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Global Outlook and the Developing Countries

World growth accelerated sharply in 2004, with GDP advancing an estimated 4 percent (table 1.1). All developing regions are now growing faster than their average growth rates of the 1980s and 1990s. The ongoing economic boom in China was a major factor, as were the surges in activity registered in Japan and the United States. The economic recovery was slower to take hold among European high-income countries, which contributed to the less marked increase in growth rates there. Meanwhile, very strong import demand—because of the torrid expansion in China and the continued tendency for domestic demand in the United States to substantially exceed production—contributed to an exceptional 10.2 percent increase in world trade volumes.

Economic growth is expected to slow in 2005 and 2006, expanding by 3.2 percent in each year. Several factors are likely to contribute to this more moderate pace of activity. First, the investment cycle in the United States has likely peaked, implying a slowdown in growth there.[1] Second, world demand has outstripped supply, resulting in substantial increases in oil and other commodity prices that have cut into incomes, moderating demand in many countries. Third, higher interest rates will slow investment growth as central banks continue shifting monetary policy from a loose to a more neutral stance. Fourth, the large fiscal impulse that has helped propel the U.S. economy in recent years will weaken in 2004—although the deficit will remain high; and in Europe, budgetary policy is expected to tighten as countries seek to regain control over deficits, which in many cases exceed Maastricht limits. Finally, efforts in China to bring growth down to a more sustainable pace should also contribute to weaker, but still strong, demand over the medium term.

Given this external environment and especially the less rapid expansion of trade, growth in most low- and middle-income countries is also expected to moderate but remain strong. The extent of the slowdown should be mitigated because of the far-reaching structural reforms carried out in many countries, which have contributed to recent gains in market share and economic growth. Recent efforts to reduce general government and current account deficits and to pay down debt should enable most developing countries to withstand the higher interest rates expected over the next few years without excessive adjustment costs. However, there is little room for complacency—especially for the more highly indebted countries.

These favorable prospects for the next two years represent a solid starting point for longer-term growth through 2015 and increase the likelihood that developing countries meet the Millennium Development Goals (MDGs). Improvements in macroeconomic fundamentals, enhanced structural flexibility, a stronger investment climate, and further progress toward reducing trade barriers should, if sustained, support the ability of developing

Table 1.1 The global outlook in summary

Percentage change from previous year, except interest rates and oil prices

	2002	2003	2004e	Forecast 2005	Forecast 2006
Global Conditions					
World Trade Volume	3.7	5.5	10.2	8.4	7.8
Consumer Prices					
G-7 Countries[a,b]	1.0	1.6	1.7	1.4	1.2
United States	1.6	2.3	2.7	2.2	1.7
Commodity Prices (USD terms)					
Non-oil commodities	5.3	10.2	17.0	−3.1	−4.2
Oil Price (World Bank average)[c]	24.9	28.9	39.0	36.0	32.0
Oil price (percent change)	2.4	15.9	35.0	−7.7	−11.1
Manufactures unit export value[d]	−1.3	7.4	5.2	−0.8	−0.3
Interest Rates					
$, 6-month (percent)	1.8	1.2	1.6	3.5	4.7
€, 6-month (percent)	3.3	2.3	2.1	2.4	3.6
Real GDP growth[e]					
World	1.7	2.7	4.0	3.2	3.2
Memo item: World (PPP weights)[f]	2.9	3.9	4.9	4.2	4.1
High income	1.3	2.1	3.5	2.7	2.7
OECD Countries[g]	1.3	2.0	3.5	2.6	2.6
Euro Area	0.9	0.5	1.8	2.1	2.3
Japan	−0.3	2.5	4.3	1.8	1.6
United States	1.9	3.0	4.3	3.2	3.3
Non-OECD countries	2.2	3.1	5.9	4.6	4.4
Developing countries	3.4	5.2	6.1	5.4	5.1
East Asia and Pacific	6.7	7.9	7.8	7.1	6.6
Europe and Central Asia	4.6	5.9	7.0	5.6	5.0
Latin America and the Caribbean	−0.6	1.6	4.7	3.7	3.7
Middle East and North Africa	3.2	5.7	4.7	4.7	4.5
South Asia	4.6	7.5	6.0	6.3	6.0
Sub-Saharan Africa	3.1	3.0	3.2	3.6	3.7
Memorandum items					
Developing countries					
excluding transition countries	3.2	5.1	5.9	5.4	5.1
excluding China and India	2.1	3.8	5.4	4.6	4.3

Note: PPP = purchasing power parity; e = estimate.
a. Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
b. In local currency, aggregated using 1995 GDP weights.
c. The World Bank average is the unweighted mean of one barrel of West Texas Intermediate, Brent, and Dubai oil.
d. Unit value index of manufactured exports from major economies, expressed in U.S. dollars.
e. GDP in constant dollars at 1995 prices and market exchange rates.
f. GDP measured at 1995 PPP weights.
g. Now excludes the Republic of Korea, which has been reclassified as high-income OECD.
Source: World Bank.

countries to achieve rapid and sustained per capita growth at a level of 3.5 percent per annum between 2006 and 2015—double the growth rate of the 1990s. Such growth would enable many developing countries to halve the incidence of extreme poverty by 2015, which is a key development goal. However, even if the higher growth of recent periods were sustained, some regions, notably Sub-Saharan Africa, will fail to reduce poverty to this degree. In Sub-Saharan Africa, per capita growth has been slow, and progress to reduce poverty has been minimal. It would take implausibly high growth rates during the next 10 years to achieve the poverty target along with substantial enhancements to pro-poor policies and significantly more assistance. Finally, even if many regions are expected to

achieve the MDG to reduce poverty, many are off track for reaching other important MDGs, such as reducing child and maternal mortality. In many cases economic growth is not enough. A more targeted approach and a realignment of spending priorities are also necessary.

