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Prospects for the Global Economy

THE FINANCIAL CRISIS THAT ERUPTED in September 2008—following more than a year of financial turmoil—has become a global crisis for the real economy. Economic activity in high-income and developing countries alike fell abruptly in the final quarter of 2008 and in the first quarter of 2009. Unemployment is on the rise, and poverty is set to increase in developing economies, bringing with it a substantial deterioration in conditions for the world's poor and most vulnerable.

The outbreak of the financial crisis provoked a broad liquidation of investments, substantial loss in wealth worldwide, a tightening of lending conditions, and a widespread increase in uncertainty. Higher borrowing costs and tighter credit conditions, coupled with the increase in uncertainty provoked a global flight to quality, caused firms to cut back on investment expenditures, and households to delay purchases of big-ticket items. This rapid increase in precautionary saving led to a sharp decline in global investment, production, trade, and gross domestic product (GDP) during the fourth quarter of 2008, a trend that continued in the first quarter of 2009. The sharpest declines in economic activity were concentrated among countries specialized in the production of durable and investment goods and in countries with serious pre-existing macroeconomic vulnerabilities.

This suddenly very weak international environment accelerated the fall in commodity prices that began in mid-2008. By end-May 2009, oil prices were down 60 percent from their peak and non-oil commodity prices, including internationally traded food commodities, were off 35 percent. Lower food and fuel prices have cushioned the poverty impact of reduced activity to a degree and helped to reduce the pressure on the current accounts of oil-importing developing countries, even as they reduced surpluses among developing oil-exporters by as much as 17 percent of GDP.

Policy reactions to the crisis have been swift and, although not always well coordinated, have so far succeeded in preventing a broader failure among financial institutions, and thereby avoided a much more severe collapse in production. In the absence of public-sector assistance, the massive losses suffered by investment banks and other institutions would have forced commercial banks to sharply reduce lending—forcing firms to cut back on investment and production even more forcefully. Instead, bank lending continued to grow until very recently, although much less rapidly than in the past. These policy measures have not been costless. Fiscal balances in 2009 are expected to deteriorate by about 3 percent of GDP in high-income countries, and by about 4.4 percent of GDP in developing countries. Longer term, increased high-income country indebtedness may raise borrowing costs, potentially crowding out developing-country private and public-sector borrowers.

The drop in economic activity, combined with much weaker capital flows to developing countries, is placing a large number of low- and middle-income countries under serious financial strain. Many countries are having difficulty generating sufficient foreign currency from exports or borrowing to cover import demand. Overall, borrowing needs for developing countries are expected to exceed net capital inflows by between \$350 billion and \$635 billion (see chapter 3). Many countries are meeting this financing gap by drawing down on the international currency reserves they built up during good times. However, the sustainability of this strategy is uncertain.

Since September 2008, 16 countries have consumed 20 percent or more of their foreign reserves, and the current stock of reserves covers less than 4 months of imports in 18 countries.

The challenges of widening current-account deficits and deteriorating fiscal positions are most acute in the Europe and Central Asia region, partly because the recession is expected to be deepest there, but also because many countries entered the crisis period with double-digit current-account deficits (as a share of GDP) and/or elevated government debt. If, as appears likely, financing is not fully forthcoming for these economies, heavy compression of domestic demand and exchange-rate depreciation will be required to restore internal and external balances.

Despite the rapid decline in GDP in high-income countries during the first quarter of 2009, a number of indicators point to the beginnings of an economic recovery. Stabilizing and even recovering stock markets, modest improvements in exports in some countries, a recovery in consumer demand and the still-to-come demand-boosting effects of discretionary fiscal stimulus measures are among the factors pointing to the beginning of recovery. High frequency indicators vary distinctly by country at the moment, however, with data for the United States and China more suggestive of economic revival than those for western Europe and other developing regions. Moreover, several factors point to continued weakness. Unemployment continues to rise throughout the world, housing prices in many countries are still falling (adding to negative wealth effects), bank balance sheets are fragile, and much more consolidation and recapitalization required. As a result, the timing and strength of the eventual recovery in the global economy remain highly uncertain. Indeed, many countries are facing growing pressure on their currencies and banking sectors. Already several high- and middle-income developing countries have entered into special borrowing agreements with the International Monetary Fund (IMF) to prevent deteriorating external and fiscal positions from getting out of hand.

The baseline scenario presented in this edition of *Global Development Finance* depicts a much more subdued recovery than during a normal recession, partly because this downturn follows a financial crisis—which tends to be deeper and longer-lasting than normal ones—and partly because today's downturn has affected virtually the entire world, precluding the more typical scenario where recovery from a more geographically isolated downturn is at least partly achieved by exporting to healthier and more rapidly growing countries. In this scenario, global GDP, after falling by a record 2.9 percent in 2009, recovers by a modest 2.0 percent in 2010 and by 3.2 percent in 2011 (table 1.1). Banking sector consolidation, continuing negative wealth effects, elevated unemployment rates, and risk aversion are expected to weigh on demand throughout the forecast period.

Among developing countries, growth rates are higher (given stronger underlying productivity and population growth) but remain similarly subdued at 1.2, 4.4, and 5.7 percent, respectively, over 2009 through 2011. Given the output losses already absorbed—and because GDP only reaches its potential growth rate by 2011—the output gap (or the difference between actual GDP and its potential), unemployment, and disinflationary pressures are projected to build over 2009 to 2011.

A more robust recovery is possible, fueled by the substantial fiscal, monetary, and sectoral initiatives that have been put into place. So too is a much weaker outcome. In the latter scenario, the drag of the financial sector on economic growth, which is a key feature of the baseline, is projected to be more intense, while even weaker confidence impedes recovery in discretionary investment and consumer spending—leading to still slower growth. Moreover, pressure on current accounts, exacerbated by a weaker recovery, could force a number of countries (notably, several in Europe and Central Asia) into a much less orderly process of adjustment, characterized by substantial currency depreciation and painful cuts in domestic demand.

Immediate impacts of the crisis

What began in the summer of 2007 as an extended period of financial turmoil caused by the losses in the U.S. subprime mortgage market, erupted into a full-blown and global financial crisis in mid-September 2008, precipitated by the failure of the investment bank, Lehman Brothers. The realization that such a key player in the international financial system could fail shook the confidence of bankers, investors, and households alike and reverberated rapidly throughout the global economy (figure 1.1).

Table 1.1 The global outlook in summary

(percentage change from previous year, except interest rates and oil price)

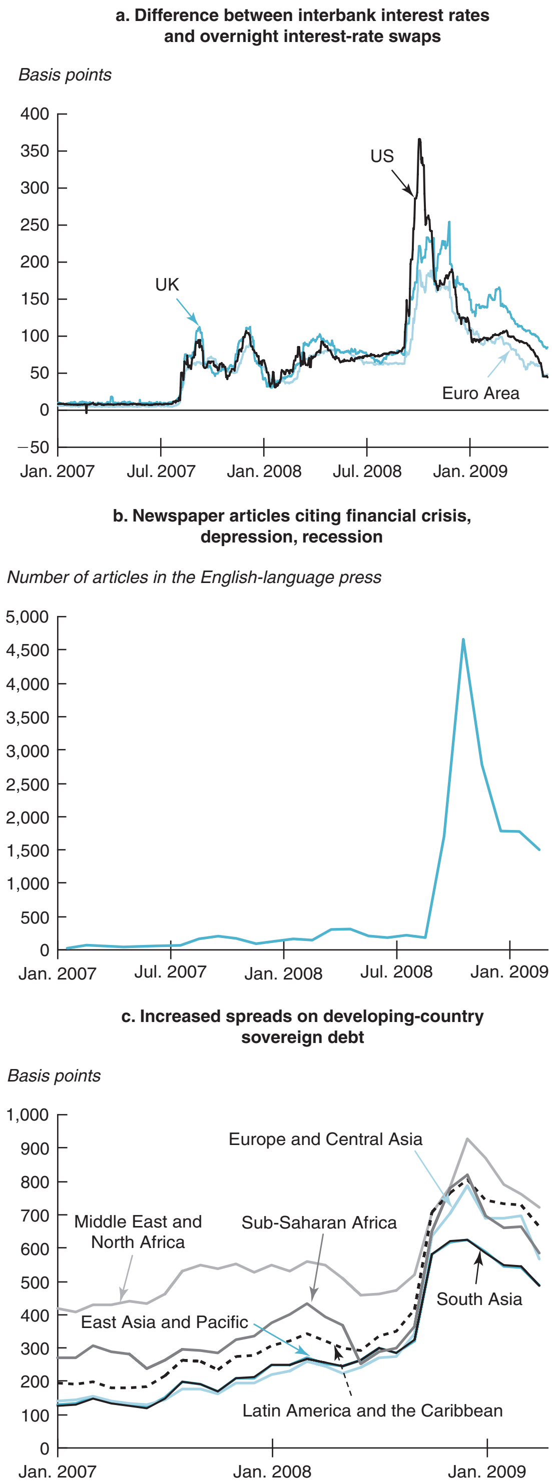
	2007	2008	2009e	2010f	2011f
Global conditions					
World trade volume	7.5	3.7	−9.7	3.8	6.9
Consumer prices					
G-7 countries [a,b]	1.7	2.9	0.5	0.8	1.3
United States	2.6	3.8	0.3	1.2	2.0
Commodity prices (USD terms)					
Non-oil commodities	17.1	21.0	−30.2	−2.1	1.4
Oil price (US$ per barrel)[c]	71.1	97.0	55.5	63.0	65.9
Oil price (percent change)	10.6	36.4	−42.7	13.4	4.6
Manufactures unit export value[d]	5.5	7.5	1.9	1.0	0.0
Interest rates					
$, 6-month (percent)	5.2	3.2	1.5	1.7	2.0
€, 6-month (percent)	4.3	4.8	2.0	2.2	2.3
Real GDP growth[e]					
World	**3.8**	**1.9**	**−2.9**	**2.0**	**3.2**
Memo item: World (PPP weights)[f]	5.0	3.0	−1.7	2.8	4.0
High income	**2.6**	**0.7**	**−4.2**	**1.3**	**2.4**
OECD countries	2.5	0.6	−4.2	1.2	2.3
Euro Area	2.7	0.6	−4.5	0.5	1.9
Japan	2.3	−0.7	−6.8	1.0	2.0
United States	2.0	1.1	−3.0	1.8	2.5
Non-OECD countries	5.6	2.4	−4.8	2.2	4.6
Developing countries	**8.1**	**5.9**	**1.2**	**4.4**	**5.7**
East Asia and Pacific	11.4	8.0	5.0	6.6	7.8
China	13.0	9.0	6.5	7.5	8.5
Indonesia	6.3	6.1	3.5	5.0	6.0
Thailand	4.9	2.7	−3.2	2.2	3.1
Europe and Central Asia	6.9	4.0	−4.7	1.6	3.3
Russian Federation	8.1	5.6	−7.5	2.5	3.0
Turkey	4.7	1.1	−5.5	1.5	3.0
Poland	6.7	4.8	0.5	0.9	3.5
Latin America and the Caribbean	5.8	4.2	−2.2	2.0	3.3
Brazil	5.7	5.1	−1.1	2.5	4.1
Mexico	3.3	1.4	−5.8	1.7	3.0
Argentina	8.7	6.8	−1.5	1.9	2.1
Middle East and North Africa	5.4	6.0	3.1	3.8	4.6
Egypt, Arab Rep. of[g]	7.1	7.2	3.8	4.2	5.0
Iran, Islamic Rep. of[g]	6.2	6.9	2.5	3.0	4.0
Algeria	3.0	3.0	2.2	3.5	4.0
South Asia	8.4	6.1	4.6	7.0	7.8
India[g]	9.0	6.1	5.1	8.0	8.5
Pakistan[g]	6.4	5.8	1.0	2.5	4.5
Bangladesh[g]	6.4	6.2	5.0	4.5	5.0
Sub-Saharan Africa	6.2	4.8	1.0	3.7	5.2
South Africa	5.1	3.1	−1.5	2.6	4.1
Nigeria	6.3	5.3	2.9	3.6	5.6
Kenya	7.1	1.7	2.6	3.4	4.9
Memorandum items					
Developing countries					
Excluding transition countries	8.2	5.9	1.8	4.7	5.9
Excluding China and India	6.1	4.5	−1.6	2.5	3.9

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 USD.
e. GDP in 2000 constant dollars; 2000 prices and market exchange rates.
f. GDP measured at 2000 PPP weights.
g. In keeping with national practice, data for the Arab Republic of Egypt, the Islamic Republic of Iran, India, Pakistan, and Bangladesh are reported on a fiscal year basis. Expressed on a calendar year basis, GDP growth in these countries is as in the table on the right.

GDP growth on a calendar year basis

	2008	2009e	2010f	2011f
Egypt, Arab Rep. of	6.7	5.1	4.2	4.6
Iran, Islamic Rep. of	6.9	2.5	3.0	4.0
India	7.3	5.9	8.1	8.5
Pakistan	6.1	3.3	1.8	3.5
Bangladesh	6.3	5.6	4.7	4.8

Figure 1.1 The crisis shook confidence worldwide and resulted in a large decline in global wealth



Sources: World Bank; JP Morgan-Chase; Thomson Datastream.

