value[d]	1.6	3.9	6.8	0.7	1.4
Interest rates					
$, 6-month (percent)	5.2	5.2	3.0	3.8	4.5
€, 6-month (percent)	3.1	4.4	4.5	4.0	4.5
Real GDP growth[e]					
World	4.0	3.7	2.7	3.0	3.4
Memo item: World (PPP weights)[f]	5.4	5.4	4.3	4.5	4.8
High-income countries	**3.0**	**2.6**	**1.6**	**2.0**	**2.5**
OECD countries	2.9	2.5	1.5	1.8	2.3
Euro Area	2.8	2.6	1.7	1.5	1.9
Japan	2.4	2.0	1.4	1.6	2.1
United States	2.9	2.2	1.1	1.9	2.5
Non-OECD countries	5.7	5.5	4.8	4.8	5.0
Developing countries	**7.6**	**7.8**	**6.5**	**6.4**	**6.4**
East Asia and Pacific	9.7	10.5	8.6	8.5	8.4
China	11.1	11.9	9.4	9.2	9.0
Indonesia	5.5	6.3	6.0	6.4	6.5
Thailand	5.1	4.8	5.0	5.4	5.5
Europe and Central Asia	7.3	6.8	5.8	5.4	5.4
Russian Federation	7.4	8.1	7.1	6.3	6.0
Turkey	6.9	4.5	4.0	4.3	5.0
Poland	6.1	6.5	5.7	5.1	5.0
Latin America and the Caribbean	5.6	5.7	4.5	4.3	4.2
Brazil	3.8	5.4	4.6	4.4	4.5
Mexico	4.8	3.3	2.7	3.5	3.6
Argentina	8.5	8.7	6.9	5.0	4.5
Middle East and North Africa	5.4	5.7	5.5	5.3	5.1
Egypt, Arab Rep. of	6.8	7.1	7.0	6.8	6.5
Iran, Islamic Rep. of	5.9	7.6	5.7	5.2	4.5
Algeria	1.8	3.0	3.5	3.5	4.0
South Asia	9.0	8.2	6.6	7.2	7.6
India	9.7	8.7	7.0	7.5	8.0
Pakistan	6.9	6.4	5.0	5.5	6.0
Bangladesh	6.6	6.4	5.0	5.5	6.0
Sub-Saharan Africa	5.8	6.1	6.3	5.6	5.9
South Africa	5.4	5.1	4.2	4.4	4.8
Nigeria	6.0	6.1	7.9	7.2	6.6
Kenya	6.1	6.3	5.0	5.7	5.9
Memorandum items					
Developing countries					
excluding transition countries	7.6	7.9	6.5	6.5	6.5
excluding China and India	6.0	6.1	5.2	5.0	5.0

Source: World Bank.
Note: PPP = purchasing power parity; e = estimate; f = forecast.
a. Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
b. In local currency, aggregated using 2000 GDP weights.
c. Simple average of Dubai, Brent, and West Texas Intermediate.
d. Unit value index of manufactured exports from major economies, expressed in US$.
e. GDP in 2000 constant dollars; 2000 prices and market exchange rates.
f. GDP measured at 2000 PPP weights.

Figure 1.1 Real GDP growth, 1980–2010



Source: World Bank data and forecasts.

burdened by large external imbalances or heavy external financing requirements. Many countries have accumulated ample foreign reserves and have reduced their external debt burdens significantly. Unlike high-yield corporate bonds in the United States, where spreads now stand 400 basis points above the levels of summer 2007, emerging-market sovereign spreads increased just 120 basis points, to stand now at 310 points. Because the yield on U.S. Treasury bonds fell by about the same amount, yields on developing-country sovereign bonds have remained relatively stable. And most countries have expanded and diversified their export base, a move that facilitates external adjustment.

Notwithstanding this strong performance among developing countries, the volume of world trade tends to show more pronounced cyclical swings than GDP does and is projected to slow to 4.5 percent in 2008, substantially less than the 10 percent expansion of trade just two years ago. At the same time, there are signs that capital flows to developing countries are slowing (see chapter 2). That combination may place particular stress and force significant adjustment on several developing countries with large current account deficits. In particular, the resilience of private corporate balance sheets in these countries will be tested, as the private sector was in many cases the main beneficiary of the surge in international lending in recent years. An additional challenge for the oil-importing developing countries is the further rise in energy prices, which has again increased import bills and financing requirements.

The sharp rise in food and energy prices of the past few years has cut into the real incomes of the very poor and raised inflation in a growing number of countries. Moreover, stocks of several major foodstuffs are at record low levels, raising the specter of an even sharper rise in food prices should a major crop failure occur in 2008. In this context, governments face a daunting challenge of protecting the most vulnerable of their citizens in a fiscally responsible and sustainable manner. As much as possible governments should use or expand social safety nets to provide targeted income support instead of subsidizing prices generally, which can be extremely expensive, and without reverting to export bans or price controls, which can jeopardize incentives to expand agricultural production and aggravate shortages in other countries.

Policy makers in developing and high-income countries alike face the difficult challenge of managing the short-term slowing of their economies and potential financial stress on one hand and the risks associated with rising inflation on the other. While a rapid and substantial slowdown would be unwelcome, some easing in activity for most developing countries is probably desirable. As a result, automatic stabilizers should be allowed to function, but given the inherent difficulties in fine-tuning an economy, in most countries a strongly stimulative policy stance would be a mistake. With very few exceptions, most countries should follow a fiscal and monetary policy approach that emphasizes medium-term fiscal sustainability and price stability. Moreover, a strengthening of financial sector supervision and review of risk management capabilities of financial institutions take on increased importance at the present juncture.

Global growth

High-income OECD countries

The U.S. economic slowdown intensified in 2007, dominated by a substantial contraction in residential investment (home construction). Falling home prices and mounting foreclosures tied to subprime mortgages helped to set the stage for turmoil in financial markets, though the roots of the housing crisis go deeper, into the loose monetary policy following the recession in 2000–01, surging home prices, and a search for yield among investors. Financial turbulence and the consequent

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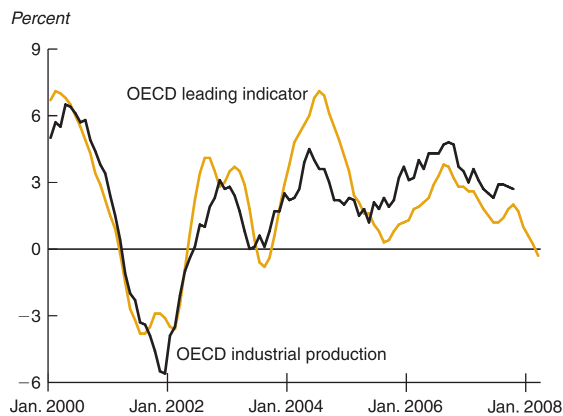
freeze-up of lending, in conjunction with rising fuel and other import prices (due in part to the falling dollar), began to weigh on other components of domestic spending. Overall, U.S. GDP growth eased from 2.9 percent during 2006 to 2.2 percent in 2007, but increased only at a 0.6 percent annual pace in the final quarter of the year. The falloff of U.S. domestic demand continued in the first quarter of 2008.

Although GDP registered another small gain of 0.6 percent during the first quarter (in large measure due to a 0.8 point contribution to growth from stock building), consumption eased to 1 percent growth (seasonally adjusted annual rate [saar]), and business investment dropped 2.5 percent in the quarter from an increase of 6 percent in the previous period. Net exports added a strong 0.6 points to growth. This profile—stagnation in domestic absorption, offset by positive impetus from trade—is likely to continue, keeping U.S. GDP growth soft over the coming quarters.

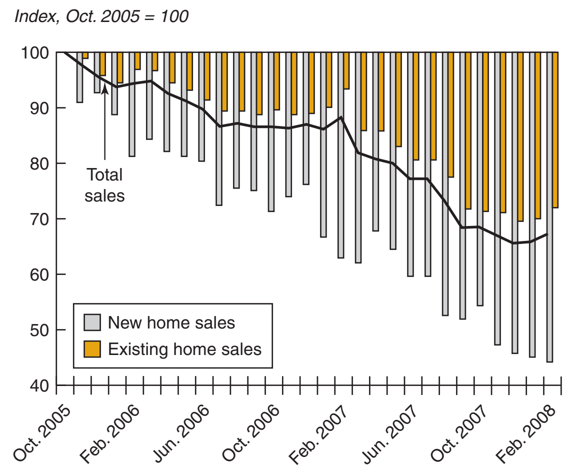
In Europe and Japan, the second half of the year is expected to be weaker than the first, as leading indicators point to weakness in activity over the period three to six months ahead (figure 1.2). Based on these indicators, the strong outcomes for GDP growth in the first quarter, Euro Area (3 percent, saar) and Japan (3.3 percent), are unlikely to be repeated.

Figure 1.2 Leading indicators of growth in high-income OECD countries



Sources: World Bank and OECD.

Figure 1.3 Trends in U.S. home sales



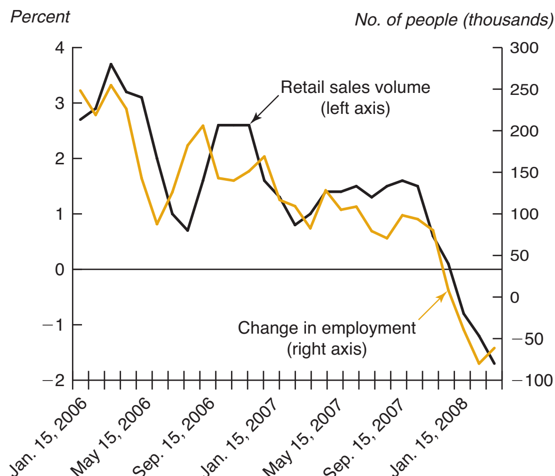
Sources: National Association of Realtors and U.S. Department of Commerce.

United States

The slowdown in U.S. GDP reflects a sharp weakening of domestic demand, which has been partially offset by strong gains in net exports. Growth in domestic demand eased from 2.8 percent in 2006 to 1.5 percent in 2007, growing at less than half the pace of GDP; domestic demand actually declined in the final quarter of the year. Much of the slowdown can be explained by the recession in the housing sector, which is the worst since 1982. Overall, residential investment fell by 17 percent in 2007, sales of new homes were down a whopping 56 percent, and sales of existing homes dropped 28 percent (figure 1.3). Housing construction was off 25 percent in the final quarter of 2007 (saar) and U.S. home prices fell between 7 and 11 percent over the past 12 months.[1] The weakness in domestic demand also reflects an end to housing price–induced dissaving on the part of consumers, weaker real-income growth, and rising fuel, food, and import prices. Taken together, these factors help explain why high-frequency data on consumer sentiment and retail sales are much closer to recession levels than data on industrial orders and production might suggest (figure 1.4).