Despite the relatively positive picture for both medium- and long-term prospects, downside risks are ever present and could have negative impacts in the near future and in the long term. An additional rise in oil prices, or a failure of them to moderate, could further restrain global demand and reduce incomes in most less developed countries. While oil prices are expected to decline from present highs, especially given substantial efforts to increase supply by oil exporting countries, existing demand conditions are such that a significant increase cannot be ruled out. Such a rise would have important negative effects on all oil-importing economies, particularly those of low- and middle-income countries that face current account constraints. For these countries, difficulties accessing international finance mean that they cannot absorb the increased costs associated with higher oil prices by increasing their current account deficit. Instead, the additional costs must be accommodated by lower imports, consumption, and investment volumes—implying a significant real-side adjustment. For the most vulnerable of such countries, an additional $10 a barrel increase in oil prices could reduce domestic incomes by as much as 4 percent. On average, incomes of oil-importing low-income countries would fall by about 1 percent of GDP.

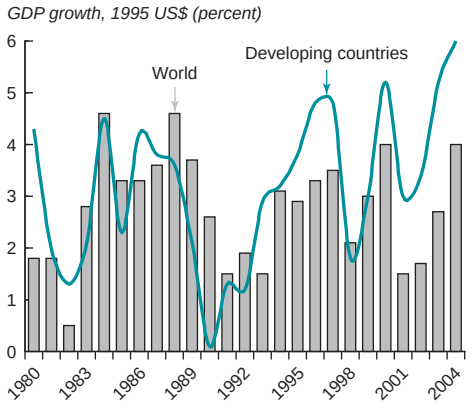
Financing requirements of the U.S. current account and government deficits, and renewed downward pressure on the dollar, may cause long-term interest rates to rise more than forecasted. If interest rates rise, short- to medium-term impacts might include a slowing in world economic growth, sharply increased financing costs, and economic hardship for heavily indebted countries. Increased financial-market turbulence might also ensue—especially for those developing countries most exposed to the U.S. dollar. Over the medium- to long-term, failure to rein in the U.S. budget deficit, which would also tend to reduce its current account deficit, could result in an ever increasing stock of dollar-denominated debt and rising future financing burdens. Moreover, higher interest rates would depress investment levels, provoking a prolonged slowing in the rate of increase of potential output. All of these factors heighten the risk of a resurgence in protectionist sentiment, which would thwart the pace at which developing countries are able to achieve their poverty reduction objectives.

Finally, if current efforts to slow the unsustainable pace of growth in China fail, major disruptions could result. Currently, investment levels may be unsustainably high, and there are some signs that rapidly rising food-price increases are feeding into production costs, which could ultimately choke off competitiveness, (although for the moment there are no clear indications that this is happening). Either problem could provoke a much more abrupt slowdown than described in the baseline. Given China's growing importance as a driver of world trade growth, such a sharp slowdown could have a significant damping effect on global economic activity, particularly among China's major trading partners.

The Global Economy: From Recovery to Expansion

The world economy accelerated sharply in 2004, expanding by an estimated 4 percent (figure 1.1). The United States and Japan, whose economies grew by more than 4 percent, continued to lead Europe in the recovery. Even stronger growth was experienced by a number of large developing countries, notably China (8.8 percent), Russia (8.0 percent), and India (6.0 percent). Their performance helped power developing countries as a whole to an anticipated 6.1 percent growth rate in 2004—an expansion without precedent over the past 30 years. Moreover, it marks a second year of very strong growth, and it may be the first time that recovery in developing countries preceded, rather than followed, recovery in high-income

Figure 1.1 A record year for developing countries in 2004



Source: World Bank.

countries. In contrast to the United States, where the surge was initially led by investment and household consumption, exports were the main source of growth in Europe and Japan—and much of the increase in external demand came from developing countries.

Across the developing world virtually every region enjoyed solid growth, and rapidly rising trade volumes played an important role. Even excluding China, India, and Russia, economic activity in developing countries is expected to have risen 5 percent in 2004. While easy credit contributed to China's remarkable performance, the benefits of WTO accession were also a major factor, and the increase of over 30 percent in Chinese import demand helped underpin growth among neighboring East Asian countries. Russia and the oil-producing countries in the Middle East and North Africa Region benefited from very strong oil revenues, which were reflected in strong import demand and the solid export performance of their trading partners. Increasing market shares, following substantial inward investment flows associated with the accession of many of the Europe and Central Asian Region's members to the EU, also contributed to these positive outcomes. Elsewhere, a strong cyclical recovery is under way in Latin America, and there are signs of a more modest recovery in Sub-Saharan Africa.

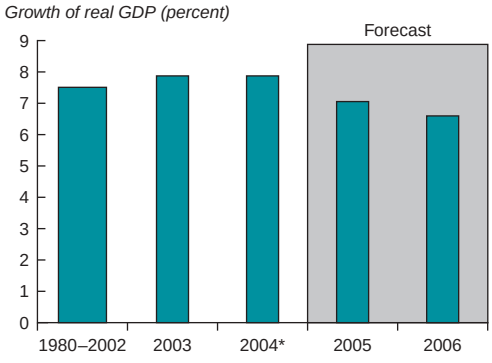
Growth should moderate in 2005 and 2006, led by a slowing of the expansion among developed countries. In the United States, as the output gap closes, productivity growth is projected to slow and unit labor costs to rise; these factors, in addition to external inflationary pressures from commodity prices, likely reflect the Fed's decision to tighten monetary conditions. This, plus the maturation of the investment cycle, a tailing off of fiscal stimulus, and the impact of higher oil costs, will contribute to slowing growth. Similar factors explain the anticipated slowdown in Japan, where output is expected to increase at about trend rates. In contrast, because of its later start and the fact that investment is only now beginning to recover, Europe's growth is expected to continue gaining momentum through 2005 and into 2006, notwithstanding fiscal tightening and a slowdown in the rate of growth of world demand. Overall estimates suggest that the hike in oil prices already observed can be expected to dampen output in 2005 by about 0.5 percent of GDP.