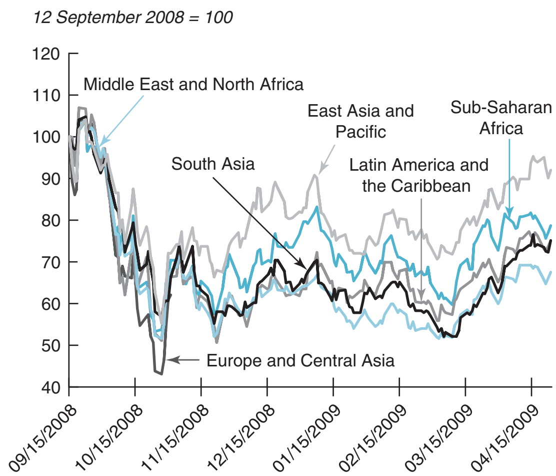
The initial loss of confidence in the financial system provoked a liquidity crunch in the interbank market (these events and their implications for financial flows to developing countries are discussed in further detail in chapter 2). Banks became extremely reluctant to lend to one another, and liquidity dried up rapidly, causing spreads between the interest rates banks charge each other (LIBOR, or the London Interbank Offer Rate for overnight funds) and what they expect to pay central banks (the overnight index swap rate) to jump to unprecedented levels (see figure 1.1, panel a). Uncertainty about the future and fears that the crisis could provoke a deep recession or even depression skyrocketed, evidenced, for example, by some 4,500 stories about the financial crisis and its potential negative effects appearing in major English-language print media in September 2008 (see figure 1.1, panel b).

The sudden drying up of liquidity and increased uncertainty also yielded a change in the pricing of risk throughout the global economy. Interest rate spreads on riskier assets, including the bonds of firms in developing- and high-income countries, and, to a lesser extent sovereign states, increased substantially (see figure 1.1, panel c). Increased risk aversion, a reassessment of growth prospects, and the need for firms and investors in high-income countries to strengthen their balance sheets resulted in a large-scale repatriation of capital from developing countries. As a consequence, stock markets the world over lost between 40 and 60 percent of their dollar values—the currencies of almost every country in the world depreciated against the U.S. dollar—implying a massive loss in global wealth (figure 1.2).

Successive interventions by authorities in both high-income Europe and North America (including substantial efforts by the Federal Reserve in the United States to intermediate directly between banks) have helped restore short-term liquidity.

As of end-May 2009, interbank spreads are down some 350 basis points since September 2008 in the case of the United States and by 200 basis points in the Euro Area. This, plus the fact that there have been no additional failures of major financial institutions or significant currency crises, has brought about a near-stabilization and even improvement in financial conditions over the period since March 2009. Spreads on developing-country bonds have narrowed (see figure 1.1, panel c), with the market now distinguishing better between the

Figure 1.2 Stock market wealth declined by 40 to 60 percent in dollar terms
Morgan Stanley Capital International Indexes



Sources: World Bank; Morgan Stanley; IFC/S&P.

risks posed by different countries. At the same time, stock market valuations are regaining ground in a number of countries.

Still, conditions continue to be tight and markets nervous. Interbank spreads remain above historical levels, and the IMF estimates that only a third of all financial sector losses have been booked at this stage (IMF 2009b). Similarly, developing-country spreads remain high, and, even though the base rates against which these spreads are calculated have declined in response to the post-crisis relaxation of monetary policy in high-income countries, yields and borrowing costs for developing-country firms have increased substantially—doubling in some cases—with potentially important effects on debt sustainability and the profitability of future investment (see below).

Global growth

The eruption of the financial crisis and the uncertainty that it provoked a crisis in the real economy. Individuals, suddenly uncertain about their job prospects and facing more expensive and difficult-to-obtain financing, delayed purchases that could be put off, typically consumer durables such as automobiles, refrigerators, and televisions. Similarly, firms delayed the implementation of investment projects, preferring to wait and see if such projects would remain profitable under future demand and financing conditions. This increase in precautionary saving (and the associated reduction in investment and consumer demand), together with increased borrowing costs and tighter lending standards, explains the unprecedentedly rapid fall in global demand for manufactured goods during the fourth quarter of 2008 and the first quarter of 2009. Moreover, while consumer demand has and will recover, saving rates are unlikely to return to earlier low levels, because households will continue to save to restore a proportion of the financial wealth destroyed during the crisis.

The cutback in fixed investment spending was widespread (table 1.2). It involved countries directly affected by the financial crisis, those with close links to affected commercial and investment banks, and those that suffered through the indirect channel of falling export demand. For some economies, notably those with large current-account deficits, these transmission channels were further amplified by a reversal in private capital flows, which forced a much sharper decline in domestic demand (see chapter 2).

Investment activity fell by an average of 4.4 percent (at a 16.5 percent annualized rate) in 27 of 30 high-income countries in the fourth quarter of 2008. The slowdown was not limited to the high-income countries where the financial crisis originated. In the 25 developing economies that report

Table 1.2 Investment demand fell sharply worldwide

	United States	Japan	Germany	Korea, Rep. of	Brazil	Russian Federation	Malaysia	Mexico	Lithuania
	(Growth in real investment, seasonally adjusted annual rates, percent)								
2007	−3.1	0.7	4.5	4.2	13.7	21.1	9.6	5.0	20.8
2008Q3	−5.3	−9.7	0.8	0.2	38.0	−13.9	1.7	1.9	−9.5
2008Q4	−22.0	−14.6	−10.2	−23.6	−33.9	−23.4	−34.5	−13.2	−45.2
2009Q1	−37.3	−27.5	−28.6	0.7	—	−30.4	−13.7	—	−65.8

Sources: World Bank; national statistical agencies.
Note: — = Not available.

quarterly national accounts data, investment growth in the final quarter of 2008 fell by an average of 6.9 percent, or at an annualized pace of 25 percent. Investment demand continued to decline precipitously in the first quarter of 2009. Investment fell at a 37 percent annualized pace in the United States, and by close to a 30 percent annualized rate in Japan, Germany, and Russia (table 1.2).

Consumer savings increased sharply as households cut back or delayed large expenditures. In the United States, the personal saving rate increased from 0.6 percent in 2007 to more than 5.7 percent in April 2009. Demand for consumer durables fell at a 22 percent annualized rate in the fourth quarter of 2008 in the United States, and by 20 percent in high-income Europe. Worldwide demand for autos plummeted by 30 percent in the quarter, sending firms in the United States, Europe, and Japan to national governments for emergency financial support. Data for the first quarter of 2009 suggest that consumer demand for durable goods may be stabilizing or even advancing—partly in response to government-sponsored incentives in several countries. In the United States, consumer spending increased at a 1.6 percent annual pace in the first quarter, led by a 9.6 percent annualized gain in durable goods (figure 1.3).

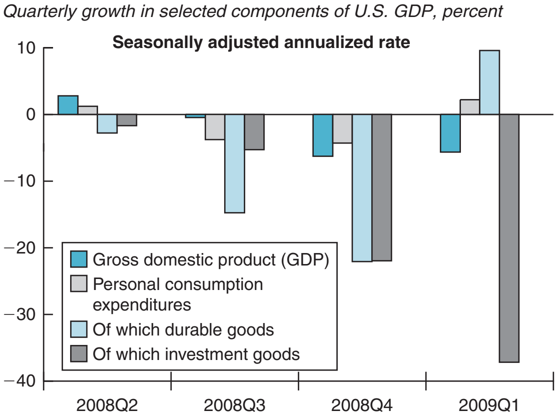
The falloff in consumption growth was less pronounced in other countries, save Japan, in part because savings rates in most economies were not as depressed as they had become in the United States. Nevertheless, increasing unemployment and the growing recession has pushed consumer confidence to all-time lows, which, in addition to the negative wealth effects from falling equity and housing prices, is weighing on—and will continue to weigh on—consumer demand for some time (the value of household assets in the United States declined by 14.7 percent, or $11.3 trillion, between the fourth quarter of 2007 and the fourth quarter of 2008). For developing-country commodity exporters, the decline in incomes resulting from lower commodity prices is exercising a similar effect, although lower food and energy prices will tend to boost the purchasing power of consumers in commodity-importing countries (see below).

Weak investment and consumer durable demand cut into global industrial production . . .

The pullback in demand for consumer durables and investment was reflected in a steep 13 percent fall in global industrial production between September 2008 and March 2009. Virtually every country that reports production data witnessed a sharp fall in output, and a wide range of countries are reporting capacity utilization rates below 70 percent (figure 1.4).

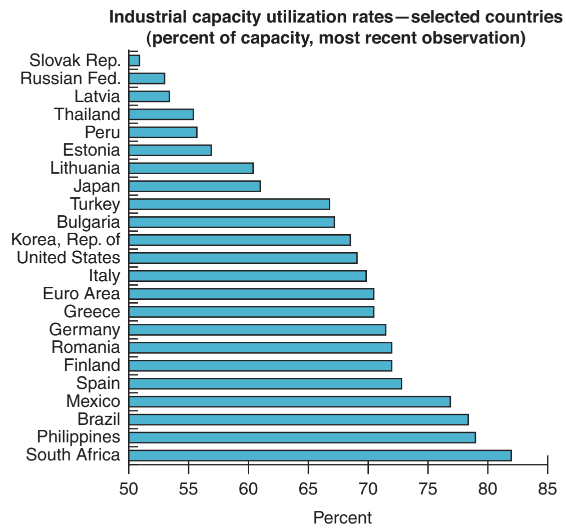
Figure 1.3 Increased uncertainty caused households and firms to delay purchases of durable and investment goods

Quarterly growth in selected components of U.S. GDP, percent



Source: United States Bureau of Economic Analysis.

Figure 1.4 Capacity is being underutilized throughout the world



Source: Thomson Datastream.

Two groups of economies have been hardest hit: those specialized in investment, high-tech goods, and consumer durable goods; and those with large current-account deficits.[1] At the country level this is reflected in sharp declines in industrial activity in countries, like Japan and Germany, that specialize in the production of investment goods. Economies in Europe and Central Asia were also hit hard, both because their industrial sectors tend to be closely tied to high-income Europe and because the drying up of international capital flows (see chapter 2) has forced many into an even sharper domestic downturn (figure 1.5).

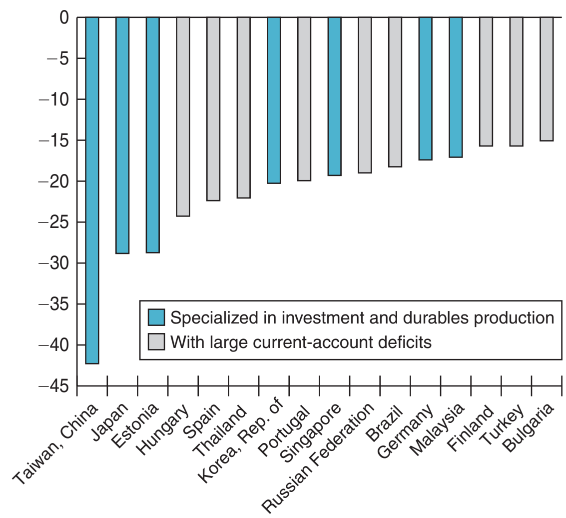
. . . contributing to steep declines in global exports

Because consumer durables and investment goods tend to be heavily traded, the sharp uptick in firm and household saving in the fourth quarter translated into an equally steep and rapid fall in global trade (table 1.3). The world dollar value of goods trade declined some 30 percent between September 2008 and March 2009. Much of the decline reflected weaker trade in manufactured goods, the dollar value of which dropped 33 percent over the same period. The volume of exports of manufactured goods from member countries of the Organization for Economic Co-operation and Development (OECD), as a group, were down 10.8 percent in December 2008 from a year earlier.[2] Across OECD countries, the value of machinery and transport equipment exports fell 12.5 percent in December (year-on-year), representing a quarter of the total decline in goods exports.

This very strong contractionary force was amplified to an uncertain degree by a shortfall in trade finance. These short-term credits, which have a typical tenor of 120–180 days, are used to facilitate

Figure 1.5 Reflecting increased precautionary saving, industrial production declined sharply

Industrial production; percent change, January 2009 versus July 2008



Sources: World Bank; national agencies.

Table 1.3 Export volumes and production plummet into early 2009

	Export volume growth (percent)		Industrial production growth (percent)	
	2008 (Whole year)	2009 (Y/y latest)	2008 (Whole year)	2009 (Y/y latest)
World	**4.5**	**−24.1**	**0.5**	**−12.8**
High-income	**1.7**	**−24.3**	**−1.9**	**−17.6**
United States	6.0	−16.2	−2.2	−12.5
Japan	−1.6	−36.0	−3.2	−34.0
Germany	1.1	−22.6	0.0	−21.7
All developing	**5.0**	**−22.5**	**6.2**	**−2.5**
East Asia and Pacific	**4.8**	**−25.0**	**11.2**	**4.6**
China	14.6	−22.7	13.0	7.4
Europe and Central Asia	**1.7**	**−32.0**	**0.7**	**−14.0**
Russian Federation	0.0	−38.0	2.3	−16.8
Latin America and the Caribbean	**−7.0**	**−11.0**	**1.0**	**−10.2**
Brazil	−2.1	−29.0	2.9	−13.3
Middle East and North Africa	**6.5**	**−3.5**	**3.6**	**−0.5**
South Asia	**10.4**	**−23.7**	**4.1**	**−4.4**
Sub-Saharan Africa	**7.1**	**−5.0**	**1.0**	**−4.5**

Source: World Bank.