The U.S. traded sector has performed much better. The sharp depreciation of the dollar against the major currencies (and a large number of developing-country units), together with still-strong

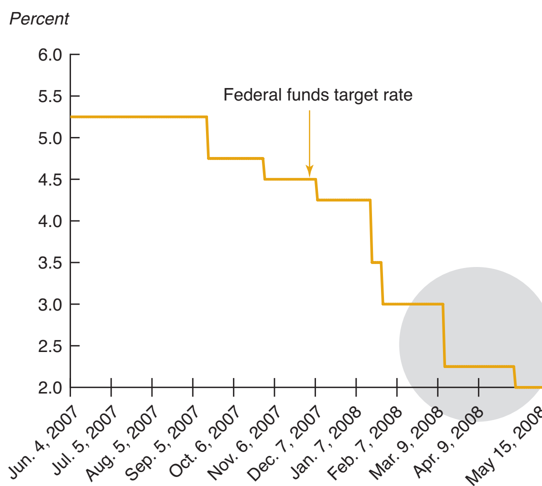
Figure 1.4 U.S. employment growth and retail sales volume



Source: U.S. Departments of Commerce and Labor.

Note: Change in employment is expressed as a three-month moving average. Growth of retail sales is expressed as percentage change of a three-month moving average year over year.

Figure 1.5 Cuts in main U.S. interest rate



Source: Thomson/Datastream.

growth in export markets, supported U.S. export volumes at a 6.5 percent pace during the fourth quarter of 2007, in the wake of a robust 19 percent gain during the third quarter (saar). At the same time, weak domestic demand meant that imports declined 1.4 percent. As a result, net exports contributed more than 1.6 and 1 percent to GDP growth in the third and fourth quarters. And the U.S. current account deficit declined from 6.2 percent of GDP in 2006 to 4.9 percent by the fourth quarter of 2007.

As noted, the 0.6 percent growth of the first quarter of 2008 reflected continued positive contributions of net-exports to growth, and weakening of key segments of domestic demand. The falloff in residential investment accelerated to a 27 percent pace (saar); and the decline in home prices intensified. Manufacturing output dropped sharply in response to the ongoing difficulties in housing as well as in autos. And retail volumes for goods slipped to negative ground, as soaring food and fuel prices took a toll on household purchasing power.

Since August 2007 the Federal Reserve has cut its main policy interest rate 7 times for a total of 325 basis points, bringing the federal funds rate to 2.0 percent as of April 2008 (figure 1.5). Interest rates faced by business and consumers have fallen by much less. Thirty-year mortgage rates stand at 5.75 percent—about 25 basis points lower than a year ago, while adjustable rate mortgages are available at about 5 percent. Interest rates facing prime borrowers remain low in historical perspective, but borrowing criteria have tightened. Expectations of deteriorating consumer servicing of debt and rolling-credit obligations have maintained rates on credit card and auto loans at high levels. And counterparty risk (banks not knowing the underlying financial condition of their transaction partner) plays an important role for business finance. Moreover, given uncertainty in interbank trades and the need to accommodate balance sheet losses, banks have been quite leery to lend.

Policy easing has not been confined to interest rates but also includes measures to shore up financial markets, addressing the waning of confidence in the banking system. The Federal Reserve, in concert with central banks in Europe, has made large amounts of liquidity available to both the traditional banking and investment banking systems; that has included giving nonbank financial institutions access to its discount window for a limited time following the dramatic collapse of Bear Sterns in late March 2008. Notwithstanding these steps, deep uncertainties continue to characterize financial markets, suggesting that significant time will be required before they return to normalcy. At

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the same time the long-term consequences of the substantial monetary policy easing of the past few months will not be visible for some time, but there is a risk that the extent of the policy easing could contribute to future inflationary pressures.

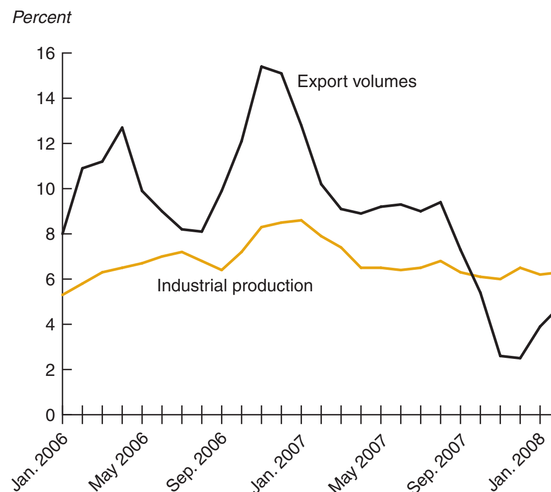
In addition to the steps taken by the Federal Reserve, the U.S. Congress enacted a fiscal stimulus package worth some $168 billion, which is expected to provide a fillip to consumer demand in the third quarter.[2] Overall, GDP is expected to grow 1.1 percent in 2008, about half as quickly as in 2007, although financial uncertainties tilt risks well to the downside. On the back of further reductions in home prices that help restore affordability to newcomers in the market, continued gains in exports, and moderation in energy prices accompanying slowing U.S. and global demand for petroleum, a rebound in U.S. activity should be taking shape by late 2008. Notably, as current housing starts fall well short of new household formation, the decline in residential investment is expected to bottom out later in 2008. Growth anticipated for 2009, at 1.9 percent, reflects these developments, and recovery is expected to come to fuller fruition by 2010, with GDP gains registering 2.5 percent. The U.S. current account deficit is expected to narrow to 5.1 percent of GDP by 2010 from 5.4 percent in 2007.

Euro Area

Economic activity in the Euro Area peaked in 2006 at 2.9 percent. Output slowed in 2007, expanding only 1.4 percent (saar) in the fourth quarter, but registered a strong 2.6 percent for the year as a whole. Despite falling unemployment, consumer confidence waned and household consumption increased by only 1.5 percent. Investment demand held up better, increasing 4.1 percent, but capital outlays faded over the course of the year, from 7 percent in the first quarter to 2 percent in the last quarter (saar). Weaker export growth (attributable in part to the 10.7 percent appreciation of the euro vis-à-vis the dollar over the year) also contributed to the easing pace of GDP growth. Overall, European exports slowed from 8.4 percent in 2006 to 5.5 percent in 2007, with German export volumes declining rapidly toward the end of the year (figure 1.6).

During the first months of 2008, the euro appreciated an additional 7.2 percent against the dollar, sending exports destined for the U.S. market into decline. Yet for European exporters, as well as for those in East Asia, the potential remains for growing sales by targeting markets outside of the dollar zone. Asian (including Japanese) exports to Europe have been considerable in the past months, while European exports outside of the United States have been robust. German exports to countries outside Europe gained 12 percent in January 2008 (year-on-year), while exports to EU partners advanced 7.7 percent. Similar developments in France are under way. These advances have been a key factor in buoying business sentiment in the Euro Area, underpinning a degree of confidence among executives that Europe can weather the U.S. downturn.

Figure 1.6 Trends in German exports and industrial production



Source: Eurostat through Thomson/DataStream.

Note: Export volumes and industrial production are expressed as percentage change for a three-month moving average year over year.

Following the disappointing 1.4 percent GDP advance (saar) of the final quarter of 2007, preliminary figures for European growth in the first quarter of 2008 (3 percent) were quite strong. However, the picture is becoming more diverse, with apparent robust growth in Germany (6.3 percent), which benefits from export opportunities for investment goods in developing countries, and further waning of momentum in southern Europe and the United Kingdom. Moreover, high-frequency numbers suggest softer GDP outturns for the coming quarters.

On balance, GDP in high-income Europe is expected to slow further in 2008, coming in at 1.7 percent. Although exports to the developing

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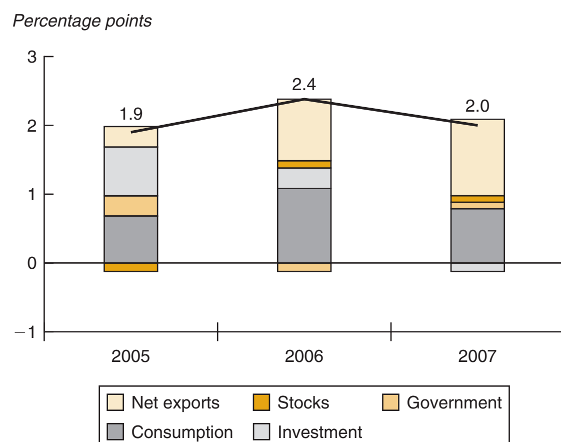
world appear to be maintaining momentum, domestic demand is expected to respond to weaker real-income growth (due to high inflation) and relatively tight monetary policy. As the inflationary effects of increased food and energy prices ease in 2009, demand conditions are expected to improve, setting the stage for recovery in activity beginning in mid-2009, with growth reaching 1.9 percent by 2010. Given the importance of Central and Eastern Europe and the Middle East for high-income European exports, a weaker-than-expected outturn for these countries (notably among those Central and Eastern European countries exposed to the impact of financial turmoil; see below) would be experienced as slower export growth and weaker economic activity in the Euro Area.

Japan

Developments over the course of 2007 underscored the fragility of Japan's foundations for growth, and GDP in 2007 dipped to 2 percent from the 2.4 percent advance of 2006. Quarterly patterns of growth were quite volatile, ranging from an advance of 4.6 percent during the first quarter to a decline of 2.5 percent in the second (saar), reflecting variability in domestic segments of demand and the vagaries of trade. More than half of overall growth came from net exports in 2007 (figure 1.7), highlighting the weakness of domestic demand and the sensitivity of future outcomes to the projected slowing of U.S. imports and world trade more broadly. Although conditions for stronger gains in household spending were widespread over 2006–07 (declining unemployment, rising job offers), real consumer spending grew just 2 percent and 1.5 percent, respectively, in 2006 and 2007, well short of levels able to sustain economywide growth. At the same time, business investment softened from gains of 9.2 percent in 2005 to 1.9 percent by 2007.

Figure 1.7 Contributions to real GDP growth in Japan



Sources: Japan Cabinet Office and World Bank calculations.

Recently consumer sentiment has waned on a string of rising inflation reports and a dramatic 22 percent falloff in Japan's equity markets during the first quarter of 2008. Moreover, weak end-of-year bonuses meant that wages declined 2.4 percent in January 2008 (year over year). At the same time, the yen has appreciated 14 percent against the dollar since the start of 2008. These developments appear to bode ill for rekindling momentum in Japan's household demand. On the other hand, emerging economies are now the destination for more than half of Japan's overseas shipments, a development that should make the economy less sensitive than in the past to changes in U.S. import demand. Although export momentum is fading at present, demand growth in China, other East Asian countries, western Europe and the world's oil exporters is expected to more than compensate for declining shipments to the United States over the coming two years.