Moderating growth in the OECD economies and a soft landing in China should translate into slower but still buoyant growth in developing countries (figure 1.2).

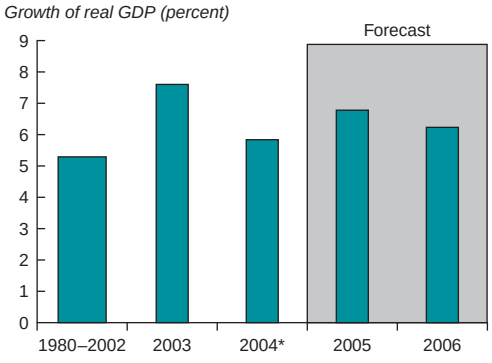
- In *East Asia,* efforts to stem the flow of credits into selected sectors of the Chinese economy are already having observable effects (figure 1.2a). The growth of imports of raw materials such as steel, copper, and various ores have moderated significantly in recent months. Steel imports have collapsed, although iron ore import volumes were growing by more than 25 percent (year/year) in September. However, there are indications that consumption demand continues to grow rapidly, and the Chinese authorities report that GDP increased 9.1 percent in the third quarter. The baseline forecast predicts that a soft landing (growth slowing to 7.1 percent by 2006) will be

Figure 1.2 Strong growth across most regions

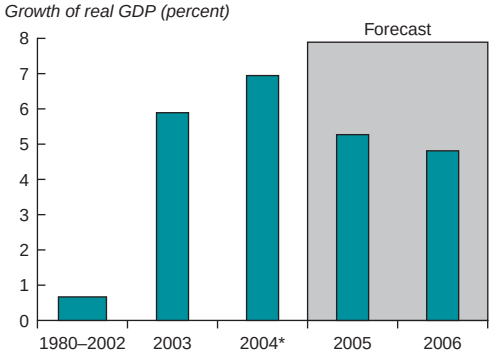
a. East Asia and Pacific



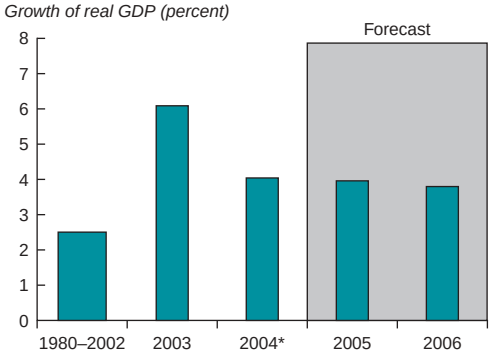
b. South Asia



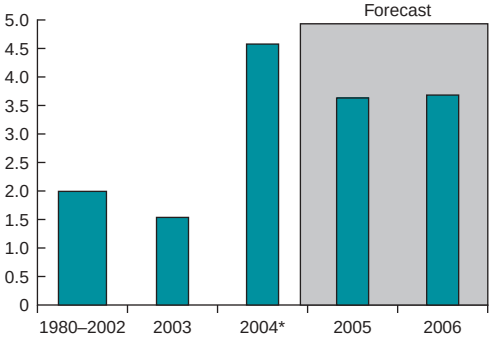
c. Europe and Central Asia



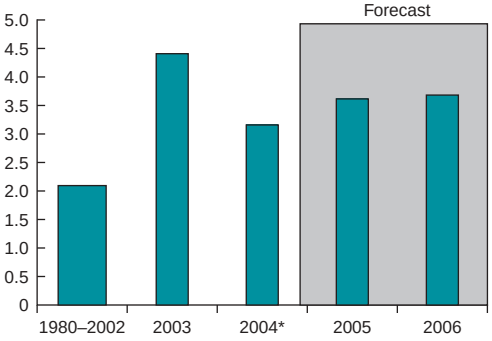
d. Middle East and North Africa



e. Latin America and the Caribbean



f. Sub-Saharan Africa



Note: * = estimate.
Source: World Bank estimates.

achieved and will contribute to slowing throughout the region.