Box 1.1 Recent initiatives to bolster trade finance

The World Bank has contributed $1 billion as a partner in the Global Trade Liquidity Program, a coordinated global initiative involving governments, development finance institutions, and private sector banks expected to support up to $50 billion of trade in developing markets over three years. The Bank's private sector arm, the International Finance Corporation (IFC), is acting as an agent on behalf of the program partners and plays a central role in mobilizing funds for trade finance.

The Bank is also supporting trade in emerging markets through the IFC's Global Trade Finance Program, which assists smaller banks and entrepreneurs to arrange for letters of credit and other forms of trade finance. The resources of the program have been tripled from $1 billion to $3 billion.

The Bank is also helping countries improve their competitiveness and reduce trading costs through its Trade Facilitation Facility, a new $40 million multi-donor trust fund focused on measures to improve infrastructure, transport, logistics, and customs procedures.

Lending for trade-related infrastructure, regional integration, export development, and competitiveness and trade facilitation programs is also to be more than doubled to $3.6 billion in fiscal year 2009, up from $1.4 billion in FY2008 (July 2007–June 2008).

deals between distant partners with limited knowledge or business experience of one another. Although they cover only between 10 and 20 percent of all trade (most trade is conducted on an "open-account" basis between regular business partners), short-term credits tend to be most important for small and medium-sized exporters. Indeed, the share of such transactions in regional trade represents an estimated 40 percent in the East Asia and Pacific region in part because of the prevalence of such small traders. Recent research (Humphrey 2009) suggests that for a sample of 30 African firms, a lack of bank financing has not constrained exports, although anecdotal evidence from the same research suggests that firms in Latin America, the Caribbean, and Africa seeking to establish trade links have been more directly affected through this channel. As part of its efforts to temper the impacts of the crisis on developing countries the World Bank has put in place a number of initiatives to bolster trade finance (see box 1.1).

Overall, high-income and developing economies are in the midst of a steep and synchronized recession. However, there are early signs that the rate of decline in output is slowing. Consumer confidence is improving in both high-income Europe and the United States, as are forward-looking indicators of business confidence. Similarly, the most recent monthly data suggest that the sharp slide in export growth in the Group of Seven (G-7) countries may be easing. The value of goods exports in January and February fell by 3.4 and 2.4 percent, respectively, contrasted with 8.5 percent in each of November and December 2008; U.S. consumer demand rose in the first quarter of 2009; and data suggest that the slide in the U.S. housing market may have found bottom. Moreover, in both high-income Europe and North America a large part of demand is being met through inventory reductions rather than production—a process that cannot continue indefinitely and that if ended could add as much as two percentage points to GDP growth.

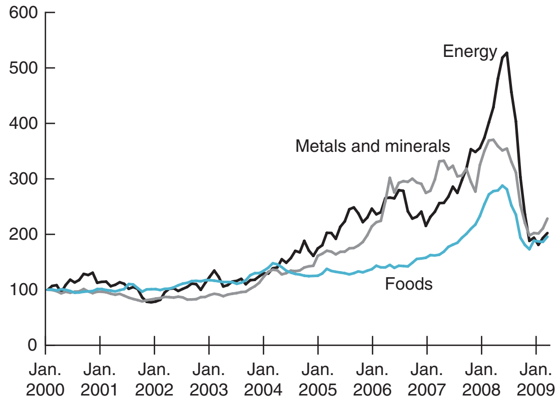
However, these signs of recovery are tentative, and should there be another round of bad news, confidence and uncertainty could be aggravated, delaying the recovery (see below). For example, business surveys suggest that investment growth will turn around in the second and third quarters of 2009. But, during 2008Q4 and 2009Q1, investment demand fell by almost 11 percent (38 percent at an annualized rate) in the United States.

Commodity markets

The slowing of global growth, which preceded the financial crisis by several months, prompted commodity prices to start falling in mid-2008 (figure 1.6). The eruption of the full-blown crisis and the rapid drop-off in economic activity since September of that year accelerated this process markedly. Demand for most commodities (notably, in high-income industries and in China) slowed or declined, particularly for oil and metals. By December 2008, crude oil prices

Figure 1.6 The sharp fall in commodity prices has now stabilized

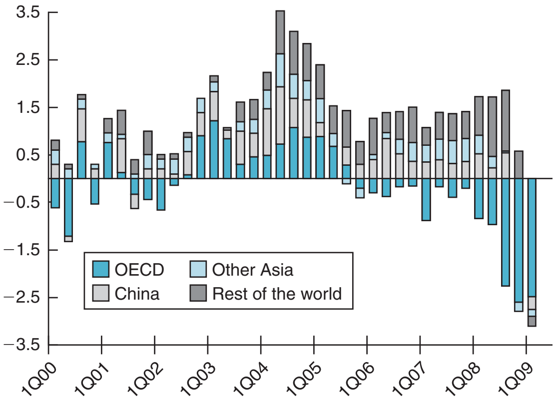
Index, January 2000 = 100



Source: World Bank.

Figure 1.7 Oil demand has fallen sharply along with global growth

Change in world oil consumption growth since same quarter a year before (mb/d)



Source: International Energy Agency.

had dropped to $41 a barrel, down more than 70 percent from the July peaks, while non-energy prices, including food, had declined by nearly 40 percent. Since December, prices have firmed, with crude oil prices up to $58 on average in May 2009, and prices for internationally traded foods and metals up 6 and 7 percent, respectively.[3]

The sharp decline in crude oil prices, from more than $140 a barrel in July 2008, reflected weaker global demand and the relaxation of some refining capacity constraints[4] that had contributed to high prices in the first half of the year.[5] World crude oil demand fell 3.6 percent between the first quarter of 2008 and the first quarter of 2009, with demand in OECD countries off 5.1 percent (figure 1.7). The fall in demand reflected both the declines in industrial activity and the effects of high oil prices during the first half of 2008. Although non-OECD demand continued to grow during the first three quarters of 2008 (led by strong gains in the Middle East), it too turned negative in the first quarter of 2009 as Middle Eastern demand growth slowed substantially and Chinese demand declined.

For 2009 as a whole, world oil demand is projected to fall by 2.6 million barrels a day (mb/d), with continuing large falloffs in high-income countries and slight declines across most developing regions. Production by members of the Organization of the Petroleum Exporting Countries (OPEC) is being curtailed sharply, while non-OPEC oil deliveries are expected to fall by 0.3 mb/d this year. This, coupled with expectations of a slow recovery in global growth, has contributed to the recent recovery in oil prices. Prices are expected to continue rising at a moderate pace over the medium term, with the weak pace of global GDP and ample spare capacity precluding a rapid rise in oil prices. How successful OPEC is in cutting supply will affect outturns in the short term. Should OPEC members reduce oil production by enough, prices could fall below the projected average of $55.5 a barrel for 2009.[6]

The financial crisis and the steep falloff in economic activity have disrupted the development of long-term supply in the hydrocarbon sector. A number of smaller producers have been forced to scale back operations due to financial constraints and several high-cost investment projects in the sector have been cancelled or deferred, notably oil sands projects in Canada. However, planned investment among the major companies has remained relatively high and their major projects, e.g., deepwater offshore, are expected to be completed. Moreover, the weaker investment demand has relaxed some of the acute constraints in the supply of investment inputs (oil rigs, materials, specialized equipment, and skilled labor), and, as a result, exploration and exploitation costs have declined. Most of the obstacles to future supply are "above-the-ground" constraints (as opposed to a shortage of oil in the ground)—such as access to reserves (three-fourths of the world's reserves are controlled by national oil companies), political problems, and the reluctance of national oil companies to engage international companies to facilitate the extraction and discovery of reserves. Nevertheless, all major oil-exporting countries are investing in new capacity, and Saudi Arabia has repeated its intention to maintain surplus capacity.

Medium-term prospects are difficult to judge, and while the consensus in the industry is for a further spike in oil prices, this appears unlikely. High prices have stimulated development of alternative technologies, and pushed governments and consumers to use energy more efficiently. Consumers' shift away from fuel-inefficient cars, the mainstreaming of hybrid automobile technologies, the recent passage of laws tightening U.S. energy efficiency standards, increasing environmental pressures—coupled with the modest pace of the expected recovery—all argue against OPEC's more than 6 mb/d in spare capacity being reabsorbed very quickly.

Demand for metals weakens; prices expected to remain soft

Most metals prices peaked in March 2008 (nickel and zinc prices peaked much earlier), but the collapse of economic growth and with it demand for many metals (table 1.4) caused prices to drop much further into 2009 before rebounding somewhat in recent months on strong import growth into China, mainly due to re-stocking.

Metals prices are expected to be relatively stable over the remainder of 2009, with most of the 41 percent decline projected between 2008 and 2009 having already occurred. As a result, spending on new extraction projects has been slashed, and output is declining because lower prices have rendered many difficult-to-exploit mines uncompetitive. The downturn has led to a buildup of spare capacity, which can be brought back into production relatively easily, and should keep prices from rising by much when demand recovers. However, because prices have been just covering exploitation costs, no further major declines in metals prices are expected, with the possible exception of copper, where prices remain above the marginal cost of production. Over the forecast period, metal prices are expected to remain broadly stable—rising in line with inflation in 2010 as demand recovers.

Prices of agricultural commodities fall to pre-crisis levels

Improved supplies resulting from favorable harvests have boosted global stocks of most agricultural commodities. This, along with weaker demand for internationally traded food commodities, has allowed prices to fall back to their December 2007 levels—with the largest declines among agricultural products whose prices had increased the most. In particular, lower crude oil prices coupled with pressure in many European countries to reconsider biodiesel mandates, has reduced the attractiveness of using edible oils for biodiesel production and contributed to a substantial decline in their prices. Overall, concerns about the adequacy of global food supplies have subsided, and many of the export bans and high export taxes that were put in place during the food price spike of 2008 have either been eliminated or substantially reduced.

Most of the price swings in agricultural raw materials reflect changes in rubber prices, which track the price of crude oil. Increased production and wider use of genetically modified cotton in

Table 1.4 Metal demand plummeted with industrial production

	2002–06	2007	1H08	2H08	1Q09
	(Annualized percent increase)				
World					
Oil	2.0	1.2	0.9	−1.5	−3.7
Aluminum	7.5	10.4	5.6	−6.0	−20.3
Copper	3.0	6.6	1.4	2.3	—
China					
Oil	9.1	4.6	5.0	3.6	−3.5
Aluminum	19.9	42.8	15.9	−4.7	−10.4
Copper	9.6	34.6	5.3	12.8	—

Sources: CRU International Limited; International Energy Agency; World Bureau of Metal Statistics.
Note: — = Not available.

Table 1.5 Most developing-country currencies depreciated sharply against the majors

	2008-Q3		September 2008 to date	
	USD/LCU	REER	USD/LCU	REER
	(Percentage change, year-on-year)			
United States	.....	−6.5	.....	16.1
Euro Area	8.3	5.6	−5.7	−2.0
Japan	10.5	3.4	10.8	16.8
Brazil	16.6	20.8	−30.4	−15.9
Russian Federation	7.8	7.5	−34.4	9.0
India	−5.3	−8.1	−14.8	−5.5
China	9.7	6.6	0.4	6.6
Memo items:				
World	**6.2**	**−1.8**	**−9.7**	**−1.1**
High-income countries	**6.3**	**−1.4**	**−7.8**	**−0.6**
All developing countries	**6.1**	**−2.4**	**−15.3**	**−2.8**
East Asia and Pacific	5.1	4.9	−4.5	−1.2
Europe and Central Asia	12.3	3.7	−32.1	3.0
Latin America and the Caribbean	7.1	5.8	−20.4	−17.0
Middle East and North Africa	4.5	−1.9	−6.8	7.2
South Asia	−6.1	−21.3	−11.9	1.2
Sub-Saharan Africa	0.0	.....	−16.4	0.8

Source: World Bank and International Monetary Fund.
Note: USD/LCU: Exchange rate expressed as dollars per local unit (an increase implies appreciation of the local currency); REER: real effective exchange rate (an increase implies an appreciation of the local currency in real terms versus all countries).

China and India meant that the price of cotton did not increase during the boom, and in the past months the price has declined due to weak import demand from China, the world's largest cotton user (and textile manufacturer). Prices of beverages declined 30 percent between their peak in June and December 2008, as both coffee and cocoa supplies appear to be ample.

Looking forward, agricultural markets are likely to remain well supplied, and stocks are beginning to return to normal levels, although weather-related production problems (especially in South America) could always intervene. Easier market conditions are likely to prevail for several years. As a result, agricultural prices are anticipated to average 21 percent lower in 2009 than in 2008, and prices in 2010 are expected to remain broadly stable.