Indeed, preliminary first-quarter GDP outturns for Japan reveal a surge in exports from 10 percent in the final quarter of 2007 to 20 percent (saar), such that net exports accounted for 2.4 points of 3.4 percent growth during the quarter. At the same time, household spending revived, advancing 3.4 percent, more than double the 1.6 percent gains of the last quarter of 2007 (a number of respected analysts attribute the outsized gain to a leap year effect, and without such distortion, consumption growth may have registered 1.8 percent). Business investment dropped 3.4 percent on expectations of weaker growth ahead and on steep declines in consumer confidence. *Tankan* surveys point to retrenchment in corporate capital spending, suggesting that growth is likely to soften from the favorable results of the first months of 2008.

Financial contagion from difficulties in the United States and European markets appears to be limited to co-movements in equity prices, with little evidence to date of large-scale losses tied to holdings of troubled U.S.-structured assets by

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Japanese institutions. Nonetheless, Japanese commercial and investment banking institutions are well integrated into international flows of interbank lending, funding of hedge funds, private investment entities and similar groups, such that second-order risks are of concern. Moreover, the use of low-interest yen funds by international investors as a conduit for investment in higher-yielding assets in a number of mature, as well as emerging, markets (the so-called carry trade) places the yen at risk of rapid change should such flows escalate or unwind.

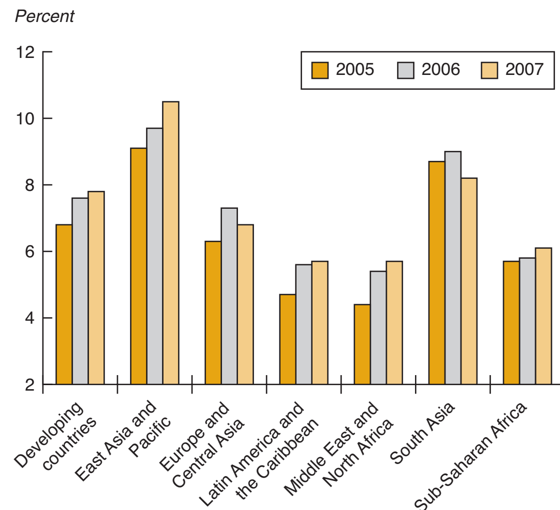
With little momentum from the consumer (growth of 1–1.5 percent through 2010) or business investment, Japan's prospects will continue to be shaped by trade developments. Japanese exports are projected to grow 2.2 percent during 2008 (down from 8.6 percent in 2007), before rebounding toward longer-term average growth of 6.5 percent by 2010. With subdued import demand, and in the absence of financial market difficulties, GDP growth is projected to ease to 1.4 percent in 2008 before picking up to grow by 2.1 percent in 2010.

Outlook for developing regions

In contrast with the high-income countries where GDP growth eased from 3 percent in 2006 to 2.6 percent in 2007, gains for developing countries as a group picked up modestly to 7.8 percent from 7.6 percent in the year. Improved macroeconomic fundamentals, diminished sovereign exposures to international financial markets, largely favorable terms-of-trade developments, and buildup of large international reserve positions helped to insulate many countries from financial spillovers. And as figure 1.8 shows, robust momentum in domestic demand, driven in many countries by investment outlays, was sufficient to buffer the initial shocks stemming from the financial turmoil in mature markets. Indeed, growth stepped up across all developing regions during 2007, with the exceptions of Europe and Central Asia and South Asia.

In looking forward, developing countries will be faced with exceptional weakness in their traditional export markets, as import demand falters among the high-income OECD countries. This will exact a toll on aggregate growth, with GDP gains slipping to 6.5 percent in 2008 and easing further to 6.4 percent in 2009–10. GDP outturns are likely to differ substantially across regions.

Figure 1.8 Developing-country GDP growth, 2005–07



Source: World Bank.

During 2007, the *East Asia and Pacific* region recorded its highest growth rate in over a decade (10.5 percent), capping more than 10 years of improvements following its home-grown financial crisis in 1998. Even more important, the region's investment in sound macroeconomic policies and structural reforms since that crisis has added economic resilience and flexibility that will help deal with the rapidly deteriorating global environment. Foreign exchange reserves are at all-time highs, nonperforming bank loans have been steadily lowered, external and public debt burdens are at acceptable levels, most governments have unused fiscal space, and diversification of trade and financial flows provides some flexibility in adjusting to the impending global slowdown. In most of the developing countries of the region, corporate financing to a large extent occurs through retained earnings or domestic bank borrowing, so exposure to international markets may be less extensive than in other developing regions.

East Asian growth is expected to diminish to 8.6 percent in 2008, which is still considerably higher than growth in other regions. Growth is as much constrained by insufficient production capacity and bottlenecks in infrastructure as by lack of effective demand. Hence, investment is likely to remain robust, and with continued prudent economic management, East Asia, and especially China, can continue to emerge as a

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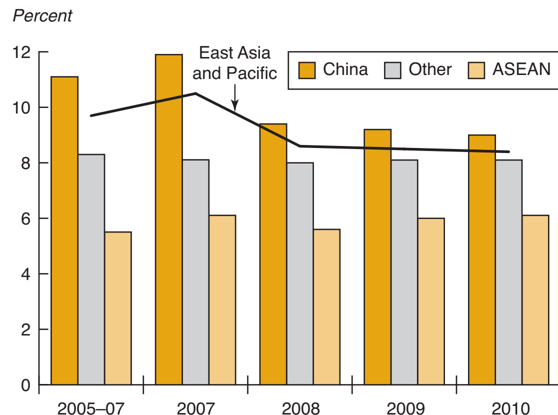
Figure 1.9 Real GDP growth in East Asia and Pacific, 2005–10



Source: World Bank.
Note: ASEAN = Association of Southeast Asian Nations.

growth pole for the world economy, providing a potential counterweight to the slowing high-income economies. To absorb in part the decline in U.S. import demand, export flows are shifting to markets in Europe and developing countries, encouraged by the strong euro and by continued strong momentum in the developing world, including in East Asia itself. Looking further ahead, GDP gains are anticipated to ease moderately to 8.4 percent by 2010 (figure 1.9).

The main risks for East Asia and Pacific do not necessarily stem from the global slowdown but from volatility in financial markets, which could manifest in steep declines in securities markets across East Asia—especially in equities and to a lesser degree, offshore bond markets. The decline has been driven not just by uncertainty and the liquidation of portfolio holdings by foreign financial institutions but also by a more realistic evaluation of risk in global financial markets. A potential risk that requires attention is that a falloff in stock prices may have a contagion effect through the balance sheets of corporations or banks. Dealing with high food and fuel prices also constitutes a challenge to governments. In the medium term, the answer lies in greater fuel efficiency and stronger and more productive agriculture. But in the short term, the bigger concern is to alleviate the harsh burden rising prices impose on the poor. East Asia has faced these problems before and adopted a variety of solutions in the past to fit different circumstances, ranging from targeted subsidies to conditional cash transfers to school lunch programs. These programs now need to be reconsidered and reintroduced before the problem becomes more acute.

GDP growth during 2007 in *Europe and Central Asia* exceeded earlier expectations, easing moderately from 7.3 percent in 2006 to 6.8 percent, largely on the back of continued high oil prices and robust growth among oil exporters in the region. Members of the Commonwealth of Independent States (CIS)—led by key hydrocarbon exporters the Russian Federation, Kazakhstan, Uzbekistan, and Azerbaijan—benefited from surging energy prices, and the CIS achieved growth of 8.6 percent, the second strongest in a decade. And in both central and eastern Europe and the CIS, GDP gains were underpinned by strong domestic demand, with investment and imports registering double-digit advances in a number of countries.

The slowdown in growth during 2007 may be attributable in large measure to fiscal consolidation in Hungary, the effects of financial market turmoil on capital inflows to countries such as the Baltics, Kazakhstan, and Romania and an easing of activity in Turkey. Accession to the European Union has also played an important role in generally strong growth outturns for central and eastern Europe, promoting capital inflows and in turn, yielding wider current account deficits. For the smaller countries of the CIS, demand has been financed by substantial inflows of remittances (which in 2006 accounted for 18 percent of GDP in Armenia, 6.5 percent in Georgia, 27 percent in the Kyrgyz Republic, and 36 percent in Moldova).

These favorable outturns are being clouded by increasing uncertainties. The region showed little improvement over the past years in its traditional exposures and vulnerabilities. Save for oil exporters, almost all economies witnessed a deterioration in current account position during 2007 (figure 1.10). This was most pronounced for the Baltic states, Bulgaria, and Romania, raising concerns about the sustainability of growth in these countries. Inflows of foreign direct investment (FDI) to the region achieved record highs in 2007 ($162 billion), but in light of the global credit crunch, flows are expected to fall off in 2008, covering a diminishing portion of current account deficits. An increasing reliance on foreign bank borrowing suggests that economic activity could suffer if the external financial environment deteriorates suddenly.

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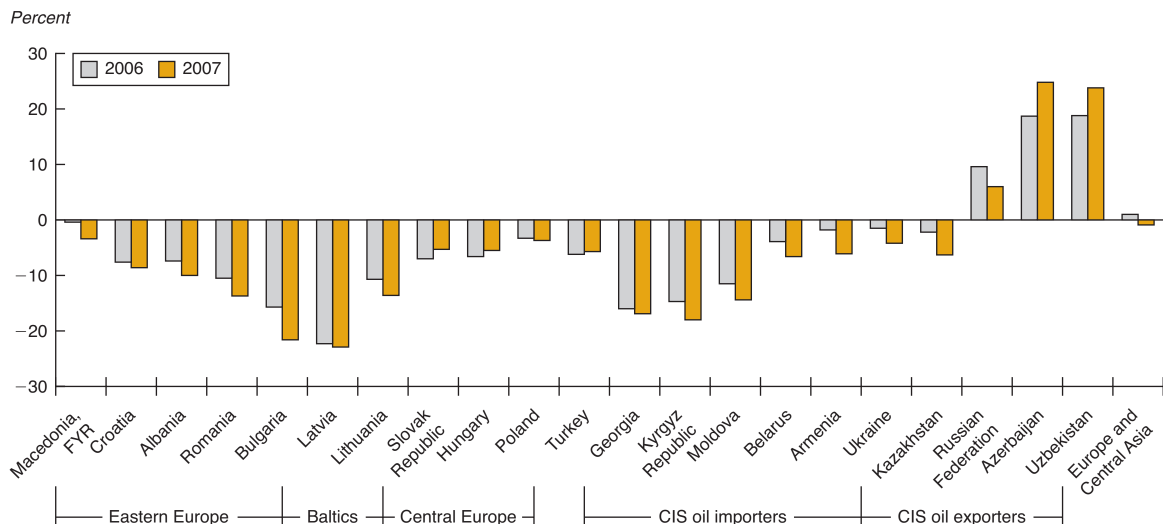
Figure 1.10 Current account as a share of GDP in Europe and Central Asia, 2006–07



Source: World Bank.
Note: CIS = Commonwealth of Independent States.