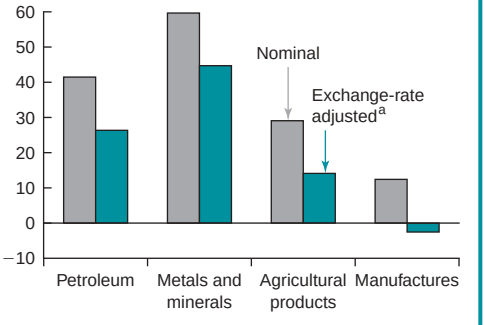
- In *South Asia,* despite the moderation of the Chinese and OECD economies, growth is expected to accelerate in 2005, reflecting the enduring impacts of structural reforms, market opening, and stronger domestic demand as the dampening impact of last year's poor crop fades. As agricultural production and related incomes return to trend growth rates in 2006, GDP growth is projected to moderate somewhat.
- Output in *Europe and Central Asia* is forecast to remain strong, with still-high oil prices supporting demand in Russia and the exports of its trading partners. Central and Eastern European countries will continue to benefit from rapid investment growth following the EU accession of some of their members. However, policymakers need to prepare for the next downturn by pursuing fiscal consolidation to reduce worryingly high government and, in some cases, current account deficits.
- Growth in the *Middle East and North Africa* region is expected to remain robust, but well below the highs observed in 2003, which were boosted by sharp increases in oil production. All countries, but especially those of the Maghreb, should benefit from the strengthening export demand emanating from Western Europe; but consumption demand, reflecting still high oil incomes, will continue to be the main source of growth for the region as a whole.
- The return to growth in *Latin America and the Caribbean* is projected to continue, with only Argentina experiencing a significant slowdown as the competitive advantage from its depreciation in 2002 wears off. Elsewhere, growth should remain strong, with Brazil expanding steadily at between 3.7 and 3.9 percent. Because Latin America and the Caribbean is a heavily indebted region, outturns will ultimately depend on the success with which policymakers deal with rising interest rates and higher payments on debt (see the risks section in this chapter). Here, country-specific conditions and the degree to which fiscal consolidation programs are maintained will play an important role.
- *Sub-Saharan Africa* will also benefit from the revival in Europe, its main trading partner, but many oil-importing countries in Africa remain vulnerable due to high oil prices. Notwithstanding substantially improved performance, growth in the region will continue to lag the rest of the world by a significant margin, implying a further widening of income gaps. Moreover, the terms of trade appear to be turning against this region as non-oil commodity prices are expected to ease. Although additional development aid and debt relief would help, continued efforts to improve fundamentals and the efficiency of public expenditure are also required to speed the pace at which these countries achieve their poverty-reduction objectives.

Commodity Markets

Strong world demand and supply shortages were responsible for commodity prices rebounding sharply during the global recovery (figure 1.3). In dollar terms, metals and minerals

Figure 1.3 Tradable price developments

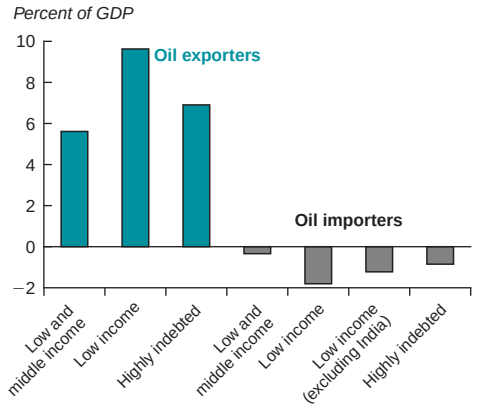
Cumulative percent change, 2001–2004



a. The adjusted data show the price change expressed as a trade-weighted average of domestic currency prices.

Source: World Bank.

Figure 1.4 Terms of trade impacts from higher commodity prices, 2001–04



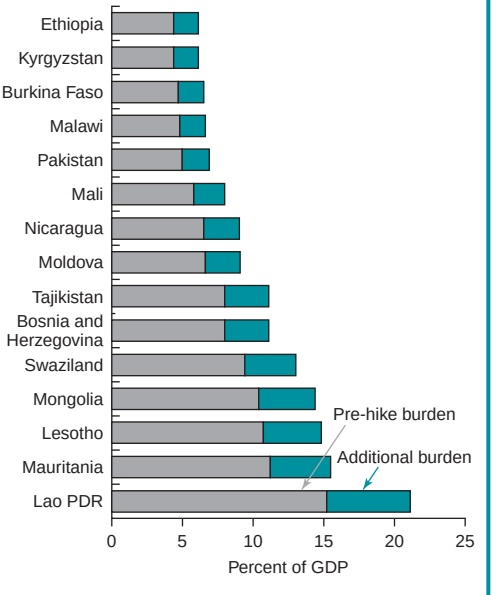
Source: World Bank.

prices have increased the most since 2001 (up almost 60 percent), but the 40 percent hike in petroleum prices has had the largest economic effect. In domestic currency terms, the impact of these price hikes was less important for many countries because of the 15 percent depreciation[2] of the dollar over the same period.

Higher commodity prices since 2001 have boosted incomes of low- and middle-income countries as a whole by an estimated 1.1 percent of GDP. However, virtually all of the gain accrued to low- and middle-income oil exporters. Most developing country oil importers suffered net terms of trade losses (figure 1.4). The major beneficiaries were the Middle East and North Africa, Europe and Central Asia, and Latin America and the Caribbean Regions—all of which include major oil exporters. In contrast, the net gains from non-oil commodity prices for low-income countries were modest or even negative. This is partly because most of the non-oil commodity price gains were concentrated in metals and minerals prices, which restricted the benefits to a few resource-rich countries. Moreover, many industrializing low-income countries, notably India and Pakistan, are now net commodity importers. The terms-of-trade impact on incomes of oil exporting developing countries was 5.6 percent of GDP, whereas for oil importers the impact was a loss of 0.3 percent.