Exchange rates and inflation

The intensification of the financial crisis in September 2008 inspired a significant reversal in capital flows, away from developing countries and toward high-income countries, notably the United States. The need to repatriate liquid assets to cover losses elsewhere and an increase in home bias on the part of global investors, caused the currencies of almost all developing economies to depreciate against the U.S. dollar (table 1.5). The collapse in commodity prices also played a role in exchange-rate depreciation for developing commodity exporters, such as Argentina, Brazil, and the Russian Federation, and also for high-income commodity exporters such as Australia and Canada. In the immediate aftermath of the crisis, only a few currencies appreciated or held their ground against the dollar, among them the Chinese renminbi and the currencies of several oil exporters that are pegged to the dollar. Many developing currencies depreciated by 20 percent or more, but the extent of depreciation was much less severe in real effective terms—because most currencies depreciated against the dollar simultaneously.[7]

The depreciation of developing countries' currencies has meant that the local currency price of many commodities fell much less sharply than the dollar price of these commodities. For example, the Brazilian price of internationally traded wheat and oil fell by 12 and 25 percent, respectively, between July 2008 and February 2009, contrasted with a drop of 25 percent and 65 percent in dollar terms. In addition, the depreciations have increased the local currency cost of servicing dollar-denominated debt. While depreciation will improve the competitiveness of affected countries, the extent to which this can be translated into increased exports will be diminished by the depressed state of world demand.

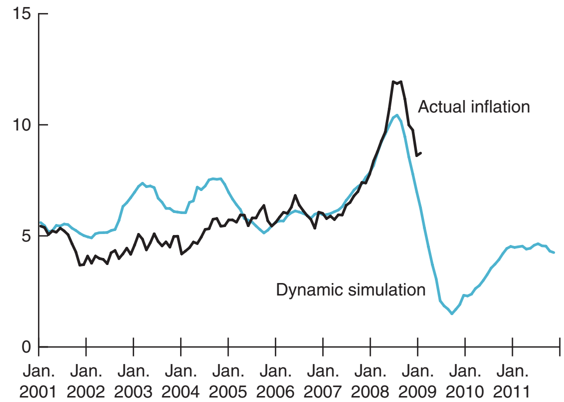
Commodity prices and headline inflation

Consumer price inflation in the G-7 countries is projected to decline from 2.9 percent in 2008 to 0.5 percent in 2009 due to lower commodity prices, weak demand, and rising unemployment. Global consumer price inflation is projected to decline, but deflation is not expected to be an enduring problem because of the additional liquidity that has been placed into financial markets, and because stabilizing commodity prices will no longer be exercising a strong negative influence on the overall price level.

Among developing countries for which separate food price data are available, econometric evidence suggests that median inflation, after increasing from about 6 percent in 2007 to a peak of more than 16 percent by mid-2008, could decline to less than 2 percent by the end of 2009 (figure 1.8). Headline inflation is projected to pick up in 2011 to near 5 percent, as underlying core inflation once again becomes the dominant influence on overall rates of price changes. This general pattern is likely to be observed in all developing countries but should be most striking in those countries (notably in Sub-Saharan Africa) where food represents a large share of total consumption expenditure. Even if headline inflation temporarily falls below zero in several developing countries, the risk of widespread deflation remains limited.

Figure 1.8 Falling food and energy prices to bring inflation under control

Percent change in developing-country consumer prices, historical and dynamic simulation



Source: World Bank.

The fall in internationally traded food prices and the anticipated decline in domestic inflation should alleviate some of the more acute increases in poverty incurred during the first half of 2008. Updated estimates suggest that the increase in local food prices between January 2005 and their average level of 2008 may have increased extreme poverty by between 186 and 226 million people.[8] The decline in international prices since that time has contributed to a reduction in domestic food prices—but with a lag. Projections of local prices for the remainder of 2009 suggest that for the year as a whole, the number of people drawn into extreme poverty because of higher food prices could decrease to between 96 and 109 million (table 1.6).

Table 1.6 Increase in the number of poor due to changes in food prices since December 2005

(millions)

	Given food prices in 2008		Given expected food prices in 2009	
Region	Lower bound estimate	Upper bound estimate	Lower bound estimate	Upper bound estimate
East Asia and Pacific	112	133	66	78
Europe and Central Asia	8	9	2	3
Latin America and the Caribbean	1	2	0	0
Middle East and North Africa	26	37	8	11
South Asia	14	20	−2	−5
Sub-Saharan Africa	24	26	21	22
Developing world	186	226	96	109

Source: World Bank, Global Income Distribution Dynamics Model.
Note: Lower bound estimate assumes low-income farm laborers work for low-income farm owners. Upper bound estimate assumes low-income farm laborers work for rich farm owners (see World Bank 2009). Poverty line is 1.25 international 2005 dollars per day.

Policy reactions

Governments and central banks have responded to the crisis in a generally decisive and helpful—if not always well-coordinated or orchestrated—manner (chapter 3 provides a comprehensive review of the policy response to the financial crisis). High-income countries, where the bulk of the banking sector adjustment must take place, have expanded the scope of deposit insurance schemes to cover larger deposits and new institutions, recapitalized some banks, taken equity positions in others, extended the range of securities accepted as collateral in central bank lending, and provided unprecedented amounts of funding to banking systems in general. By reducing the uncertainty of holding funds in high-income countries, many of these moves have had the unintended side effect of increasing the relative risk of holding funds in developing countries. As such, they may have contributed to the capital outflows from developing economies and the increase in their risk premiums that has been observed.

Governments have also offered guarantees to specific markets (for example, the United States has offered guarantees on securities backed by auto loans, credit card loans, student loans, and certain small business loans). Notwithstanding these efforts and private sector recapitalizations, much more restructuring is required. The IMF (IMF 2009b) estimates that total write-downs related to the crisis in the banking sector will probably total $4.1 trillion. Of that, it estimates that U.S. banks will require further capital injections of $525 billion and that European banks may require as much as $1.27 trillion.

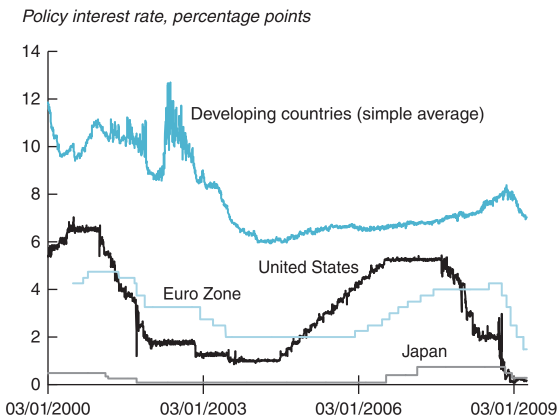
Countries have also responded by easing monetary conditions. Policy interest rates have been reduced sharply throughout the world and especially in the United States. Among high-income countries, rates have fallen by an average of 180 basis points since mid-September 2008 (table 1.7). Continued weak financial conditions also led major central banks to adopt unconventional expansionary measures, including purchases by the U.S. Federal Reserve and the Bank of England of long-term government securities, interventions by the Fed in the mortgage and commercial paper markets, and purchases of corporate bonds and commercial

Table 1.7 Policy interest rates have dropped across most of the world

	Dec-07	Sep-08	Dec-08	Latest	Change since September 15, 2008
Nominal policy rates					
United States	4.52	1.94	0.52	0.15	−1.79
Euro Area	4.00	4.30	2.70	1.14	−3.16
Japan	0.80	0.80	0.40	0.30	−0.50
Developing countries	8.20	8.75	9.10	8.00	−0.75
East Asia and Pacific	7.40	7.30	5.50	5.30	−2.00
Europe and Central Asia	6.00	6.30	6.50	6.40	0.10
Latin America and the Caribbean	8.20	9.15	9.20	6.87	−2.28
Middle East and North Africa	9.00	11.20	11.50	11.50	0.30
South Asia	8.55	9.15	9.70	9.45	0.30
Sub-Saharan Africa	10.50	10.50	10.00	10.00	−0.50
Real policy rates					
United States	0.42	−3.00	0.43	0.90	3.90
Euro Area	0.90	0.40	1.30	0.67	0.27
Japan	0.10	−1.30	0.00	0.60	1.90
Developing countries	2.25	−0.75	1.64	1.64	2.39
East Asia and Pacific	1.10	−4.50	−2.20	3.37	7.90
Europe and Central Asia	−2.40	−4.80	−0.50	1.65	6.40
Latin America and the Caribbean	0.10	−1.00	1.50	1.67	2.66
Middle East and North Africa	2.10	−2.50	2.50	3.50	6.00
South Asia	−0.25	−3.95	−4.70	1.60	5.55
Sub-Saharan Africa	4.60	−3.00	−2.45	−2.45	0.55

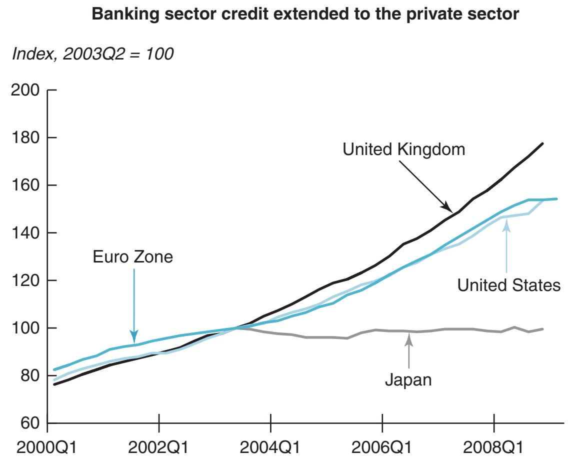
Sources: World Bank; Thomson Datastream.
Note: Policy rates for developing regions are medians; real interest rates are calculated as nominal rate less current-period CPI inflation (y/y), using median inflation rates for developing countries.

Figure 1.9 Policy interest rates in both high-income and developing countries have been sharply reduced



Sources: World Bank; Thomson Datastream.

Figure 1.10 The contraction in bank lending has been limited



Source: National authorities.

paper by the Bank of Japan. As a result of these steps, the balance sheets of central banks have expanded at an unprecedented rate. The U.S. monetary base increased from $900 billion in September 2008 to $1.5 trillion by February 2009.

Developing countries have also reversed the overall stance of monetary policy, with policy interest rates having been cut in three-quarters of the countries for which data are available (figure 1.9). As a result, the median policy rate for developing countries has declined from 8.1 percent in December 2008 to 6.6 percent at the end of May 2009. Despite relatively modest declines in nominal policy interest rates in developing countries, real interest rates in these countries have declined to around 1.6 percent on average, because high commodity prices drove up inflation in 2008 and the decline in commodity prices has yet to pass through fully to local prices (see above).

So far, efforts to support banks have prevented a sharp decline in lending, although the pace at which lending has increased has slowed (figure 1.10). The money pumped into the banking sector has been intended directly or indirectly to shore up capital and to prevent banks from being forced to cut sharply into their lending. Based on the most recently available data, total bank credit to the private sector continued to grow in all of the major economies during the fourth quarter of 2008. Indeed, the stock of outstanding corporate loans increased at double-digit rates in both the United States and the United Kingdom during the period, possibly suggesting that the "credit crunch" was not the key reason for the sharp falloff in investment. In contrast, corporate lending in Europe was stagnant,[9] and the latest data suggest that credit in Europe stopped expanding in the first quarter of 2009. Whether this slowdown reflects weaker demand for loans or constrained supply is not clear.

But data on bank lending do not capture the precipitous decline in securitization and other financial innovations that underpinned the rapid rise in liquidity during 2003–07. By one measure, in the months before the crisis, loans held as securitized assets in the "shadow banking system" (banks' off-balance-sheet structured investment vehicles) were more than half again as large as those held on balance sheet and included in the data in figure 1.10 (Helleiner 2009). More than 20 percent of U.S. private credit market debt was securitized by the end of 2008 (Federal Reserve 2009).

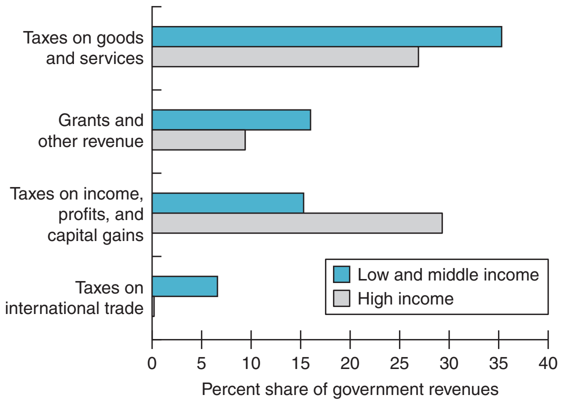
Fiscal responses

High-income countries and a number of middle-income economies have responded to the crisis by approving proactive countercyclical spending, and by letting automatic stabilizers, such as unemployment insurance and welfare systems, operate.