The region has exhibited surprising resilience to tremors stemming from the financial turmoil in high-income financial markets. But risk appetites of international investors will be tested during 2008. Sovereign spreads have been widening since the start of the turbulence in August 2007, but increases have differed across countries. Spreads for Turkey, Hungary, Bulgaria, Ukraine, and Kazakhstan have increased by 93 to 270 basis points moving across the four countries, compared with Russia (63) and Poland (42). Investor sentiment has also been reflected in currency movements: the National Bank of Kazakhstan used reserves to stabilize its currency in the second half of 2007; and the Turkish lira dropped 16 percent against the euro in the first quarter of 2008.

The region's prospects display a gradual slowing of growth to 5.4 percent by 2010, but performance will become more diverse across countries. Central and Eastern European countries will see a downturn in export growth, as demand conditions in the Euro Area fade during 2008. That slowdown will be partly offset by increased demand from neighboring oil exporters as oil prices are likely to persist at high levels through 2008. The Baltic economies have shown signs of cooling, partly because of more prudent lending by banks, but there is risk of a hard landing. An abrupt slowing of growth in Latvia in the previous two quarters underscores the downside risks.

An increasingly serious risk facing the region is inflation, which jumped to nearly double digits in a number of countries, including Bulgaria, Latvia, Russia, and Ukraine in recent months. Although a global phenomenon, the inflation situation in the Europe and Central Asia region is more complicated. Unlike other regions where inflation is being stoked by surging food and energy prices, with unclear second-round effects, this region has seen strong real wage growth (from tightening labor markets) much earlier than others. Regulated prices and indirect tax increases among the central and eastern European economies, currency board systems in the Baltics and Balkans, large capital inflows into CIS oil exporters (and these countries' spending of expansive oil revenues), and high energy prices for oil importers all bode unfavorably for the region's near-term inflation outlook.

GDP growth in *Latin America and the Caribbean* registered 5.7 percent in 2007, up modestly from 5.6 percent in 2006. This marks the first time in nearly three decades that growth has exceeded 5 percent for two years in succession, and the first time since the early 1970s that GDP gains have registered more than 4 percent for four consecutive years. Growth in the region has become

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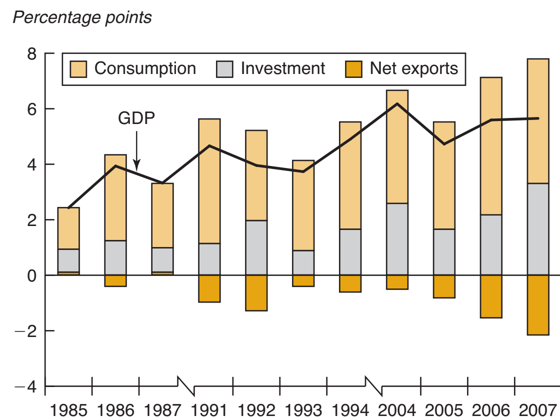
Figure 1.11 Contributions to GDP growth in Latin America and the Caribbean, 1985–2007



Source: World Bank.

more resilient, and countries are likely better positioned to weather the unfolding slowdown in the United States. Although a favorable external environment has played a key role in the region's improved performance, stronger domestic fundamentals have been just as important. Capital formation has made a stronger contribution to GDP growth during the recent growth spell than during two previous growth episodes in the early 1980s and 1990s (figure 1.11). Financial stability across a large number of countries in the region also played a role in supporting growth, and this environment is anticipated to buffer what is likely to be continued turbulence stemming from U.S. financial markets over 2008–09.

In contrast with previous episodes of market instability in high-income economies, the increase in risk premiums in Latin America has been fairly contained in the current credit crisis. Similarly, capital inflows remain strong, suggesting the region's financial markets may be providing diversification benefits for international investors. International reserve levels are large and foreign debt stocks continue to decline, limiting the region's vulnerability to terms-of-trade shocks or to a sudden withdrawal of capital.

Despite improved resilience, deterioration in the global environment is considered likely to weigh down regional growth in 2008. GDP gains are projected to ease to 4.5 percent in 2008, with further moderation to 4.2 percent by 2010. A key factor in the continued step-down in growth is a marked slowing in Argentina, from 8.7 percent in 2007 to 4.5 percent by 2010, and an even sharper decline in República Bolivariana de Venezuela, from 8.4 percent in 2007 to 3 percent. Excluding these countries, regional GDP is likely to slow from 4.9 percent in 2007 to 4.3 percent in 2010, with a dip to 4 percent in 2008 due to weak conditions in the United States.

Many countries in the region have been riding a wave of high commodity prices that have buttressed current account surpluses. As commodity prices ease over 2009–10, the surpluses of oil, metals, and agricultural exporters are likely to diminish substantially, although many energy importers in Central America and the Caribbean will experience much-needed relief. While many exporters have capitalized on the benefits of high commodity prices, the region has been less successful in exploiting the opportunities produced by the changing global trade landscape. Latin America has not taken advantage of the rising share of China in global imports, which keeps growth of export volumes subdued, especially during the current period. For several countries the damage is not coming from the external environment, but from internal stimulus and resulting overheating, leading to open or suppressed inflation.

GDP growth in the developing *Middle East and North Africa* region fared well during 2007, supported by record-high crude oil prices, stronger growth in key export markets (particularly in western Europe), and continued flows of remittances and tourism earnings. Regional growth stepped up to 5.7 percent in 2007, a 12-year high, from 5.4 percent in 2006 on the back of improved activity among the developing oil exporters of the region, as well as by a majority of diversified exporters. Foreign direct investment continued to play an important role in shaping growth outturns, registering some $30.5 billion in 2007, up from a record $27.5 billion in 2006. Three countries are attracting the bulk of flows: Saudi Arabia, the Arab Republic of Egypt, and the United Arab Emirates, which now account for more than half of inward FDI into the broader geographic region (figure 1.12).

Among the economically diversified countries, GDP gains eased from 6.2 percent in 2006 to 5.5 percent in 2007, although a severe drought suffered by Morocco (the second in three years) reduced output there from a record 8 percent in 2006 to 2.3 percent.[3]

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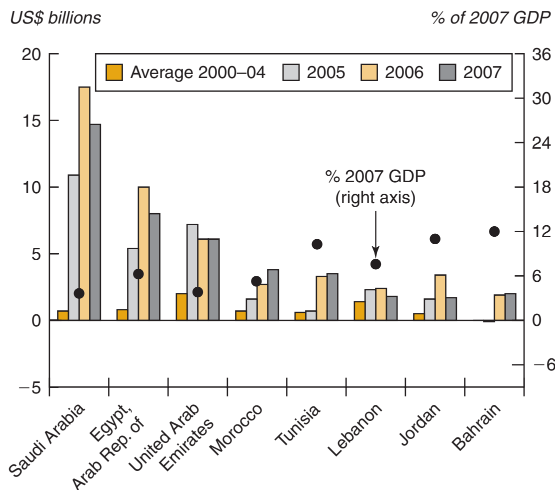
Figure 1.12 Growth of FDI in selected countries of the Middle East and North Africa



Source: World Bank.

This decline tends to mask improvements across a wider range of countries. Growth in Egypt, which reached a record 7.1 percent in the year, is broadly based, with non-oil manufacturing and retail trade accounting for half of overall output growth. Although deficits continue on merchandise trade, for Egypt and other countries of the group, tourism and other services receipts and burgeoning remittances tend to outweigh these shortfalls and help maintain current account surplus positions. Growth among the developing oil exporters increased to 5.8 percent from 4.7 percent in 2006. Output gains in Algeria have been constrained by a fall in hydrocarbon output, with GDP advancing just 1.8 percent in 2006 and 3 percent in 2007. Non-hydrocarbon activity expanded by a strong 6 percent in 2007. A major government investment initiative there has belatedly started and is slated to expend more than $22 billion over the next years on housing, transport, and agriculture. In the Islamic Republic of Iran, major fiscal expansion over the past two years has pushed growth up smartly to 7.6 percent in 2007 from 5.9 percent in 2006.

Rising food prices represent a growing vulnerability and risk for the developing Middle East and North Africa region, a net importer of food, especially in the context of poorly targeted safety nets. Large food and energy subsidies are quite unique to this region, ranging from 3 percent to 15 percent of GDP. Rising food prices have made reforming these programs even more difficult. At the aggregate, the region suffers from low levels of poverty, with less than 2 percent of the population living on less than $1 a day. However, there is tremendous disparity across countries and within countries in the region, and large numbers of people live above (but close to) the poverty line. Overall, some 20 percent of the population lives on less than $2 a day. With heavy clustering of large proportions of the population around the poverty line, rising global food prices represent a serious risk to wider-scale poverty.

The keys to the 2008 outlook for the diversified economies are rebounds in Morocco, to 5.5 percent growth from the depths of drought, and in Lebanon, to 3.5 percent, which would offset a modest easing across the remainder of the group tied to conditions in the external environment—and support a return to growth of 6.2 percent in the year. Beyond 2008 GDP growth is anticipated to average 6 percent. Investment-led growth appears increasingly well established in Egypt, and activity there should remain within a 6.5–7 percent range. Sustained growth near 6 percent is also likely in Jordan and Tunisia, grounded in services exports and increasingly in investment and construction funded by FDI. Growth among the oil-dominant economies is anticipated to ease by almost a full percentage point to 4.9 percent in 2008, largely attributable to a sharp slowdown in Iran. Continued work to supplement hydrocarbon output in Algeria, with implementation of the government's public works plan, should underpin investment and consumption, carrying GDP growth back to a 4 percent range. For the region overall, growth is expected to ease from a high of 5.7 percent in 2007 to 5.1 percent by 2010.

GDP growth in *South Asia* registered 8.2 percent in 2007, moderating from a 25-year-high 9 percent in 2006. Output gains reflected continued dynamic—albeit softening—domestic activity, while slowing external demand also contributed to the regional moderation. All South Asian countries experienced a slowing, to varying degrees, save Afghanistan and Bhutan, where GDP accelerated. Restrictive monetary policies in a number of countries, combined with a degree of fiscal consolidation, helped to dampen the robust pace of domestic demand; and the momentum of growth in South Asia's export market diminished, exacting a toll on the region's outbound shipments. Inflation accelerated, evidenced by a buildup in the median GDP

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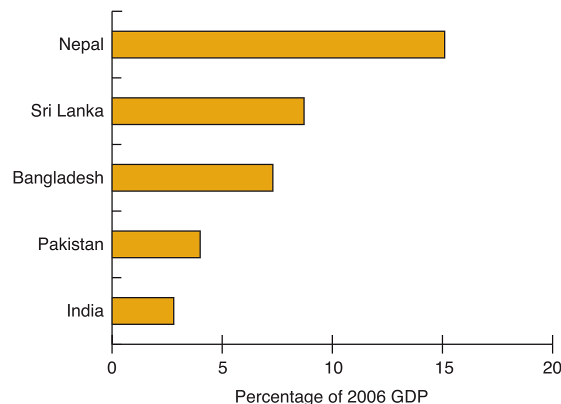
deflator to 7 percent in 2007 from 6.6 percent the previous year. Inflation pressures are reflecting sharp increases in international food and fuel prices as well as limits to domestic output linked to capacity constraints. Despite sustained worker remittance inflows, high commodity prices and weaker external demand combined to yield a worsening in the region's current account deficit in 2007.