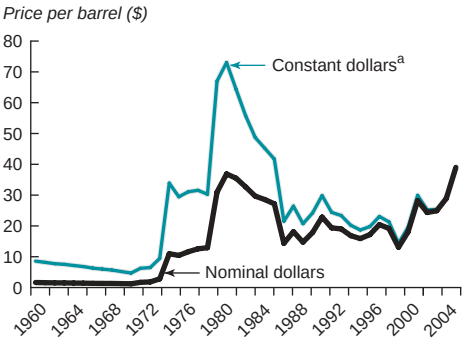
For the poorest oil-importing countries, high oil prices have dramatically exacerbated already serious poverty. Many of these countries remain particularly vulnerable to high oil prices. Even before the oil price hikes, a number of these countries were spending more than 5 percent of GDP to cover oil imports. The unweighted average of West-Texas Intermediate, Brent, and Dubai crude oils is estimated to have been $39 in 2004.[3] At this level, it is estimated that as many as seven countries will have oil-import bills in excess of 10 percent of GDP; these countries would be forced to make substantial cuts in spending elsewhere in their economies to compensate for the additional burden (figure 1.5). Indeed, for the poorest countries the net additional burden in 2004 is expected to consume 75 percent of the World Bank funding they receive for all development programs, and

Figure 1.5 The oil-import burden for selected countries



Source: World Bank.

Figure 1.6 Crude oil prices, 1960–2004



a. Nominal petroleum prices deflated by the U.S. GDP deflator, 2003 = 1.

Source: World Bank.

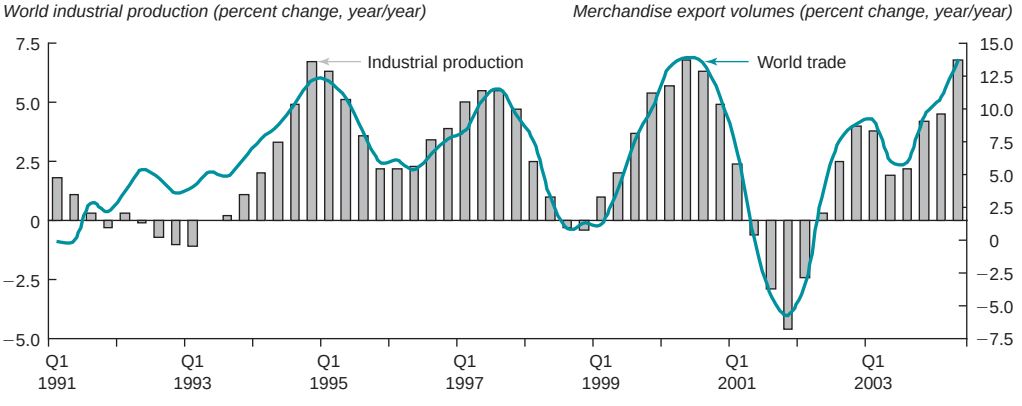
12 percent of all the bilateral aid they receive. To keep development projects on track, high-income countries will need to increase commitments substantially—at least as long as high oil prices continue.

Although a substantial rise in oil prices is not the most likely scenario, given new sources of supply and reduced oil intensities in the world economy, there remains considerable scope for higher oil prices, particularly given the current sensitivity of oil markets to localized disruptions in production (figure 1.6). Indeed, OPEC excess capacity is estimated to have fallen from 4.6 million barrels per day in 2001 to only 1.4 million barrels per day in 2004. Moreover, oil prices remain well below past peaks. Corrected for inflation and expressed in 2003 dollars, oil prices averaged more than $72 in 1980, and actually reached more than $100 in November of the previous year. Viewed from this perspective, further hikes would not be unprecedented.

World Trade

World trade growth averaged 10.2 percent in 2004, reflecting rapid increases in industrial production and investment activity (figure 1.7). The expansion in trade volumes in 2004 is reminiscent of the increase observed in 2000 and mirrors the rapid recovery in industrial production that began to take shape in the second half of 2003 and continued into 2004. More than 20 percent of the increase in world merchandise trade volumes was represented by China, whose imports increased by 32 percent—reflecting both the positive impact of its accession to the WTO and unsustainable rates of investment and consumption demand.

Figure 1.7 World trade rebounds

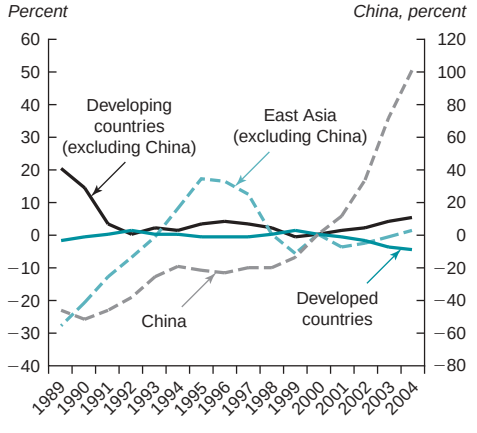


Source: World Bank.

Trade in raw materials and investment goods was particularly strong. As discussed above, robust demand for raw materials was an important factor underlying the trade expansion in a number of developing countries. In particular, oil, steel, and minerals trade was strongly influenced by the rapid increase in Chinese manufacturing and construction sectors. Similarly, fast-growing global investment expenditures were particularly important in spurring export demand in countries such as Germany and Japan that specialize in the fabrication of machinery and other physical capital.

As a whole, developing countries have grown their share in world markets by about 19 percent (figure 1.8), up from 19 to 23 percent since 2000. Much of this rise is attributed to China, which has seen its share in world exports double from 2.9 to 5.8 percent between 2000 and 2004. Excluding China, the improvement in the export share of low- and middle-income countries has been more modest (from 16 to 17 percent), although developing countries in the South Asia and Europe and Central Asia regions have increased their market shares considerably. Other regions either maintained their market share (the rest of the Eastern Asia and Pacific and the Middle East and North Africa) or lost market share (Sub-Saharan Africa and Latin America and the Caribbean).