Government deficits in high-income countries are expected to increase by around 3 percent of GDP on average during 2009. The increase reflects a number of factors: reduced tax revenues (taxes

Figure 1.11 Much weaker industrial production and exports will cut deeply into government revenues in developing countries

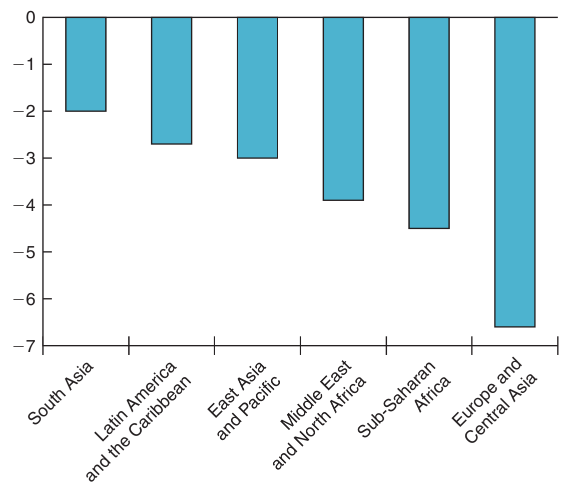
Key sources of central government revenues among developing countries



Source: World Bank.

Figure 1.12 Government balances are expected to deteriorate most sharply in Europe and Central Asia

Projected change in fiscal balance between 2008 and 2009, percentage points of GDP



Source: World Bank.

on business profits tend to be particularly volatile); upfront contributions to support financial systems (including capital injections, purchases of assets and lending by the treasury, and backing by the treasury for central bank support);[10] automatic stabilizers (rising expenditures for unemployment insurance and welfare systems); and proactive stimulus packages.

Overall, the discretionary component of the easing is expected to amount to only 1.6 percent of high-income GDP, with automatic stabilizers accounting for the remainder (IMF 2009b). The largest discretionary stimulus packages announced so far are in Spain (2.3 percent of GDP), the United States (2.3 percent), Australia (2.1 percent), and the United Kingdom (2 percent). Smaller measures have been announced among major European countries (0.7 percent of GDP for France, 1.5 percent for Germany, and 0.2 percent for Italy). However automatic stabilizers tend to be more pervasive and reactive in Europe. Such expenditures are projected to increase by 2 percent of GDP in the United Kingdom and France, contrasted with 1.5 percent of GDP in the United States. While the widening of fiscal deficits, coupled with the financial measures described above, will likely help to reduce the depth and prospective length of the global recession, the additional debt and increase in long-term spending obligations they entail will also present challenges to economic management once recovery takes hold (box 1.2).

The fiscal positions of developing countries are also expected to deteriorate, perhaps by more than those of high-income countries. Lower levels of industrial activity will reduce indirect taxes on domestic goods and services (which account for some 33 percent of developing-country tax receipts) and on trade (8 percent of receipts) (figure 1.11). Resource-related revenues of many commodity exporters are also falling with the decline in commodity prices. And higher bond spreads imply higher borrowing costs on new debt issuance (especially problematic for countries with a high proportion of debt in short-term instruments). A further potential public-sector liability may arise if high interest rates force private (or public) companies, the bulk of whose debt tends to be concentrated in short-term instruments, to come to the government for assistance (as already has happened in a number of countries).

The largest increases in fiscal deficits are expected to arise in developing Europe and Central Asia, where contraction in trade and production is particularly severe, social safety nets have broad coverage, and the private sector has a large debt burden denominated in foreign currency (figure 1.12). The next largest increase is anticipated

Box 1.2 Managing the recovery: Coping with the future impact of recent policies

The expansionary policies and financial sector interventions undertaken by governments and central banks over the past months should reduce the depth and length of the recession. They also, however, will pose a challenge to economic management once the global economy begins to recover.

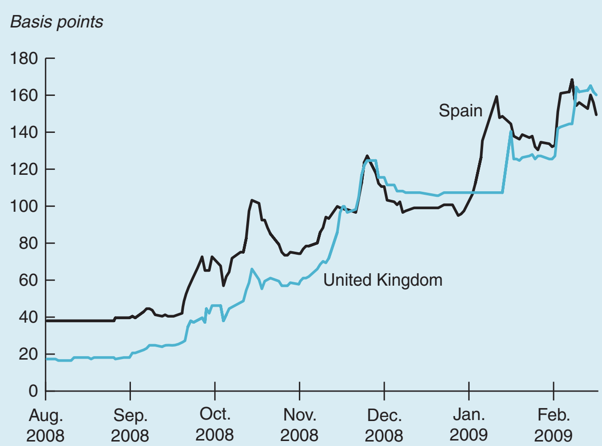
First, governments in high-income countries, including Belgium, France, Ireland, the Netherlands, the United Kingdom, and the United States, have increased their stakes in the financial system to an extent not seen since the Great Depression. They have become involved in compensation, dividend, and risk management decisions that governments may not be well placed to make. An eventual return to private sector control of the banking system is critical to reestablishing an efficient financial sector.

Second, the huge expansion of the money supply, reflected in the surge in central bank balance sheets, will need to be unwound to contain inflationary pressures once investors and consumers begin to spend again.

Third, reducing fiscal deficits to maintain debt sustainability will be an important political challenge. The major industrial countries (save Japan) began the crisis with modest ratios of debt to GDP. However, the unprecedented amounts spent to bail out financial firms, discretionary fiscal stimulus measures, and the impact of the recession on taxes and transfer payments have already substantially increased those debt ratios. Moreover, governments have taken on additional contingent liabilities related to various financial guarantees, and the potential effects of these liabilities on government debt remain unknown. For example, the quality of the assets on the balance sheets of some central banks has deteriorated markedly. Well-timed disposal of these assets as market conditions improve will be important to limit fiscal losses.

Experience with unsustainable increases in fiscal deficits during the 1970s and 1980s showed how painful the reestablishment of sustainability can be. This will be especially difficult if interest rates rise to reflect the increase in debt ratios or higher inflation, adding to governments' borrowing costs. Already the costs of buying credit protection on government debt issued by advanced economies have increased sharply, particularly for the United Kingdom and Spain, both hard hit by the downturn (see figure). Among the negative effects of large-scale government borrowing will be crowding out of other borrowers—private firms and developing-country borrowers—whose revival will be key to a resumption of global economic growth. Thus governments should be vigilant to reverse quickly the fiscal stimulus that is now necessary.

Markets are pricing in an increased risk of sovereign default on the debt of Spain and the United Kingdom
Spreads on five-year credit default swaps



Source: Thomson Datastream.

for Sub-Saharan Africa, where government revenues are especially dependent on indirect taxes, and in the case of commodity exporters, on ad valorem taxes and fees on commodity exports.

External balance and vulnerabilities

The crisis has gone a long way to unwinding—in an admittedly disorderly fashion—many of the tensions that precipitated it. Sharply higher savings in the United States over the past several years, has greatly reduced the extent of the global imbalances that had been characterized by very high current-account deficits in the United States and surpluses elsewhere, notably in China (figure 1.13). The current-account deficit of the United States diminished to an estimated 3.5 percent of GDP in the first quarter of 2009, down from more than 6 percent during the course of 2007; and China's trade surplus, though still very high, has

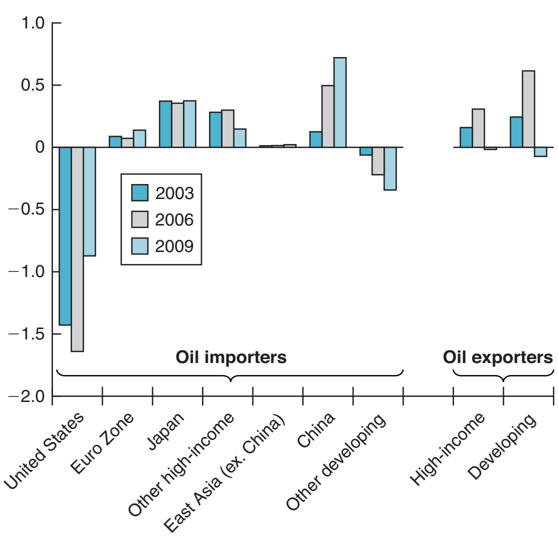
Table 1.8 Lower commodity prices have reduced imbalances

	2nd oil shock	Commodity boom	Financial crisis	Change in current account balance
	1979–82	2005–08	2009–10	2009/2008
Oil exporters		Current-account balance % of GDP		(percentage points)
High-income	**5.2**	**3.8**	**−0.4**	**−5.8**
OECD	−0.1	0.3	−1.1	−2.1
Non-OECD	29.6	29.8	5.2	−27.9
Developing	**−2.6**	**6.3**	**1.2**	**−7.8**
East Asia and Pacific	−1.2	4.8	2.2	−2.6
Europe and Central Asia	...	7.1	2.2	−6.6
Latin America and the Caribbean	−3.3	1.6	−1.4	−4.7
Middle East and North Africa	−0.4	19.8	7.8	−20.7
Sub-Saharan Africa	−5.0	7.9	−2.5	−16.5
Oil importers				
High-income	**−0.6**	**−1.3**	**−0.2**	**1.0**
OECD	−0.6	−1.6	−0.4	1.0
Non-OECD	1.5	5.1	4.6	1.0
Developing[a]	**−4.3**	**−3.0**	**−3.4**	**1.2**
East Asia and Pacific[a]	−6.3	2.1	1.2	0.4
Europe and Central Asia	−4.5	−6.4	−5.3	2.0
Latin America and the Caribbean	−5.8	−0.5	−2.8	0.1
Middle East and North Africa	−7.3	−4.9	−4.3	4.9
South Asia	−1.7	−2.2	−1.7	2.2
Sub-Saharan Africa	−3.3	−6.7	−8.1	0.1

Source: World Bank data.
Note: a. excluding China.

Figure 1.13 The crisis has reduced global imbalances

Current-account balance as percent of world GDP



Source: World Bank.

also declined as a share of GDP. Lower commodity prices have reduced current-account surpluses among oil exporters and deficits among importers (table 1.8). The current-account balances of developing oil-exporting countries are projected to move from a surplus of 6.3 percent of GDP during the 2005–08 commodity boom to a surplus of 1.2 percent in 2009–10.

While the increase in U.S. savings and lower interest rates have contributed to the reduction in its current-account deficit, longer-term prospects for imbalances are less certain. The very large monetary and fiscal stimulus that has been put in place will reduce overall savings (the sum of private and public saving) in the United States, especially if the authorities have difficulty in reversing the stimulus when the economy recovers. Moreover, the monetary expansion has already regenerated the low interest rates that contributed to the excess liquidity in the first instance. If too expansionary, these stimulus measures could regenerate very strong demand conditions and a return to low savings rates in the United States.

Lower oil prices should provide current-account relief for many countries

The decline in oil and other commodity prices has improved the terms of trade for many developing countries. For oil-importing developing countries, lower import and higher export prices have increased incomes by about 1.2 percent of GDP between 2009 and 2008 (table 1.9). For countries such as Fiji, Jordan, and the Seychelles, the estimated impact of these price changes exceeds 10 percent of their GDP. Other countries with positive gains in their terms of trade (in excess of 5 percent of GDP) are Nicaragua, the Kyrgyz Republic, Togo, Honduras, Lebanon, and Dominica. Terms-of-trade effects between early 2009 and the average price of 2008 are most pronounced for oil-exporting countries. On average, oil-exporting developing economies are projected to suffer terms-of-trade losses equivalent to 6.8 percent of their GDP. The largest income losses are for Equatorial Guinea, the Republic of Congo, the Islamic Republic of Iran, and Azerbaijan, amounting to about a quarter of their 2008 GDP. For metals-exporting countries, the deterioration in terms of trade has been less marked but is still large—in part because lower food and fuel prices have offset some of the terms-of-trade losses from lower metals prices.[11] Compared with 2007—when commodity prices were closer to their current levels—all of these terms-of-trade effects are much more modest.

The impact of lower food prices on terms of trade for most economies will be relatively small, because most food consumed in developing countries is produced domestically. Exceptions tend to be small island economies and other countries for which food imports account for a large share of overall merchandise imports (such as Benin, Comoros, Eritrea, Haiti, Senegal, Somalia, and the Republic of Yemen).

Table 1.9 Lower commodity prices should improve terms of trade for oil importers

Country groups	Terms of trade as % GDP, 2009/2008
Net oil exporters	
All developing	−6.8
East Asia and Pacific	−0.3
Europe and Central Asia	−7.9
Latin America and the Caribbean	−3.8
Middle East and North Africa	−16.3
South Asia	...
Sub-Saharan Africa	−13.4
Net oil importers	
All developing	1.2
East Asia and Pacific	2.1
Europe and Central Asia	1.1
Latin America and the Caribbean	−1.1
Middle East and North Africa	4.2
South Asia	2.7
Sub-Saharan Africa	−0.7

Source: World Bank.

The region that stands to lose most is the Middle East and North Africa, which is projected to suffer a terms-of-trade decline of close to 12 percent of GDP in 2009, followed by Sub-Saharan Africa, dropping 16.1 percent. In contrast, South Asia and East Asia and the Pacific—regions heavily dependent on oil imports—will register the largest terms-of-trade gains: 2.7 and 1.7 percent, respectively.