The turmoil in U.S. and international financial markets has affected South Asia primarily through a falloff in portfolio inflows and weakness in local equity markets, with the latter most pronounced in India. Further effects on the real side of the economy are likely to be muted compared with other regions. The decline in share of the United States and the European Union in South Asia's export market in recent years has been offset by a concomitant increase in China and oil-exporting countries' shares, so effects on export volumes should be less severe than in other regions. Moreover, although South Asia's integration with the global economy advanced rapidly in recent years, it remains the least integrated among developing regions. Trade openness as a share of GDP is twice as high in East Asia and the Pacific and in Europe and Central Asia as in South Asia.

For South Asia's poor, one of the more direct effects of the deterioration in the external environment could come through international remittances. A falloff in growth in the countries where migrants are employed—combined with the sharp depreciation of the dollar—could lead to substantially lower remittance flows in local currency terms. For the poor whose incomes are being squeezed by higher food and fuel prices, lower remittances would make a difficult situation still worse. For most South Asian countries, remittances represent a major source of hard currency, and in some countries, inflows significantly boost the current account position. In Nepal, remittance inflows were equivalent to 15.1 percent of GDP in 2006, and in Sri Lanka and Bangladesh, they represented close to 9 percent and 7.3 percent, respectively (figure 1.13).

South Asia is poised for a further easing of GDP growth to 6.6 percent in 2008. Private consumption and investment will likely ease, due to tighter domestic and international credit conditions and to lower purchasing power for consumers due to higher food and fuel prices. High prices for grain, oilseed, and energy in particular

Figure 1.13 Worker remittances as a share of GDP in South Asian countries, 2006



Source: World Bank.

are expected to continue to exert upward pressures on inflation, representing perhaps the largest challenge for regional policy makers. The prices for these staples would strike the poor directly, since food and fuel represent a significant share of household consumption. Continuing volatility in international financial markets and a decreased appetite for risk among international investors may lead to still-lower capital inflows over the next years.

Growth outturns in 2007 for *Sub-Saharan Africa* were stronger than estimated in *Global Economic Prospects 2008* (World Bank 2008), with GDP gains picking up to 6.1 percent, from 5.8 percent in 2006, as South African output was revised up to 5.1 percent, and growth in oil importers outside South Africa was more robust than earlier anticipated. Regional growth appears to be increasingly broad based, with one in three countries growing by more than 6 percent during 2007 (figure 1.14). Moreover, growth has accelerated in resource-poor economies as well as in resource-rich countries, in landlocked as well as coastal countries. Per capita GDP has increased markedly in most countries in the region. Domestic demand (investment and private consumption) continues to supply the driving force for activity, a profile that, barring a collapse in commodity prices, stands to help the region weather the anticipated slowdown among the high-income countries. Indeed, many of the ingredients that contributed to robust expansion in Sub-Saharan Africa over the past years are still present, including high commodity prices,

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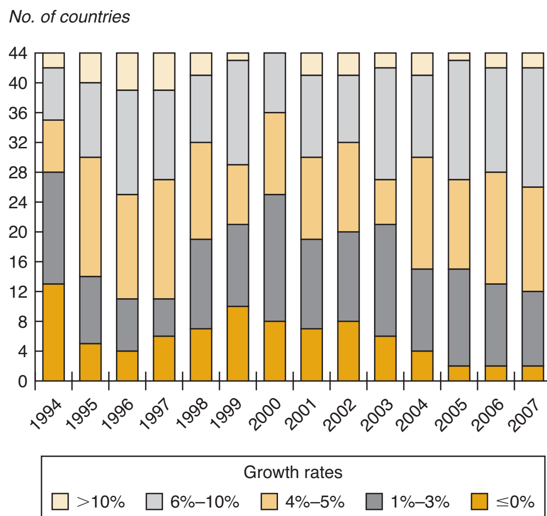
Figure 1.14 GDP growth in Sub-Saharan Africa, 1994–2007



Source: World Bank.

increased trade openness, and improved macroeconomic stability. But risks are significantly tilted to the downside, as weaker global expansion could translate into a downshift in export growth and deterioration in current account positions.

Economic expansion in Sub-Saharan Africa should remain strong, with growth picking up to 6.3 percent in 2008 on the back of gains in oil-producing countries, notably Cameroon, Nigeria, and the Republic of Congo. GDP growth among the oil-exporting countries of the region is likely to register 9.8 percent in the year. In South Africa, growth is projected to ease to 4.2 percent because of weaker private consumption and lower export growth; and capacity constraints in the electricity sector will limit output growth in mining and manufacturing. Slower growth in the regional powerhouse may spill over to other countries in the region (especially in southern Africa) that trade heavily with South Africa. Growth in East Africa is expected to ease on weaker agricultural output in 2008. Drought conditions and high inflationary pressures caused by surging food and energy prices will erode real incomes throughout the region, undermining private consumption. The risks for regional growth are mainly to the downside and include a sharper-than-expected slowdown in the global economy with negative consequences for export growth and investment on the real side and weaker commodity prices on the nominal side.

Increased volatility in the international financial system and increased risk aversion among international investors create risks for South Africa in particular, which runs a significant current account deficit. In recent years on average 84 percent of South Africa's current account deficit was financed by portfolio investment, but this share plunged to 38 percent in the final quarter of 2007. Unwillingness to continue to provide such short-term flows could put pressure on the rand, which in turn would fuel inflationary pressure and add impetus for the country's Reserve Bank to hike interest rates.

International trade links

The slowing of domestic demand in the United States and the relative strength of its exports reflects a more general rotation of global demand away from dissaving fueled by the collapse of the U.S. housing sector toward a more balanced profile where demand in developing countries is increasingly driving the global expansion. The rotation in demand is helping to rebalance both the U.S. and the global economies. The effects are already visible in the U.S. balance of payments. Despite rising oil prices, the U.S. trade deficit narrowed by 0.6 percent of GDP during 2007. Although a scaling back in household spending is painful in the short run and is likely to amplify the distress in financial markets, rebalancing of growth is crucial for long-term stability, because it will reduce the potential for future financial turmoil.

While the improvement in the U.S. trade balance is positive news from a global perspective, it has been accompanied by a sharp decline in U.S. imports, which prompts the question of whether domestic demand in the rest of the world can expand quickly enough to support strong growth for developing countries while at the same time cushioning the slowdown in the United States (and potentially in Europe and Japan) by providing sufficient demand for its exports.

Since the early 1990s, developing countries have become increasingly integrated in global markets. Paradoxically, their overall growth has become less dependent on their external environment or more specifically, on imports of the high-income

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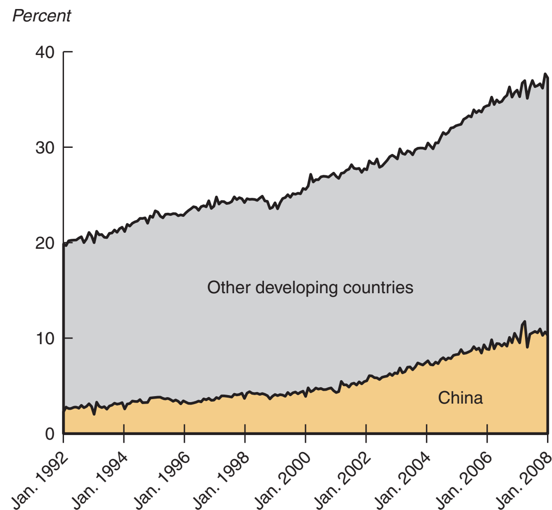
Figure 1.15 Share of developing countries in world exports, 1992–2008



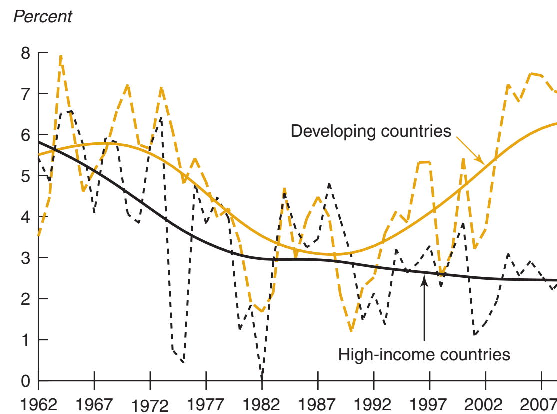
Source: World Bank.
Note: Nominal dollar exports were used in the calculation.

countries. Over the past 15 years, developing countries opened up their economies, increased exports, and quickly gained market share in global trade. Exports as a share of developing economies' GDP increased from 22 percent in 1992 to 29 percent in 2000 and to 39 percent in 2007. Over the same period their share in world exports increased gradually from 20 percent to 37 percent, with China responsible for fully one-half of the increase in market share (figure 1.15).

On first sight, the more dominant role of exports in developing countries suggests that their economies depend now—more than 15 years ago—on import demand in the high-income countries and on the global trade cycle. However, this is not the case for two reasons. First, the remarkable export performance of developing countries has been driven by increased production capacity, not by acceleration of foreign demand. Production capacity is currently constrained by a lack of adequate infrastructure (including power), not a lack of effective demand in world markets. Second, South-South trade is growing more than twice as fast as North-South trade, which reduces the impact of import demand in high-income countries.

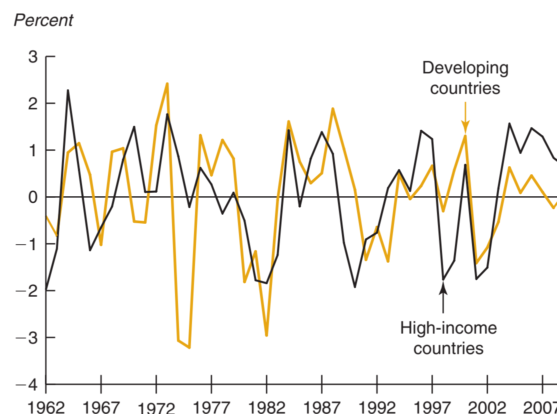
The shifts toward domestic drivers of growth in the developing world can be illustrated by decomposing GDP growth into trend and cyclical components. Since the 1960s growth rates of developing countries and their high-income counterparts were remarkably similar. But during the 1990s structural growth rates diverged rapidly (figure 1.16). In the meantime, the cyclical components of growth remained strongly correlated. If anything, the correlation coefficient for cyclical growth between developing and high-income countries increased over time, consistent with the penetration of developing countries into global markets (figure 1.17). However, overall growth in the developing world was increasingly dominated by quite strong trend growth, and cyclical fluctuations became a smaller percentage of growth. And even with a cyclical downturn, growth rates exceeded previous peak rates.

Figure 1.16 Comparison of trend GDP growth



Source: World Bank.

Figure 1.17 Comparison of cyclical GDP growth



Source: World Bank.