Figure 1.8 Export performance, percent change in market share since 2000



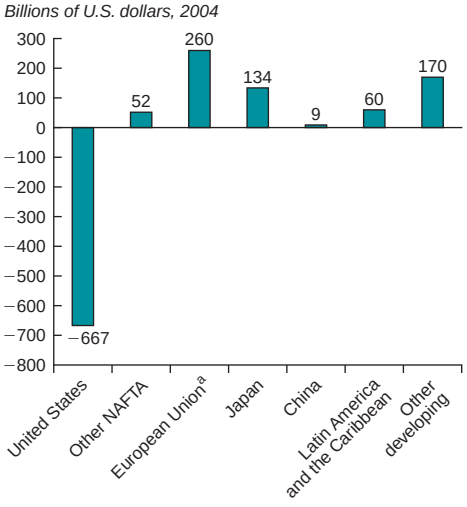
Source: World Bank.

Within regions the performance of specific countries continues to be dictated, in part, by domestic factors. So notwithstanding very strong Chinese import demand, exports in the rest of East Asia failed to increase as quickly, partly because political instability held back industrial and investment activity in the Philippines and Indonesia. In Latin American and the Caribbean, export volumes in Brazil and Argentina grew briskly under the continued influence of currency devaluations 2 years ago, while strong world demand for metals and minerals gave special impetus to Chilean exports.

Slower activity throughout the global economy should translate into less rapid trade expansion in 2005 and 2006. Trade in goods and nonfactor services is forecast to expand by about 8.5 percent in 2005, down from an estimated 10 percent in 2004. Much of the deceleration is conditional on the success of efforts to dampen the pace of activity in China, which should be reflected in slower import growth in China and slower exports among its trading partners. Looking to other regions, the easing of activity in the United States, coupled with broadly stable growth in Europe, is expected to result in a somewhat more pronounced deceleration of trade volumes in Latin America as compared with Africa, the Middle East, and Eastern European areas.

Major imbalances in the world trading environment persisted during 2004 and will likely continue to play a large role in 2005–06 (figure 1.9). Notwithstanding the sharp acceleration in world import volumes, the U.S. current account deficit reached 5.7 percent of GDP in the second quarter of 2004, as American consumption and investment volumes exceeded domestic production by a wide margin (higher oil prices represented 0.6 percentage points of the 1.4 percentage point deterioration in the current account since the first quarter of 2002). The expansion in the trade deficit since the mid-1990s has been the main

Figure 1.9 Trade balances in major regions



a. European Union refers to the 15 member countries, prior to the latest expansion.

Source: National agencies.

factor behind the rise in the U.S. current account deficit—itself a major factor behind the 15 percent real effective depreciation of the currency since February 2002. Barring a substantial increase in domestic savings by, for example, a tightening of fiscal policy, downward pressure on the U.S. dollar is likely to resume as U.S. foreign borrowing requirements remain high, and the already large amounts of external debt continue to accumulate (see, for example, Bergsten and Williamson 2004).

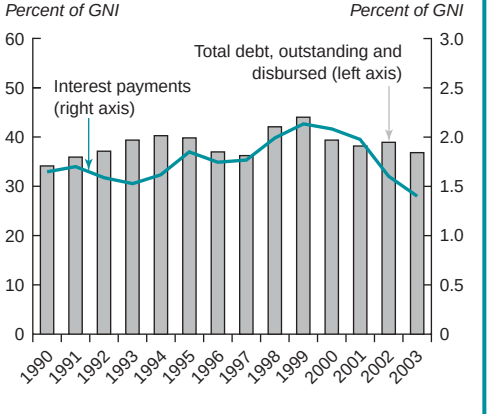
The U.S. trade deficit is largely a homegrown problem. While bilateral trade deficits with specific countries are large, notably with respect to China, the fact that these countries have only small overall surpluses supports the view that the deficit with the United States is more a reflection of U.S. trade patterns than an indication of unfair trading practices. For example, China's large bilateral surplus with the United States (but very small global surplus) reflects its specialization in the production of final consumption goods (sold to the United States) based on intermediate and primary imports from other developing countries with whom China has a cumulatively large trade deficit (Lau 2003).[4]

Failure to address the twin U.S. deficits could have significant impacts on developing countries, especially if that failure leads to an increase in protectionist behavior. This is especially relevant because the substantial improvements in living standards, wages, and incomes in many upper-lower and middle-income countries have been the result of expanding their world market share in manufactures. An increase in protectionism could halt these countries' progress and deny other poor countries the same avenue to development. Moreover, a retreat from recent efforts to reduce trade barriers or a failure to make further progress—especially concerning agricultural subsidies—could have substantial negative consequences on many of the world's poorest countries.

International Finance

Over the past several years, favorable global conditions, strong growth, rapidly expanding trade, and domestic reforms (including lower fiscal deficits and inflation) have allowed developing countries to substantially improve their financial positions (figure 1.10).

Figure 1.10 Developing countries' debt and interest payments easing downward since 1999



Source: World Bank.

On average, their debt to GNI ratio has fallen from 44 to 37 percent since its peak in 1999. This progress, plus low interest rates and strong growth, has substantially lowered the debt-servicing burden for most countries. While the situation of the most heavily indebted countries remains serious, they have made the greatest gains—debt to GDP ratios for these countries are down from 161 to 86 percent since 1994—partly because of debt-relief programs instituted over this period.

These favorable conditions have also allowed many countries to strengthen their external position. Most countries have succeeded in improving their structural positions so that, even in the face of higher oil prices or a more moderate pace for growth, their current account positions should not deteriorate to the point where financing becomes problematic. As a whole, the current account position of the major groups of developing countries is close to balance or in surplus (table 1.2).