Serious vulnerabilities remain

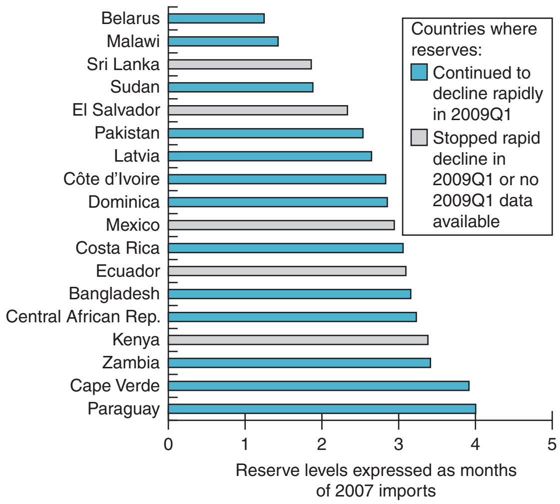
While the current-account positions of oil-importing developing countries are expected to improve over the course of 2009, deficits in a number of countries remain exceptionally high. More than 43 low- and middle-income countries registered current-account deficits in excess of 10 percent of GDP during 2008. In years past, these deficits were relatively easily financed by strong capital inflows. However, the financial crisis has sharply curtailed such flows, with total private inflows projected to decline from more than $1 trillion in 2007 to just $360 billion in 2009. At the same time, the external financing requirements of developing countries are expected to have increased, implying a financing gap of between $350 billion and $635 billion in 2009.

The effects of this shortfall have already been manifested in the pressures on the banking sector and currencies of a number of developing and high-income countries. Several countries have opened lines of credit with the IMF, while others are meeting shortfalls by reducing their international financial reserves. Many developing countries have seen their reserves fall by 20 percent or more since September 2008. For several, the decline in reserves followed an earlier period of accumulation, and reserve levels remain comfortable. But for at least 18 countries, reserves have been depleted to the point where they no longer cover four months of imports (figure 1.14). In most of these countries, reserve levels have stabilized more recently, but in at least five, reserves continued to decline by 5 percent or more a month during the first quarter of 2009.

Other countries have been forced to deal with much tighter borrowing conditions and large current-account deficits by reducing imports and current-account deficits. Fully 20 countries whose

Figure 1.14 Many developing-country reserves have reached worrisomely low levels

Developing countries whose reserves have declined by 20 percent or more since August 2008 and whose current levels are low

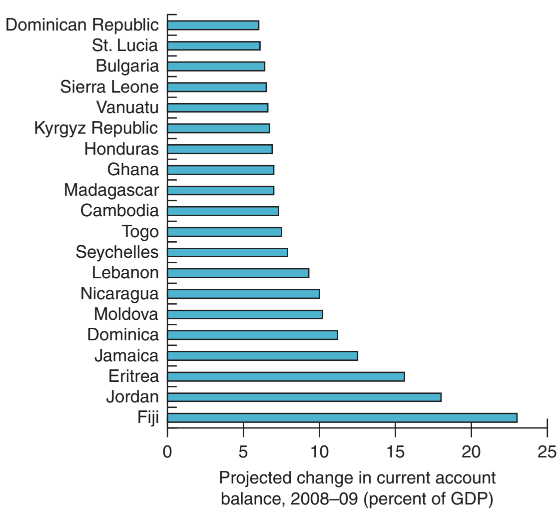


Sources: World Bank; Thomson Datastream.

current-account deficits in 2008 totaled 10 percent or more of GDP are expected to undergo internal adjustments that lower that deficit by 6 percent or more of GDP (figure 1.15).

Figure 1.15 Many countries will need to reduce imports sharply due to reduced access to foreign capital

Countries with large current-account deficits that are projected to undergo large real-side adjustments



Source: World Bank.

An uncertain medium-term outlook

Prospects for the recovery of the global economy are unusually uncertain. The sharp decline in global GDP, industrial production, and trade in the fourth quarter of 2008 and the continued weakness in the first quarter of 2009 are without modern precedent. So, too, is the extent to which the cycle has been synchronized across the planet. The fragility of banks and other financial institutions further complicates the assessment of when and how the recovery will take shape.

While there are incipient signs of a stabilization of activity in the United States (a recovery in consumer demand, increased housing sales, a rebound in the stock market) and of recovery in China (an increase in industrial production, acceleration of credit supply, and sharp gains in government spending), there are also ample indicators of a deepening and spreading recession. Unemployment is rising, housing prices continue to decline—adding to negative wealth effects. And, although no major bank has failed since October 2008 and many reported positive earnings in the first quarter of 2009, huge losses (IMF 2009b), restructuring, consolidation, and government intervention remain the order of the day.

A subdued recovery

The baseline projection presented in this edition of *Global Development Finance* is characterized by a subdued recovery from the current deep recession. The main cyclical factors that made the downturn so steep—the sharp fall in investment, rapidly rising precautionary savings, the use of inventories rather than new production to meet demand, and the postponement of durable goods purchases—are likely to ease in the second half of 2009 and push growth into positive territory by 2010. Cost-cutting measures and inventory reductions are running their course, and at some point firms will stop drawing down on and begin taking orders for new industrial output to catch up to underlying demand. In high-income countries, consumer demand and manufacturing orders have already improved or are improving, although for the moment available data do not show a similar turnaround in investment demand. These normal drivers of cyclical recovery will be amplified as the already-passed monetary and fiscal stimulus measures kick in during the second half of 2009—boosting consumer and investment demand directly through government expenditure and transfers, and indirectly through very low interest rates.

However, the expected recovery is projected to be much less vigorous than normal. The large overhang of devalued assets and nonperforming loans will limit the extent to which the banking sector is able to finance new investment and consumer spending. Banking-sector consolidation, combined with mounting unemployment, negative wealth effects, and increased risk aversion will drag on growth throughout the forecast period. Because GDP growth only reaches its potential pace by 2011, the output gap (the difference between actual GDP and its potential), unemployment, and disinflationary pressures continue to build (figure 1.16).

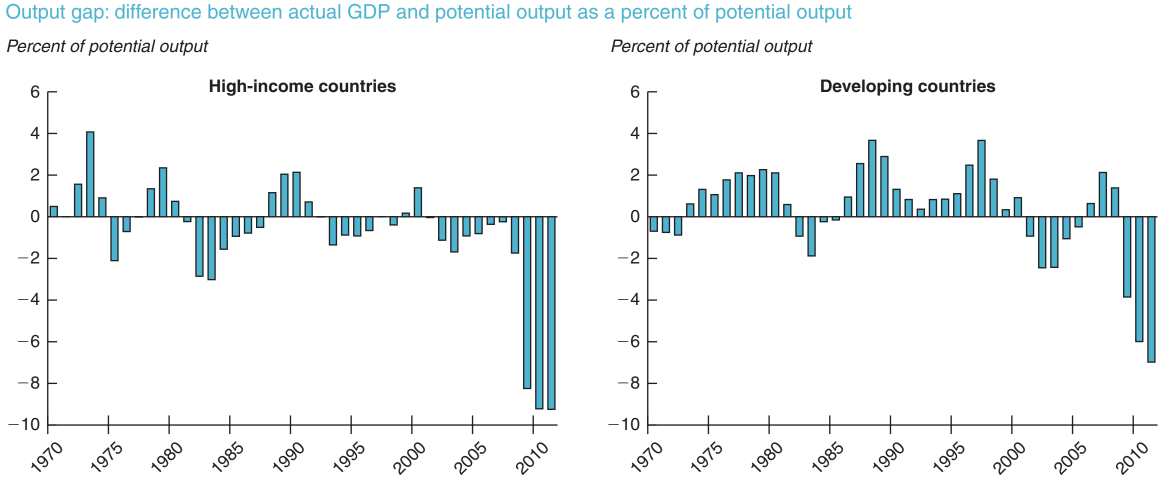
Notwithstanding the beginning of a recovery in the second half of the year, global GDP is projected to contract by a record 2.9 percent in 2009 considered as a whole (the first decline in world output since the 1960s and probably since World War II).[12] Output is then expected to rise a modest 2.0 percent and 3.2 percent in 2010 and 2011, respectively. After falling a projected 10.4 percent in 2009, tight financing conditions and abundant spare capacity should keep gains in global investment to a modest 2 percent and 4.7 percent in 2010 and 2011, respectively. Partly because of the heavy share of investment goods in global merchandise trade, global trade of goods and services is expected to decline by an unprecedented 9.7 percent in 2009, before picking up to a 3.8 percent and 6.9 percent rate of increase in 2010 and 2011, respectively.[13]

GDP in high-income countries is projected to fall 4.2 percent in 2009, recovering only modestly to a 1.3 percent pace in 2010 and to 2.4 percent in 2011. Notwithstanding the return to positive growth, these economies will remain depressed even in 2011. Unemployment will only be starting to decline at that time, and the output gap, the difference between the productive capacity of an economy and the actual level of demand, will likely have reached some 6 percent of GDP.

Prospects for developing countries are for an almost equally sharp 4.7 percentage point deceleration of GDP growth in 2009. The GDP of all developing countries combined is projected to increase by only 1.2 percent, or by only 0.1 percent in per capita terms. Excluding India and China, economic output in the developing world is projected to fall 1.6 percent, or 2.9 percent in per capita terms. GDP is projected to decline in two developing regions: by 2.3 percent in Latin America and the Caribbean and by 4.7 percent in Europe and Central Asia.

The recovery of output in developing countries is projected to be even more sluggish than in high-income countries. GDP growth is expected to increase by only 4.4 percent in 2010 and by 5.7 percent in 2011, as still weak activity in high-income

Figure 1.16 Despite projected stronger growth, considerable excess capacity remains even in 2011
Output gap: difference between actual GDP and potential output as a percent of potential output



Source: World Bank.

countries drags on growth, and capital inflows to developing countries remain about half their pre-crisis levels (see chapter 2).

In this weak overall environment, commodity prices are projected to recover only slowly. After halving in 2009, oil prices are forecast to rise by less than 10 percent a year over 2010–11, as demand for oil increases slowly and continued surplus capacity prevents any return to the price levels of the first half of 2008. The recovery in the prices of metals and minerals will be even slower, while agricultural prices are projected to remain stable in 2010–11 (after the 21 percent drop forecast for 2009). Thus producers of commodities (other than oil) are expected to see a continuing decline in their terms of trade vis-à-vis manufactured goods.

Regional outlooks

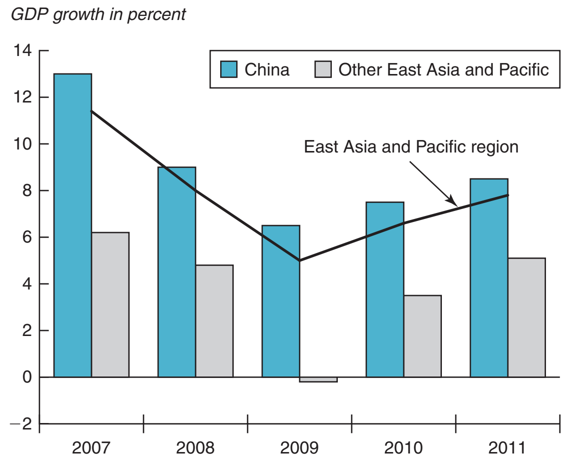
More detailed discussions of prospects for developing regions, including country-specific projections, are available in the Regional Outlooks appendix at the end of this volume and online at www.worldbank.org/globaloutlook.

East Asia and Pacific had little direct exposure to the toxic securitized assets and other sources of financial turbulence that originated in the financial centers of the OECD. But the region has felt the crisis particularly hard because of its well-developed trade links with the high-income countries and substantial capital inflows that over the past years have helped fuel an investment boom.

Investment in developing East Asia and Pacific represented 36 percent of GDP in 2008, much higher than its 26 percent share in the rest of the developing world. As the international environment deteriorated beginning in September 2008, private investment in East Asia and Pacific came under substantial pressure. The rising cost of capital, falling equity prices, rising bond spreads, and rapidly declining foreign demand sent exports and manufacturing production in the region to double-digit declines.

Regional exports in dollar terms dropped a full 48 percent between September 2008 and February 2009, while industrial production declined 4.6 percent over the same period.[14] In turn, investment spending for the countries outside of

Figure 1.17 The recovery in East Asia and Pacific will be led by China



Source: World Bank.

China declined at an unprecedented 25 percent annualized rate during the first quarter of 2009 (saar). Partly as a result, the region's GDP growth is projected to slip to 5 percent in 2009 from 8 percent during 2008, with China's 6.5 percent advance almost fully offsetting the 0.2 percent GDP decline for the remainder of the region (figure 1.17).

Faced with a quickly deteriorating situation, most developing economies in East Asia and Pacific eased monetary policy aggressively by lowering interest rates, reducing reserve requirements, and in some cases, providing direct liquidity into the banking system. To the extent affordable, most have launched fiscal stimulus programs; the most ambitious of these is in China.

GDP for the region is anticipated to revive over the course of late 2009 and into 2010, though for several countries, including Malaysia, Thailand, and the Philippines outright recession is anticipated this year. Recovery is expected to be relatively gradual, reflecting substantial fiscal stimulus in China combined with a gradual recovery of demand for the region's exports among high-income countries. GDP should increase by 6.6 percent in 2010 and by 7.8 percent by 2011.

Europe and Central Asia has been the region most adversely affected by recent developments, and economies in the region may be the most at risk. Since the end of the Cold War, growth in the region has relied heavily on increased trade linkages and investments from the European Union (especially for the countries of central and eastern Europe). As a result, the abrupt reversal of capital flows and weaker demand for exports hits particularly hard. Sharply declining economic activity in Russia has also produced considerable spillover effects across the Commonwealth of Independent States (CIS).