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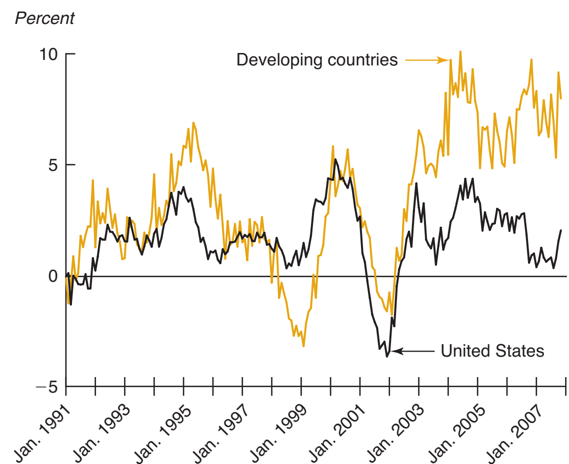
The acceleration in developing-country growth that set in after 2002 corresponds with the period of increasing commodity prices (lasting through today). Could the current upturn in growth be simply a function of favorable terms of trade for developing commodity exporters (a boom, potentially "bust," cycle), rather than a reflection of shifts in fundamentals? This is unlikely, in that the initial surge in oil, metals, and agricultural prices was initiated by the onset of faster output growth and strong materials demand in large emerging-market countries, such as the BRICs, or Brazil, Russia, India, and China.

The divergence in trend growth is also clearly visible in trade performance. During the 1980s growth of export and import volumes in high-income countries exceeded the corresponding growth rates in developing countries, where imports (in particular) were hindered by debt burdens and macroeconomic instability. During the 1990s circumstances were quite similar across the two country groups, but since 2000, developing countries' trade growth has accelerated to an annual pace of 10 percent, almost double that of the high-income countries.

The rapid increase in developing-country market share over the past 15 years means that developing countries themselves have become a driving force underlying the global trade cycle, reducing (but certainly not eliminating) the influence of high-income countries. During the 1980s the contribution of high-income countries to growth in global import volumes was nine times as large as the contribution of developing countries. High-income imports grew three times as fast as developing countries' imports, and the share of high-income countries in world trade was three times as large. During the 1990s the relative contribution of high-income countries was reduced from ninefold to threefold, already a major shift, increasing the relevance of developing countries. But the breakthrough occurred in the current decade as developing countries became larger contributors to global imports than high-income countries. The size in value of developing countries' imports has risen to two-thirds that of OECD imports, and annual import growth exceeds OECD import growth by 60 percent. Relative to the United States, where import growth has slowed sharply, the increased contribution of developing countries to global import demand is even more impressive (figure 1.18).

Figure 1.18 Nominal import growth, developing countries and the United States, 1991–2007



Source: World Bank.

This dramatic reversal in relative importance means that the direct effects of a drop in OECD import growth are still important, but smaller, than in earlier decades, even taking into account the now larger ratio of developing-country exports to GDP. More and more, export opportunities for developing countries are shaped by import demand in other developing countries.

The combination of a pronounced slowing of imports in high-income countries and strong trends in developing countries provides a mixed picture at the global level. Global industrial production, strongly correlated with global GDP, is slowing. This has been confirmed by other cyclical indicators such as metal prices (figure 1.19), though these prices rose sharply during the first quarter of 2008. And because industrial production remains so strongly correlated with GDP at the global level (figure 1.20), high-frequency indicators can provide a reliable proxy for global growth. Indeed, the coming slowdown in the developing world is likely to reflect to a greater degree the direct and indirect effects of global credit tightening rather than the direct impact of slowing import demand in high-income countries.

The impact of higher commodity prices

Commodity prices have shown spectacular increases since the summer of 2007. Most of the increases were directly or indirectly linked to higher oil prices and increased demand for

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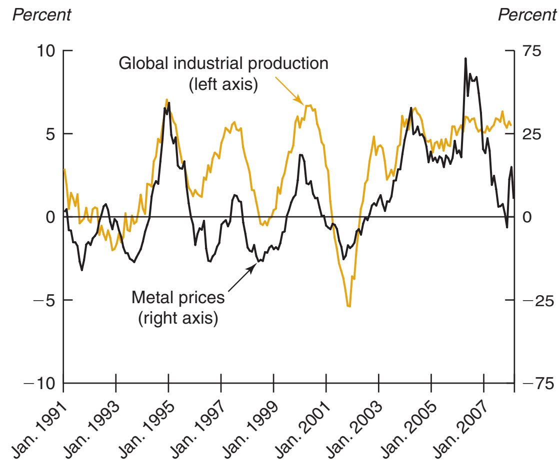
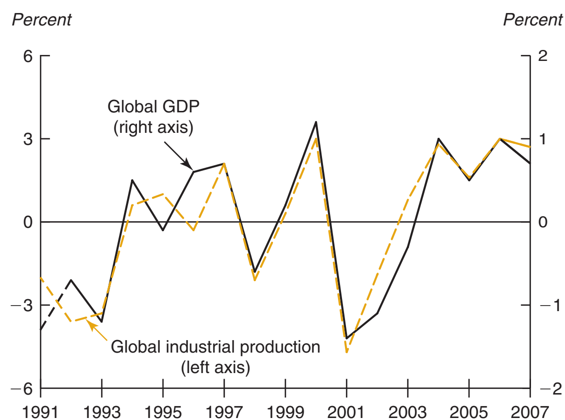
Figure 1.19 Global industrial production and metal prices



Source: World Bank.

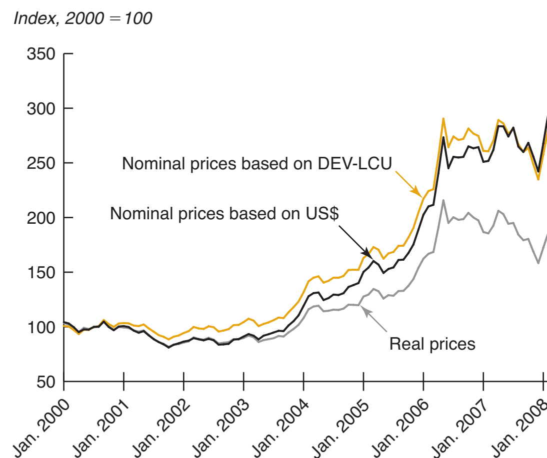
Figure 1.20 Global industrial production and GDP



Source: World Bank.

Note: Industrial production and GDP are expressed in percentage points as deviations from period average growth.

Figure 1.21 Metal prices rebound in 2008



Source: World Bank.

Note: DEV-LCU = developing-country local currency units.

biofuels. Oil prices approached $130 per barrel in May 2008, almost double the price a year earlier. Fertilizer prices caught up with the oil price increases of the last several years and almost tripled over the year to May 2008. Grain prices doubled over the past year. The run-up in grain prices started in the summer of 2006 when maize prices jumped, largely as a result of increased use of maize for ethanol. In the summer of 2007, wheat prices followed, largely because cropland for wheat had been diverted to feedstock for biofuels (maize and soybeans in the United States, and rapeseed and sunflowers in wheat exporters such as Argentina, Canada, and Europe). Rice prices remained low in 2007 compared with other grains. However, that changed dramatically in the first quarter of 2008, when rice prices almost tripled, partly because of substitution on the demand side between wheat and rice and partly because of policy responses that included export restrictions and import increases to build reserves.

Increases in other commodity prices have been more moderate, and more mixed. The average price of metals actually declined in late 2007 before rising to new highs in early 2008 (figure 1.21). Expressed in dollars, metals prices dropped 15 percent over the second half of 2007, but then jumped almost 30 percent through April 2008, leaving them 10 percent above the levels of a year earlier. At the same time, currencies of commodity-importing developing countries appreciated 9 percent against the dollar on average over the past 12 months, such that metals prices expressed in local currencies of those countries have basically not changed from a year ago. And relative to domestic consumption prices, that is, corrected for overall inflation, metals prices declined 7 percent over the previous year.

Oil markets. Oil prices moved sharply higher during the final months of 2007, surpassing $130 a barrel in May 2008 (figure 1.22). The recent jump in oil prices mainly reflects stagnant supply conditions due to sluggish non-OPEC production

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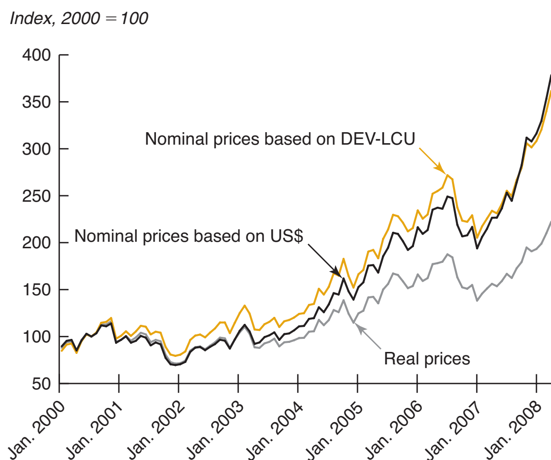
Figure 1.22 Energy prices spiked on supply concerns



Source: World Bank.
Note: DEV-LCU = developing-country local currency units.

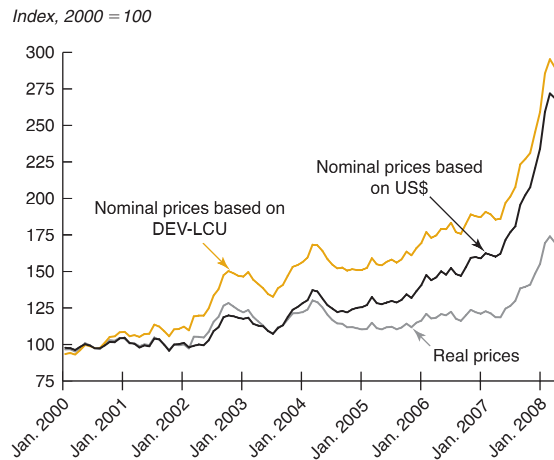
growth, and OPEC output restraint, rather than strong growth in demand. Growth in global oil demand has slowed substantially, from 3.6 percent in 2004 to near 1 percent in both 2006 and 2007, as OECD oil demand has fallen slightly the past two years and was down in the first quarter of 2008. Non-OECD oil demand has continued at a brisk pace, particularly in Asia and in oil-exporting countries. In China, oil demand is estimated to have jumped 8 percent in the first quarter, as the country resumed using diesel in backup generators because of power shortages. Nevertheless, global demand has eased as the effects of high oil prices of the last several years are now being felt, triggering increases in energy efficiency and substitution to non-hydrocarbon energy sources.