Developing countries have become major sources of international capital. Since 2000, the central banks of some of the largest developing countries have increased their foreign reserves by more than 80 percent. Taken as a group, the reserves of Brazil, China, India, Mexico, Thailand, and Turkey now represent over 45 percent of developing country reserves. Indeed, following

Table 1.2 Current account balances

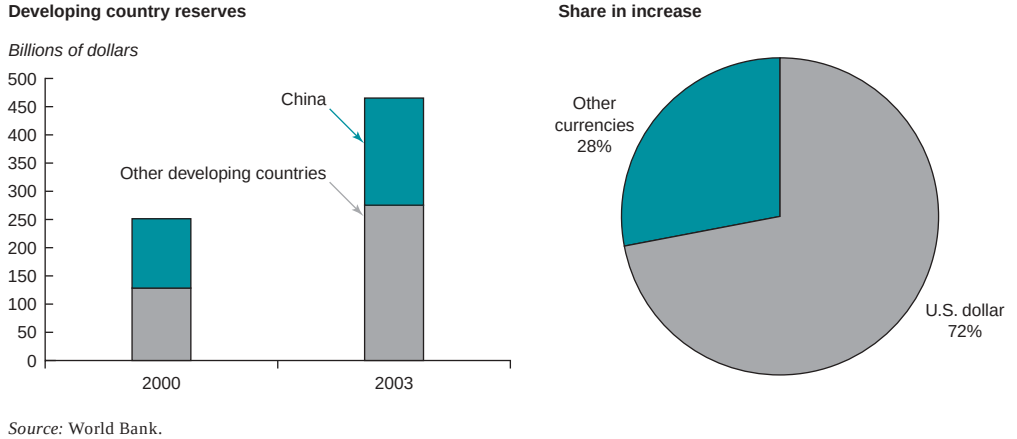
Percent of GDP in 2004

East Asia and Pacific	1.5
South Asia	−0.5
Middle East and North Africa	14.4
Sub-Saharan Africa	1.3
Europe and Central Asia	0.1
Latin America and the Caribbean	0.7
High-income countries	−0.8

Source: World Bank estimates.

private investors' retreat from equity and bond investments in U.S. dollar-denominated assets,[5] the central banks of these countries have become one of the most important sources of financing for the large U.S. current account deficit, absorbing 51 percent of the overall increase in foreign officially-held U.S. treasury bills between March 2000 and January 2003. While this has allowed these countries to increase their reserves by a substantial margin, it has been achieved at the expense of increasing their exposure to the U.S. dollar (figure 1.11). Among these countries, the share of U.S. treasury bills in their official reserves has increased by as much as 20 percentage points and equals almost 70 percent in the case of Mexico, and 58 percent in China. Should these countries decide to rebalance their reserve portfolio by slowing the pace at which they accumulate dollar-denominated reserves, either

Figure 1.11 Rising U.S. dollar reserves



Source: World Bank.

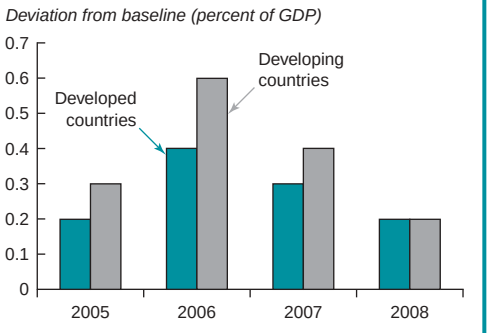
downward pressures on the dollar will accentuate, or interest rates will have to rise in order to attract sufficient private capital inflow.

Notwithstanding robust aggregate performance, many countries have been less successful in reaping the benefits of the last few years of strong economic conditions, and their high current account deficits could imperil their stability—especially in the context of slower growth in trade and world economic activity. More than 50 developing countries have current account deficits that exceed 5 percent of GDP. As a result, even the moderate hikes in interest rates, deterioration in terms of trade, and the slower export demand projected in the baseline will likely require these countries to undergo significant cuts to imports and domestic consumption in order to maintain external stability. If trade growth were to slow more than currently predicted, or if terms of trade were to deteriorate more because of an additional hike in oil prices, the required adjustment could be severe.

Risks and Policy Priorities

Forceful steps are required to reduce the twin deficits in the United States. As the preceding discussion has indicated, over the past few years, private sector equity and direct investment financing of the very large U.S. current account deficit has dried up,[6] having been replaced to a large extent by increased purchases of U.S. bonds by foreign central banks, notably those of developing countries. While these countries' build up of reserves has helped improve their external financial position, the stock of U.S. dollars that they now hold is very high and represents a disproportionate share of their assets. It is not clear that they can or should increase these stocks further by continuing to absorb the lion's share of net new U.S. treasury bills (6 developing countries absorbed more than half of net new issues since 2000).[7] Assuming their appetite for treasuries wanes, downward pressure on the U.S. dollar is likely to re-emerge, and yields will probably have to rise in order to motivate private investors to re-enter the market.[8]

Figure 1.12 Impact of a 200 basis point increase in interest rates



Source: World Bank.

Simulations suggest that a 200 basis point increase in long-term interest rates could reduce world GDP over the short- to medium-term by about 0.5 percent per annum;[9] the impact would be somewhat stronger for developing countries, because higher rates will raise debt servicing burdens, which require additional cuts to spending and demand (figure 1.12). Over the longer term, if the twin deficits in the United States are not addressed (a tightening of fiscal policy would reduce both deficits by increasing U.S. savings[10]), the problem is likely to intensify. Permanently higher long-term interest rates would render a wide range of investment projects uneconomic and slow the pace of potential output for a considerable time[11]— leading, perhaps, to a period of stagflation similar to that observed during the 1970–80s.