Conditions have been made more difficult by the large current account deficits that evolved during this period and for which financing now appears in short supply. Many countries entered the global financial crisis with current-account deficits in excess of 10 percent of GDP, which made them especially vulnerable to a reversal of capital flows. Further buildup of foreign debt has become problematic, and meeting repayment obligations on short-term debt might become difficult in a number of countries (figure 1.18). The adjustment process is especially harsh because exports to the Euro Area are declining, and oil revenues—which fueled demand and remittances in the CIS—are falling.

The currencies of a number of economies in the region are under pressure and several countries have sought the assistance of the IMF in order to forestall a serious crisis. At the household and firm levels, the accumulation of large debt levels denominated in foreign currencies raises the risk of default and potential systemic difficulties in the event of adverse currency movements.

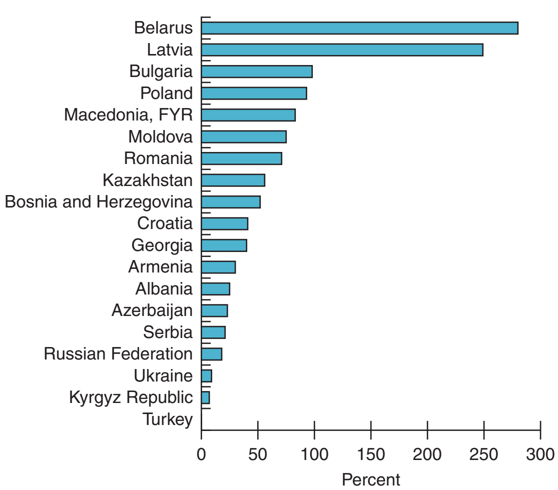
Under these very trying circumstances, output in the region is projected to fall 4.7 percent in 2009 and recover only modestly in 2010, growing by 1.6 percent. Continued adjustment and negative wealth effects suggest that even in 2011, growth at 3.3 percent will be below the region's potential rate, and little progress is likely to be made in reducing unemployment.

Latin America and the Caribbean entered this crisis period supported by much stronger fiscal, currency, and financial fundamentals than the region had in the past. Nevertheless, it is feeling the crisis on the financial side. Foreign funds were withdrawn quickly, equity markets tumbled, and exchange rates have plummeted. Some countries are suffering more than others because of the close trade and remittance ties they have with the United States, while others are feeling the effects of sharply lower commodity prices and of markedly weaker external demand that have cut into incomes. These factors have contributed to a sharp deceleration and even contraction in GDP growth in the final quarter of 2008 in several economies in the region (figure 1.19).

Brazil's large resilient domestic market has offered some cushion against declines in exports; however, it will be increasingly squeezed if external demand slides further. Countries such as Chile and Peru have used good years to improve their fiscal and reserve positions, creating room for expansionary

Figure 1.18 High short-term debt-to-reserves ratio in Europe and Central Asia

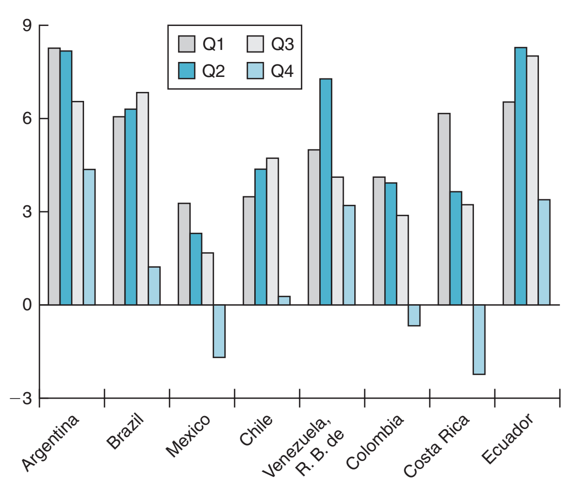
Short-term debt in 2009 as percent of February 2009 reserves



Sources: International Financial Statistics; Bank for International Settlements; World Bank.

Figure 1.19 GDP growth deteriorated markedly in the fourth quarter of 2008 in several major economies in Latin America and the Caribbean

Percent, year-on-year



Source: World Bank.

policies, but an extended, deep recession will take a toll on growth. Tourism and remittances have also suffered, particularly affecting countries in Central America and the Caribbean.

Output for the region as a whole is projected to decline by 2.3 percent following gains of 4.2 percent in 2008. However, this aggregate masks diverse outcomes. Mexico, having suffered significant disruption due to the novel A H1N1 flu, and having strong financial and trade ties with the United States, is projected to see output fall by 5.8 percent in 2009. GDP is projected to contract less sharply in countries like Brazil that have a more diversified portfolio of export markets and resilient domestic demand. Weaker terms-of-trade for commodity exporters will pressure budgets in a number of countries, some of which failed to build up sufficient buffers during the commodities boom. Moreover, the scope for fiscal stimulus varies greatly across countries in the region.

Reflecting Latin America and the Caribbean's improved fundamentals, its recovery is projected to be fairly robust, with growth reaching 2 percent in 2010 and 3.3 percent by 2011.

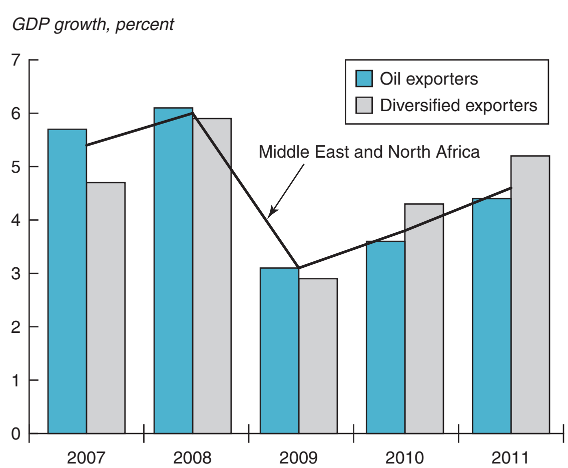
The Middle East and North Africa region has been less directly affected by the credit crunch than other regions. But local equity and property markets have come under intense pressures, and weaker GDP growth and flows of foreign direct investment from the countries of the Gulf Cooperation Council are cutting into activity among the developing countries of the region. Moreover, the effective collapse of growth in the Euro Area (a critical export market for the region) has resulted in sharp declines in non-oil exports, remittances, and tourism receipts, further dampening prospects for the more diversified economies. Remittances, services exports, and FDI flows to the region are expected to fall fairly sharply as a share of GDP from a peak of 9.5 percent in 2007 to 7.2 percent by 2011.

Growth is projected to halve to 3.1 percent in 2009, from the strong 6 percent advance during 2008. Fiscal revenues and expenditures in oil-exporting countries will be adversely affected by the sharp decline in oil prices. Oil revenues among developing exporters are estimated to drop precipitously from $320 billion in 2008 to $140 billion during 2009, the change equivalent to 28 percent of the group's GDP. Although lower food and fuel prices should boost incomes among oil and food importers in the region, that will not be sufficient to offset the heavy falloff in export volumes and international services revenues attendant upon the deep recession in the Euro Area. As a result, current-account balances are projected to deteriorate.

The recovery among Middle East and North African developing countries is expected to be less vigorous than elsewhere, partly because the slowdown had been less pronounced and because oil demand and prices are expected to remain low. Growth is projected to pick up by just seven-tenths of a percentage point in 2010 to 3.8 percent before improving to a 4.6 percent pace by 2011. The diversified economies should see growth pickup to a faster clip than the oil-dominant economies over 2010–11, as the array of factors that restrained their growth turn more favorable (figure 1.20).

In South Asia, GDP is projected to expand 4.6 percent in 2009, down from 6.1 percent in 2008. Capital inflows have diminished considerably, which has contributed to a falloff in investment growth. Although the decline in oil prices since the middle of 2008 has improved terms of trade for the region, weakening demand in South Asia's export markets is being felt sharply in the manufacturing sector and has tempered the growth of services exports, including high-tech and tourism. Remittance inflows have decelerated sharply or contracted in recent months, and are expected to decline in 2009, albeit with some lag as conditions in host countries

Figure 1.20 Growth to slow sharply for both oil and diversified exporters in the Middle East and North Africa



Source: World Bank.

falter. GDP growth rates are projected to rebound fairly briskly, with regional output increasing by 7.0 percent in 2010 and 7.8 percent in 2011.

Given already high budget deficits, countries in the region have limited room to expand fiscal policy. Food and fuel subsidy bills have begun to shrink, which is creating some space on the expenditure side, even if only for shifting outlays to meet other demands. Lower commodity prices have provided a strong disinflationary impulse to economies in the region, which has allowed policy makers to pursue more expansionary monetary policies. The pressure on current accounts from reduced exports, combined with lower capital inflows, was initially met by drawing down international currency reserves to support their exchange rates. More recently, countries have shifted to a posture of conserving reserves, and permitted their currencies to devalue.

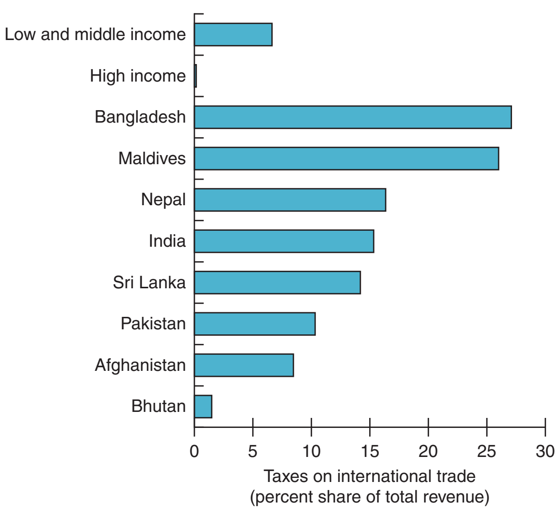
Downside risks to the forecast are pronounced. On the domestic front, they are centered on the region's large fiscal obligations and relatively high reliance on taxes on trade and large subsidy programs, both of which would lead to heightened fiscal pressures in the event of a protracted global recession (figure 1.21). Ongoing budgetary pressures are also likely to lead to cuts in development spending, which could have long-term effects. Large fiscal deficits also represent a threat to long-term growth, weighing on potential output by crowding out private investment due to increased public-sector borrowing and higher interest rates.

Sub-Saharan Africa. The global financial and economic crisis has hit Sub-Saharan Africa hard, because of reduced external demand, plunging export prices, weaker remittances and tourism revenues, and sharply lower capital inflows, notably FDI. Growth in the region is expected to decelerate sharply this year to 1 percent down from an average of 5.7 percent the previous three years (figure 1.22). GDP declined during two quarters in South Africa, the region's largest economy, for the first time in 17 years and some large oil-exporting and mineral-dependent economies are also expected to see output drop. As elsewhere, the expected recovery in 2010 will be weak, with growth rising to a below-trend 3.7 percent for the region as a whole, 4.3 percent excluding South Africa. Sub-Saharan Africa's disappointing growth outturn will translate into a decline in per capita GDP of close to 1 percent in 2009, the largest since 1994, marking a pause in poverty reduction.

Reflecting slow GDP growth, low commodity prices and government revenues that are relatively dependent on formal and traded activities,

Figure 1.21 Government revenues in South Asia very dependent on trade

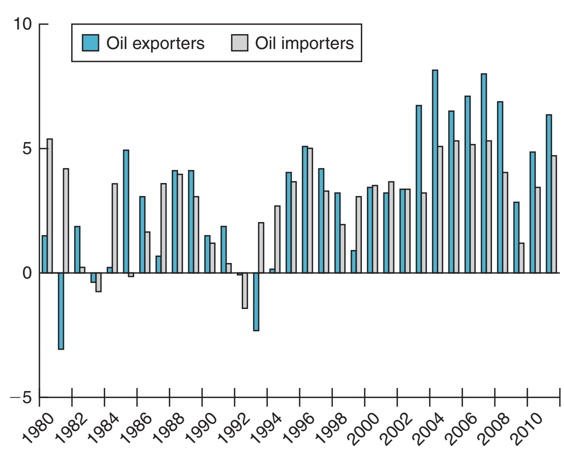
Shares as of 2007 for countries (except Bhutan = 2004) and 2006 for income groups



Source: World Bank.

Figure 1.22 Economic growth in Sub-Saharan Africa is projected to decelerate abruptly in 2009 to the lowest level in almost a decade

Annual growth, percent



Source: World Bank.

both current-account and fiscal balances are set to deteriorate markedly this year, and improve only marginally in 2010, impeding the implementation of counter-cyclical policies. In countries heavily reliant on commodity export revenues, fiscal balances will deteriorate sharply, cutting into much-needed infrastructure expenditure and social programs, while borrowing requirements crowd out the private sector investment. On the positive side, widening output gaps and lower food and energy prices are putting downward pressure on inflation, although the impact of last year's high food and fuel prices is still being felt in many countries in the region. Much weaker demand and price conditions in the mining sector have reduced employment in the sector, cutting into remittances in many countries, notably those in southern Africa.

Prospects for continued diversification away from the primary sector and toward higher value-added sectors have weakened because the region's manufacturing sectors have been dealt a heavy blow.