Global oil supply stagnated in 2007. Production by members of the Organization of Petroleum Exporting Countries (OPEC) declined due to large cuts of 1.7 million barrels a day in late-2006/early-2007. This contributed to the large decline in stocks in the second half of 2007 and to sharply higher prices. More recently, production has gradually increased to meet market demand, including increases from Iraq and new member Angola. But non-OPEC supply gains outside the former Soviet Union have been disappointing, as large declines in the North Sea and the United States—and more recently Mexico—have generally offset solid gains elsewhere, for example, in Canada, Brazil, and West Africa. In the first quarter of 2008, Russian production declined for the first time in nine years, and this has added to the nervousness about future oil supplies. Non-OPEC production has been hampered by a number of factors: rising costs, limited supply of materials and skilled labor, depletion of aging fields, higher taxes, renegotiation of current contracts or de facto nationalization, and diminishing access to abundant low-cost reserves. The latter is forcing international oil companies to explore and develop in higher-cost and more difficult environments, such as oil sands and deep-water oil deposits. Frontiers still exist to find new reserves in still deeper waters, the Arctic, and other unexplored regions.

With low stocks and limited spare OPEC capacity, temporary oil disruptions (as have occurred in Nigeria and in the North Sea) or potential disruptions (for example, when Venezuela threatened to stop oil shipments to the United States) can easily lead to sharp spikes in prices. Two additional elements made prices even less stable, allowing for even steeper spikes. Investors moving away from loss-generating financial assets in search of yield increased their participation in crude oil futures markets, eager to benefit from rising prices. The number of futures contracts on NYMEX doubled since 2005, although with the sharp run-up in prices since the fourth quarter of 2007, the number of noncommercial participants (often deemed speculators) actually diminished. The weakening dollar and global inflationary pressures have also contributed to oil price increases.

Although the oil market is expected to remain tight over the coming years, there is room for a slight moderation in price as the global economy slows and oil demand turns more subdued, while new, non-OPEC supply (temporarily held back by project delays) should eventually come to market. In addition there are large investments taking place in a number of OPEC countries, which will add significant capacity in the coming years. However, whether these projects will translate into production or whether yet further investments will take place have contributed to supply uncertainty. Still, high prices are inducing all manner of innovation on the demand and supply sides of the market that in addition to environmental pressures, should moderate oil demand going forward. In the medium to longer terms, oil supplies will be supplemented by unconventional oil and other

Figure 1.23 Food prices driven up by biofuels demand



Source: World Bank.
Note: DEV-LCU = developing-country local currency units.

liquids (from coal, gas, and agriculture—mainly cellulosic).

Agricultural commodities. Among various food and agricultural commodities, the dominant drivers for higher prices are the demand for biofuels in the United States and Europe, higher fertilizer and energy prices, and the weak dollar. Price increases were largest for oilseeds, which during the first months of 2008 were nearly twice as expensive as a year earlier; and for grains, for which prices increased 76 percent over the same period (figure 1.23).

High prices are directly linked to the rising production of ethanol from maize in the United States and of biodiesel from vegetable oils in Europe. In each of the past two years, more than half of the growth in global grain demand came from increased U.S. use of maize crops for ethanol production. The share of global maize production used for ethanol was 2.5 percent in 2000, 5 percent in 2004, and 11 percent in 2007. The increase in demand was first met by a reduction in stocks, with limited increase in price. Global maize stocks declined from 32 percent of global demand in 1999 to 13 percent of demand by 2007. Once stocks were reduced to low levels, prices spiked as the possibility of supply shortages became real.

Other sources of demand for food and feed products have not grown at exceptionally rapid rates. For example, China's feed use this decade has grown at an annual pace of less than 1 percent. And grain imports into developing countries have remained constant in recent years, declining as a share of global production. In a few markets, sudden increases in developing countries' demand did occur in 2007 (for example, a sharp jump in China's imports of soybeans), but these instances were exceptions rather than the rule.

Price increases in international food markets have been amplified by policy responses, especially among grain-exporting countries. These policies—such as a ban on non-Basmati rice exports from India; increases in tariffs or bans on grain exports from Argentina, China, Kazakhstan, Russia and Ukraine, and a decline in import tariffs in food-importing countries—attempt to restrain domestic prices, but they also result in higher international prices, in both the short and longer runs. In the short run, these policies exacerbate shortages in international markets. In the longer run, they discourage supply increases in response to higher prices.

To the extent that increased demand for biofuels is linked to high oil prices, a new and stronger correlation between oil and agricultural markets has been created. But historically oil prices have always influenced agricultural prices through cost structures. Grain production, especially in the United States, is energy and fertilizer intensive. This link was clearly at work in 2007. By the beginning of 2008, fertilizer prices had tripled from their level a year earlier.

Prices of internationally traded food commodities are expected to decline from recent record highs but to remain strong relative to historical levels. Energy prices are likely to remain at elevated levels; new mandates will increase biofuel use in Europe and the United States, whereas trade restrictions prevent the full utilization of the large potential for ethanol production in Brazil. Supply can adjust to sharply increased demand only gradually because it requires substantial time and investment to bring additional cropland into production.

Increasingly, policy makers will be challenged to address both causes and consequences of current high food and energy prices. With respect to causes, mandates for increasing use of biofuels in the United States and Europe—in combination with import restrictions on Brazilian ethanol—could be reconsidered. The high agricultural prices also create an

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opportunity to reduce distortions in agricultural markets, which is needed to complete the Doha trade negotiations. And oil-producing countries could adjust production quotas upward or eliminate restrictions on the buildup of new capacity.

Just as important, policies should focus on the mitigation of the widespread adverse effects of extraordinarily high commodity prices. The elevated oil prices of the past years have generated large international transfers from oil-importing to oil-exporting countries, increasing current account imbalances across the globe. Oil-importing countries that are already running substantial current account deficits will be strained, especially as international credit supplies tighten. The short-term options for addressing this problem are limited, but the needed long-term adjustment to a higher oil-import bill should be facilitated to the extent possible by prudent fiscal policies, incentives to increase energy efficiency, and measures to promote export competitiveness.

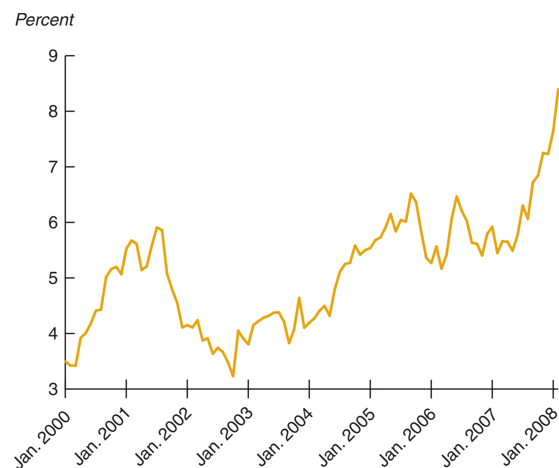
Unlike the case of oil, international income transfers linked to high food prices are relatively small. Two-thirds of global oil production is internationally traded, and increases in oil prices imply large income transfers between countries. The balance-of-payments effects of higher global food prices, however, have been minor. Only 19 percent of global wheat production is internationally traded, and the corresponding shares for maize and rice are 13 percent and 4 percent, respectively. An exception is edible oils, of which 42 percent of global consumption is imported, but the amounts are too small to have large terms-of-trade effects. But for a few small countries, heavily dependent on food imports, the negative terms-of-trade effects have been substantial already and were not offset by increases in other commodity prices. These countries include Cape Verde, Djibouti, Eritrea, The Gambia, Haiti, Lesotho, and São Tomé and Principe. Countries that have enjoyed a more substantial positive terms-of-trade effect due to increased food crop prices include Belize, Fiji, Guyana, Malaysia, Paraguay, and Swaziland.

While balance-of-payments effects are modest, the opposite is true for domestic effects. Terms-of-trade changes are not a particularly good indicator of the potential seriousness of the domestic consequences of higher food prices. For grain-exporting countries, high prices imply terms-of-trade gains, and at the same time, high domestic prices cause strains for the country's population. More important is the impact on those who live in dire poverty and do not benefit from high agricultural prices because their incomes do not rise in step with these prices. Most of these poor are in urban areas, but many among the rural poor are also net consumers of food. The poor are especially hard hit because they often spend more than half of their incomes on food and energy and they have no accumulated wealth to absorb upturns in costs.

Inflationary consequences. An additional concern is the potential effect of higher commodity prices on domestic inflation. Although food prices have a smaller impact on terms of trade and the current account than do oil prices, effects on domestic inflation tend to be larger, because food accounts for a larger share in consumption than does energy. This is especially true for developing countries. In the same fashion as a large share of the poor's consumption basket consists of food products, food is also a relatively large share of total consumption in poor countries. As a result, spikes in food prices tend to have a bigger impact on consumer price inflation in developing countries than in high-income countries.

Since commodity prices began rising in 2003, the median inflation rate has increased significantly among developing countries, with a particularly sharp jump observed during the course of 2007 as food prices surged (figure 1.24).

Figure 1.24 Rising inflation in developing countries



Source: World Bank.

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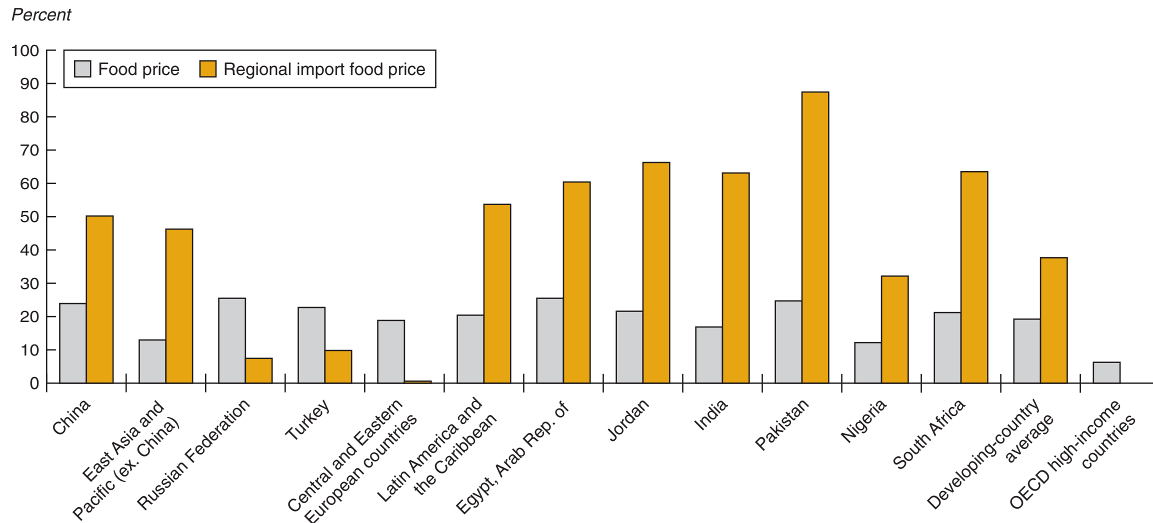
Figure 1.25 Domestic and imported food prices compared

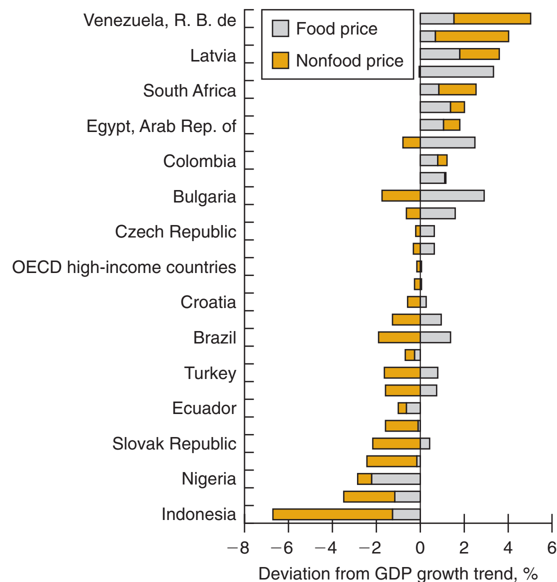


Source: World Bank.