Risks

Given the severity of the downturn, its synchronized nature, and the weakened state of the world's major financial institutions, there is much more than the usual level of uncertainty surrounding future prospects. As the recent outbreak of a novel form of influenza in Mexico serves to remind us (box 1.3), the world's economy is at a particularly vulnerable juncture, where an event that might otherwise have carried relatively minor economic consequences could have a much broader impact.

Not all of the uncertainty concerns the possibility of slower growth, although the economic and human costs of a deeper or more protracted recession are most troubling. One upside scenario concerns the possibility that private sector confidence and the financial sector respond more robustly and more quickly than is assumed in the baseline. Under such circumstances, the fiscal and monetary stimulus already in place could provoke a more rapid recovery than anticipated, which could rekindle inflationary pressures. In this scenario, the authorities would be forced to respond with a relatively quick tightening of policy measures that could induce a second round of below-potential growth toward the end of the projection period.

A protracted recession

The main downside risk to the outlook is that the confidence and wealth effects of the financial crisis are much more persistent than in the baseline, and that the consolidation efforts of banks constrain lending more durably. In this scenario, second-round effects intensify—including rising unemployment and the bankruptcy of firms that might have survived a milder recession and unemployment. Instead of recovering somewhat during 2010, global investment could decline by another 5.5 percent, with the sharpest contractions in those countries experiencing the most marked reversals in capital flows and in investor confidence.

In this scenario, the projected rebound in private consumption would be much weaker due to slower income growth and higher savings, notably, in high- and middle-income countries where households have more discretionary income with which to maneuver. As a result, instead of rebounding as in the baseline, global trade would continue to decline, intensifying the pressures on the most vulnerable middle-income countries (those with current-account deficits in excess of 10 percent of GDP). In the protracted recession scenario reported in table 1.10, this causes severe currency crises characterized by sharp exchange-rate depreciations and even more significant reductions in domestic spending in many economies.

Overall, this scenario implies that the fall in world output in 2009 would be deeper than in the baseline because the recovery expected in the second half fails to emerge. Output would stagnate in 2010, before rebounding by 3 percent in 2011. World trade volumes would fall a further 4.7 percent in 2010, bringing global trade volumes almost 17 percent below 2008 levels. In this scenario, GDP in developing countries would register a very modest 2.0 percent increase in 2010, with the bulk of the weaker performance concentrated in Europe and Central Asia, where GDP is projected to decline by an additional 1.5 percent. Not all countries in the region would be affected equally, and several (such as Latvia, Lithuania, and the Russian Federation) are projected, even in this downside scenario, to experience stronger growth than in 2009.

Box 1.3 Potential economic impacts of the A H1N1 flu outbreak

At the time of this writing (June 1, 2009), the outbreak of H1N1 flu has not run its course, although there are encouraging signs that it is neither as deadly nor as easily spread as might have been first thought. Initial estimates suggest that its clinical severity is similar to that of the Hong Kong flu of 1968–69 and that while its infectiousness (rate of spread) is higher than normal flu it is in the lower range of previous influenza pandemics (Fraser and others 2009). Younger populations and individuals with chronic disease appear to be most vulnerable, in part because as much as 33 percent of people 60 and older appear to have some immunity to it (Centers for Disease Control and Prevention, 2009).

To date, the World Health Organization reports some 12,954 laboratory confirmed cases of the flu in 46 different countries, and 92 deaths. More than 90 percent of the cases recorded so far are in North America, with all but 12 deaths having been in Mexico—which accounts for about one-third of all cases.

It is not yet known what explains the much lower mortality rates outside of Mexico. Possible explanations include: a much higher incidence of disease than reported in Mexico and therefore a lower mortality rate, the timing of the outbreak toward the end of the flu season in the Northern hemisphere, and some aggravating and as yet unknown cofactor.

So far, the economic costs of the epidemic have been concentrated in Mexico and in the transportation sectors. Air travel to and from Mexico is down by 80 percent, and hotels in popular resorts report vacancy rates as high as 80 percent. Overall, tourism revenues are down an estimated 43 percent, increasing Mexico's external financing gap because tourism is an important source of foreign currency. Following an initial closure of restaurants, theaters, and sports stadiums, the Mexican authorities ordered all businesses to shut down for five days in an effort to stem the spread of the disease. Because this last measure fell over a long weekend, its economic effect was much smaller than it would have been had it been declared during the course of a full business week. Should recent levels of disruption in the commerce, restaurant, hotel, and transportation businesses in the Mexico City region (representing 30 percent of the country's GDP) persist, they could reduce second-quarter GDP by as much as 2.2 percent.

Although the spread of A H1N1 appears to have eased, its spread is likely to pick up as the flu season begins in the southern hemisphere and again when it returns in the northern hemisphere. Even if it does not mutate into a more deadly form, a second wave of the flu in low-income countries' could have serious consequences—given poor countries limited capacity to monitor and treat an outbreak and the higher incidence of chronic disease within their populations (the pre-existence of chronic health conditions and delays before medical intervention appear to be among the factors that have contributed to deaths where they have occurred). More worrisome is the possibility that H1N1 could mutate into or combine with a more aggressive form of the flu—such as H5N1 (avian influenza). As a flu for which much of the world's population has limited pre-existing immunity (WHO 2009), A H1N1 could infect as much as 35 percent of the world's population (WHO 2006)—spreading throughout the world in as few as 180 days during flu season.

As compared with a normal flu season, where some 0.2–1.5 million die (WHO 2003), deaths from even a mild new flu might include an additional 1.4 million people worldwide. A more virulent form, such as the 1918–19 flu, which was more deadly for healthy adults than a normal flu, could have much more serious consequences, killing as many as 1 in 40 infected individuals (Barry 2005), or some 71 million. Some authors suggest that as many as 180 million to 260 million could die in a worst-case scenario (Osterholm 2005).

Simulations of the potential economic and human costs of a global pandemic undertaken for the 2006 *Global Development Finance* report in the context of avian influenza (Burns, van der Mensbrugghe, and Timmer 2006, 2008) suggest that the costs of a global influenza pandemic could range from 0.7 to 4.8 percent of global GDP depending on the severity of the outbreak. The lower estimate is based on the Hong Kong flu of 1968–69, while the upper bound was benchmarked on the 1918–19 Spanish flu. In the case of a serious flu, 70 percent of the overall economic cost would come from absenteeism and efforts to avoid infection. Generally speaking, developing countries would be hardest hit, because higher population densities, relatively weak health care systems, and poverty accentuate the economic impacts in some countries.

Table 1.10 A protracted recession

(percentage change from previous year, except interest rates and oil price)

	2007	2008	2009e	2010f	2011f
Global conditions					
World trade volume	7.5	3.7	−11.9	−4.7	5.8
Real GDP growth[a]					
World	**3.8**	**1.9**	**−3.6**	**−0.4**	**3.0**
Memo item: World (PPP weights)[b]	5.0	3.0	−2.4	0.2	3.8
High income	**2.6**	**0.7**	**−4.8**	**−1.2**	**2.2**
OECD countries	2.5	0.6	−4.8	−1.2	2.1
Euro Area	2.7	0.6	−5.3	−2.8	1.7
Non-OECD countries	5.6	2.4	−5.8	−1.2	4.2
Developing countries	**8.1**	**5.9**	**0.5**	**2.0**	**5.5**
East Asia and Pacific	11.4	8.0	4.2	3.9	7.5
Europe and Central Asia	6.9	4.0	−5.8	−1.5	3.0
Latin America and the Caribbean	5.8	4.2	−2.7	0.2	3.1
Middle East and North Africa	5.4	6.0	3.0	3.4	4.5
South Asia	8.4	6.1	4.0	4.7	7.6
Sub-Saharan Africa	6.2	4.8	0.2	0.6	5.3
Memorandum items					
Developing countries					
Excluding transition countries	8.2	5.9	1.2	2.4	5.7
Excluding China and India	6.1	4.5	−2.2	0.3	3.7

Source: World Bank.
Note:
PPP = purchasing power parity; e = estimate; f = forecast.
a. GDP in 2000 constant dollars; 2000 prices and market exchange rates.
b. GDP measured at 2000 PPP weights.

Policy challenges

Developing countries face an extremely challenging policy environment. Falling government revenues and limited access to external sources of capital constrain most countries' ability to respond with countercyclical fiscal policies. Based on past experience, an inability to maintain spending at earlier levels—let alone to increase outlays to meet the challenges associated with the slowdown—will oblige many governments to pursue a procyclical policy cutting back on spending precisely when it is most needed.

Demands on social assistance programs are climbing; these are immediate and pressing needs. As a result, spending on longer-term issues such as infrastructure, health, and education tends to take a back seat or even get cut when additional financing is unavailable. Just maintaining core public spending on education and health and preventing a widening of infrastructure gaps would require an estimated $200 billion in 2009. About $42 billion of additional external financing would be required in 2009 to assist those countries with limited fiscal capacity.

In the current context, with external finance heavily constrained (see chapter 3), many developing countries will be unable to meet these challenges unless additional support from high-income countries is forthcoming.

The implications for poverty reduction and the Millennium Development Goals of a failure to maintain social spending could be far-reaching. For example, following the East Asian crisis in the late 1990s, it took almost a decade for the poverty headcount to regain its pre-crisis level in affected countries. Very young children who are seriously affected by poor nutrition may endure permanent cognitive impairment and never catch up to their peers who were born in more fortunate times. Following the Indonesian crisis in 1997–98, the number of children 7 to 12 years old not enrolled in school doubled in rural areas to 12 percent in a few years. The crisis also affected health outcomes; infant mortality increased by over 3 percentage points during the crisis.

Not only is social spending essential to protect the vulnerable and avoid loss of human capital, it also is a more effective form of fiscal stimulus than tax cuts. Investments that reduce infrastructure bottlenecks in developing countries can have even larger multipliers (IMF 2009a; Hooper and Sløk 2009).[15] Raising the infrastructure services of all Sub-Saharan countries to the level in Mauritius could add as much as 2.2 percentage points to per capita growth (Calderón and Servén 2008), while achieving the level in the Republic of Korea could raise growth by 2.6 percentage points.

Notes

1. Econometric evidence suggests that a 10 percent rise in capital spending in developed countries will elicit a 6.6 percent increase in global manufacturing output. Country sensitivities vary, with stronger links in the United States, and the Republic of Korea (both with elasticities of 2.1), Singapore, and the Central European countries (1.5).

2. Data refer to 28 OECD countries, excluding Canada, Greece, and Mexico, for which the OECD Stat does not report monthly data. The 28 countries are Australia, Austria, Belgium, the Czech Republic, Denmark, Finland, France, Germany, Hungary, Iceland, Ireland, Italy, Japan, the Republic of Korea, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

3. Over the same period, the dollar appreciated against most currencies, rising by 4.4 percent in real effective terms.

4. Refineries struggled to produce sufficient distillates to meet newly mandated ultralow sulfur diesel fuel standards in high-income countries. Lack of refining capacity to produce this distillate from lower-grade oils increased demand (and the price) for light, sweet crude oil by between 3.2 and 5.1 million barrels a day at the peak.

5. World Bank (2009) provides more in-depth discussion of the causes of the run-up in commodity prices during 2008 and their long-term prospects.

6. Prices during the first five months of 2009 averaged $46, thus even if prices continue to rise from their end-of May level of $58, the average price of oil during the whole year will be lower than its current level.

7. The real effective exchange rate is an index of a country's exchange rate with that of its key trade partners (weighted by export and import shares) and corrected for inflation differentials.

8. These estimates are consistent with the methodology used in World Bank (2009), but are based on a more complete history of local food prices in 2008 and an enhanced methodology for estimating the influence of international prices on domestic prices.

9. Corporate lending rose at an annualized rate of 22 percent and 15 percent, respectively, in the United States and the United Kingdom during the fourth quarter of 2008, despite the sharp contraction in activity. Some observers attribute this development to firms arbitraging the low interest rates on existing credit lines or compensating for reduced access.

10. The eventual cost of these up-front contributions is difficult to estimate because it depends on the extent to which the assets acquired hold their value over time.

11. Metals exports represent close to half of the merchandise export revenues in countries such as Chile, Guinea, Jamaica, the Kyrgyz Republic, Mali, Mauritania, Mongolia, Mozambique, Papua New Guinea, Peru, Surinam, Tanzania, and Zambia.

12. Calculations of global GDP before 1960 are complicated because large parts of the world were not covered by national accounting statistics before that date, and indeed, many developing regions had yet to emerge from colonial rule. Maddison (2004) has made a valiant effort to estimate global GDP during this and even earlier periods.

13. The projection for 2009 is broadly consistent with the recently reported forecast of the World Trade Organization for a 9 percent decline in merchandise trade. The value reported here is higher mainly because it includes the growth in internationally traded services, which are much less cyclically sensitive than goods alone.

14. Industrial production in this reference excludes China, as difficulties in seasonally adjusting the time series data for output over the months covering the annual Lunar New Year introduces substantial distortions that render the variable noncomparable with others in the database.

15. Hooper and Sløk (2009) report multipliers for different forms of fiscal expenditure. The mean of these multipliers ranges from 1.2 for purchases of goods and services (including infrastructure spending) down to 0.2–0.5 for various forms of tax cuts.

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