These inflationary pressures present a further challenge for macroeconomic policy in developing countries, as a notable part of their economic success over the past decade originated from policies that stabilized and then reduced inflation. In some cases, price increases tied to international energy and food markets come to augment domestic and other international factors underlying inflation. This is true among some oil-exporting economies and in several Central and Eastern European countries where large capital inflows have created rapid credit growth, as well as in a few countries in Latin America where loose monetary and fiscal policies have created shortages.

In part because of limited data, the correlation between international and domestic food prices for developing economies and the relationship between domestic food prices and overall inflation is difficult to detect. Data for 23 mainly middle-income countries show that upturns in domestic food price indexes are almost universal, albeit by a factor of 5 to 10 times less than the surge in internationally traded food crops (figure 1.25). Almost without exception, food prices have been the dominant force pushing inflation up across developing countries. Indeed, for most countries, the nonfood portion of consumer prices in 2007 decelerated relative to 2006 (figure 1.26). This may be good news, as the recent two-year surge in food prices may give way to a degree of easing in the next years, and there are few signs to date that food prices have had substantial second-round effects. Hence, central banks in most developing countries remain cautious, and many are in tightening mode.

Figure 1.26 Contribution of food and nonfood in increase of inflation 2006–07



Source: World Bank.

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Key economic risks

The slowdown in high-income countries and tighter credit conditions are expected to curb the rapid pace of growth exhibited by developing countries over the past two years. A slowdown was inevitable, and indeed desirable, in the many countries where overheating had become a major concern. Despite the slowdown, growth in most developing countries is expected to remain above historical averages, and prospects are good that their robust growth can be sustained over the long term. The degree of uncertainty surrounding the economic outlook has been elevated by the turmoil that has disrupted financial markets since mid-2007. The risks have clearly shifted to the downside.

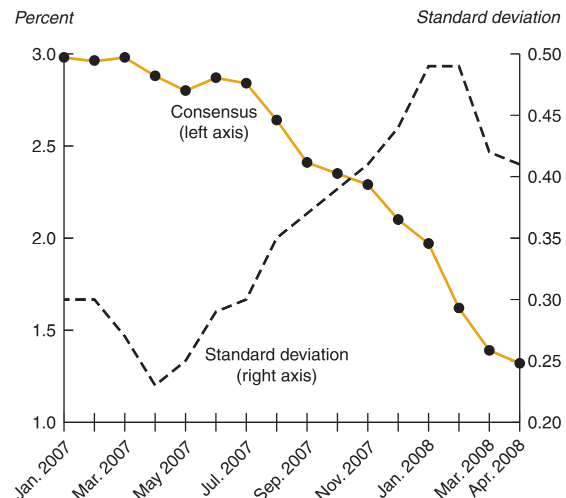
A key risk to the outlook at the current juncture is that the deterioration in global economic and financial conditions will become more severe and prolonged. A sharp relapse in financial markets could trigger a vicious cycle in which economic and financial conditions negatively affect each other, potentially leading to extreme outcomes. The impact of significantly tighter credit conditions in the United States would be pervasive across the U.S. economy. In turn, deteriorating economic conditions have an adverse impact on the financial system, leading to larger loan losses, further balance-sheet consolidation, and tighter credit conditions. Even if the United States continues to bear the brunt of the adjustment, the impact would be transmitted worldwide through waning export opportunities and tighter credit conditions in international markets.

The uncertainty about the outlook for the United States is reflected in increased dispersion of forecasts for economic growth in 2008. Not only did the average GDP forecast, as illustrated by those of Consensus Economics Ltd. surveys, come down rapidly from 3 percent in January 2007 to 1.3 percent in April 2008, the standard deviation of the underlying forecasts increased to an average of 0.45 percent in the first four months of 2008 from 0.27 percent during the same period in 2007 (figure 1.27). In this environment of heightened uncertainty, alternative outcomes for developing countries have to be thought through carefully, and policy makers in developing countries have to be prepared for varying modes of downside risks and scenarios.

A sharper slowdown in the United States, implying a serious recession, would hit U.S. investment and manufacturing especially hard. These are sectors of the economy that are closely linked to the global economy, with relatively high import content. A simulation using the World Bank's global forecasting model *Isimulate* shows that an autonomous 10 percent additional decline in business fixed investment in 2008, relative to the baseline, yields an additional 7 percentage points contraction in U.S. imports. That shock would carry the United States into a severe recession, with GDP dropping 0.6 percent for the year (a 1.7 percent difference with the baseline) and would—through endogenous feedback—leave investment 17 percent below baseline growth.

The sharp decline in U.S. imports could have quite severe effects for close trading partners. Total exports from Mexico would decline in a such scenario by more than 9 percent (vis-à-vis baseline), as almost all of that country's exports are destined for the U.S. market, and Mexico is specialized in highly cyclical components for inputs to manufacturing. China's export growth would be reduced by 3 percentage points, as that country is more geographically diversified than is Mexico, and the growth of China's exports is driven more by market penetration than by fluctuations in the size of export markets. Several other

Figure 1.27 Consensus forecasts for the U.S. economy



Source: Consensus Economics Ltd.

Note: Forecasts for 2008 GDP growth were prepared on dates along x-axis.

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countries in East Asia and the Pacific that specialize in high-tech exports could see a similar reduction in overall exports, again relative to baseline. Exports from the European Union would decline some 2.5 percent, while the impact of a sharp decline in U.S. imports would be smaller for many other countries.

The simulation effects on developing countries' GDP project a 0.2 percent reduction in GDP growth in 2008, reflecting the fact that effective demand is not the main constraint to growth for many developing countries. Lack of production capacity and infrastructure is a much greater limiting factor. As a result, even in the face of slowing exports, domestic investment continues to increase at rapid rates. These results are consistent with developments during 2006–07, when U.S. imports slowed sharply, contributing to a more than 2 percentage point deceleration in world trade, without measurably affecting the pace of GDP growth among developing countries.

A much larger impact on growth in developing countries is to be expected from further deterioration in international financial markets. Countries with large current account deficits and heavy financing needs are most vulnerable to the risk of an abrupt downturn in the credit cycle. Vulnerable countries include several in the Europe and Central Asia region where a surge in cross-border bank lending over the past few years has supported rapid growth in investment and consumption. Economic conditions in such countries could worsen significantly if external financing were to stop suddenly. Investment would be hardest hit in the affected countries.

A more severe recession in the United States, combined with additional distress in financial institutions, could lead to monetary policy reactions in the United States to diverge further from those in the rest of the world, putting the U.S. dollar under more pressure. Further weakening of dollar would increase uncertainty in the international trading system as it changes relative competitiveness across countries in the short run, depending on their exchange-rate regimes. Similarly, further weakness in the dollar would increase uncertainty about relative yields in the financial markets. And a sharply weakening dollar would boost inflationary expectations in the United States, which could fuel global inflationary expectations, pushing commodity prices up further.

Oil prices have become notoriously difficult to predict. Yet further price increases cannot be ruled out, even in the scenario where there is a moderate slowdown in global growth. Further increases in oil prices would have significantly more severe effects on oil-importing developing countries than the price increases of previous years. In earlier episodes, many countries enjoyed surpluses or small deficits on current account and benefitted from rising export prices for other commodities, while domestic inflation was muted. Now, current accounts of many oil-importing countries have already deteriorated, metals prices are no longer on a strong upward trend, and inflationary pressures are on the rise. And with the current high levels of oil prices, the share of oil in GDP of the importing countries is a multiple of what it was only a few years ago, implying that the same percentage rise in the oil price has a substantially larger impact.

The potential for large exchange-rate movement increases uncertainty in the international trading system as the value of contracts varies with currency denominations. The possibility of a further depreciation of the U.S. dollar runs the risk of accentuating existing inflationary pressures in countries with fixed or managed exchange-rate regimes (linked to the U.S. dollar). A weakening dollar also runs the risk of fueling inflationary expectations in the United States, which could escalate investor interest in commodity markets, pushing commodity prices up still higher.

Soaring food prices over the past years have had a major adverse impact on poverty in some of the poorest countries. Global food markets remain very tight, making them extremely susceptible to supply disruptions. With global grain stocks at near-record lows relative to consumption, a drought affecting the coming harvest would put severe pressure on prices. A moderate drought in a major producing country results on average in a 2 percent decline in global yields from trend. That would reduce grain production by 40 million tons and global stocks by about 12 percent from the projected 320 million tons at the end of the current marketing year. A yield decline of at least that magnitude has occurred approximately 30 percent of the time since 1960, and a decline of 3 percent or greater has occurred about 20 percent of the time. High fertilizer prices may increase the chance of disappointing yields, because farmers can't pay for fertilizer. And average grain prices

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would, in such a scenario (drought), rise by an estimated 30 percent on top of already very high prices. Further increases in food prices would have a major impact on many of the poorest and most vulnerable, particularly those in urban centers.

Notes

1. The decline in home prices has varied across various measures of price. The National Association of Realtors' (NAR) measure of the median price of a new home declined 7.2 percent (year over year) through February 2008. The U.S. Department of Commerce's measure of the median price of an existing home, similar in concept to the NAR index, declined by the same amount in February 2008. And the Case/Schiller Index of home prices, which encompasses both new and existing homes for 20 major U.S. metropolitan areas fell 10.7 percent in January 2008 (year over year).

2. Based on past experience, about 60 percent will be expended within 90 days.

3. The developing countries of the Middle East and North Africa region can usefully be arrayed into oil-exporting economies and a more economically diversified group. In the former, Algeria, Iran, Oman, the Syrian Arab Republic, and the Republic of Yemen are key players, dominated by the first two countries in terms of oil potential and population density. A group of more diversified exporters would include Egypt (although the country is increasingly viewed as a net oil exporter), Jordan, Lebanon, Morocco, and Tunisia, all largely export-based economies focused on the European and U.S. markets in basic industries such as textiles and clothing.

Reference

World Bank. 2008. *Global Economic Prospects 2008: Technology Diffusion in the Developing World.* Washington, DC: World Bank.