While higher U.S. interest rates might maintain investor interest in the dollar, they would have serious disruptive impacts on countries with large U.S. dollar debts. For countries such as Brazil, Indonesia, the Philippines, Poland, and Turkey, a 200 basis point increase in dollar interest rates would significantly increase debt-servicing charges. Increased outflows could provoke large depreciations in their currencies (as much as 9 percent), which would only increase the

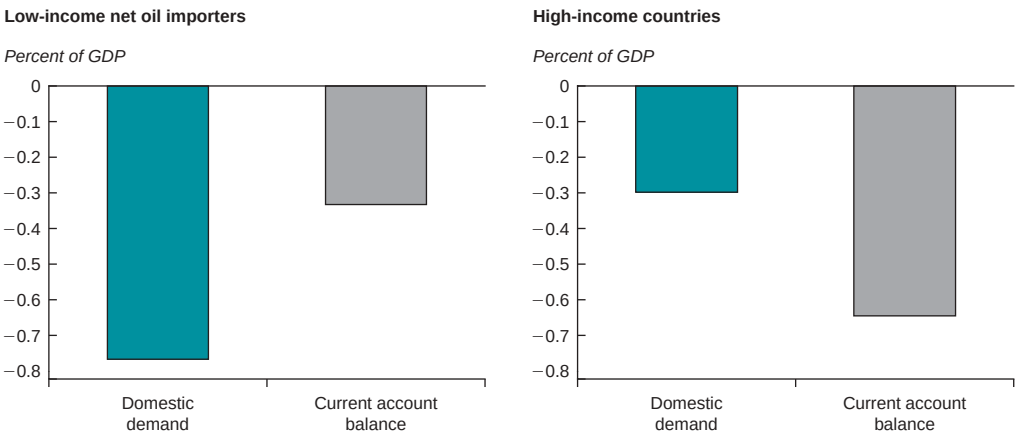
domestic burden of their external debt and generate further downward pressure on their currencies. Maintaining stability would, in all likelihood, require a substantial reduction in imports, consumption, and investment, which would result in slower growth and impede increases in poverty reduction.

The risk of such outcomes makes redressing imbalances all the more pressing. Among developed countries, steps need to be taken to reduce the U.S. government deficit, which would lower overall borrowing requirements and investor's concerns over the long-term financing of the debt. In Europe and other OECD countries, more resolute steps to redress government deficits and to create the fiscal room necessary to deal with the fiscal consequences of aging will be necessary if long-term interest rates are to remain low. For developing countries, a gradual appreciation of some currencies relative to the dollar could help by permitting a further depreciation of the dollar. However, in the absence of fiscal tightening in the United States, such measures are unlikely to have a significant impact. Fiscal consolidation is also required in many developing countries. Recent steps to lower existing government deficits move in the right direction and need to be pursued—as do efforts to reduce trade barriers so that export opportunities can increase. While these actions may well imply hardship and impose real political costs, the human and political consequences of entering into a period of higher interest rates without external and internal finances on a firm footing would be even more dramatic. Finally, funding for initiatives to relieve the debt burden of the poorest countries needs to be increased.

Should oil prices rise even further, the economies of low-income countries are likely to be among the hardest hit. Oil prices are assumed to moderate in the base case, falling from $39 per barrel (for the average of West-Texas Intermediate, Brent, and Dubai oils)[12] in 2004 to $32 in 2006. However, given supply and geopolitical conditions, there is a real risk that prices will either remain at current levels ($46.8 in October 2004 for this average—$49.5 for Brent) or rise even further. Simulations suggest that were events to temporarily disrupt supply by about 1 million barrels per day, oil prices could be expected to increase by about $10 a barrel. In macroeconomic terms, such an increase would slow economic growth by about 0.5 percentage points in the following year.[13] However, the resulting terms of trade shock would be larger in many poorer countries (−2.4 percent of GDP for highly indebted poor oil-importing countries versus −0.2 percent of GDP for high-income countries) because of the relatively high share that energy represents in their imports. And such economies tend to be more sensitive to a given terms of trade shock because of their limited ability to attract capital flows that would offset any resulting increases in their trade deficits. In contrast to high-income countries, which can increase their external borrowing to offset the real-side impact of higher oil prices, low-income countries are obliged to absorb most of the shock immediately. As a result, they undergo a depreciation and substantial reductions in consumption and investment spending—adjustment mechanisms that ultimately reduce spending on imports by almost the entire amount of the increased oil bill (figure 1.13). Their inability to defer adjustment (like high-income countries do) implies significant costs, both to individuals who see their consumption possibilities reduced and to the economy, as lower levels of investment feed through to reduce the capital stock and diminish productive capacity.

Finally, a failure of current efforts to slow the unsustainable pace of growth in China by engineering a soft landing could result in major disruptions. The Chinese authorities have put into place a number of specific—mainly command and control—measures, that restrict additional investment and lending to the construction and heavy production sectors. In the World Bank's forecast, this is projected to succeed in slowing overall growth

Figure 1.13 First year impacts of a $10 increase in oil prices



Source: World Bank.

to some 7.1 percent in 2006, down from an estimated 8.8 percent this year.

So far, these steps have slowed import demand in a number of sectors, notably metals and ores,[14] while credit restrictions have dramatically reduced the pace of money creation. In contrast, private consumption growth shows no sign of easing, and inflation has picked up rapidly. For the moment increased costs have not found their way into wages, but such a possibility cannot be ruled out. Should overheating contribute to further increases in inflation, a stronger policy response may be required. Moreover, investment levels remain very high, leaving open the possibility of a very rapid correction, especially if bad loans in the banking sector reveal themselves to be a serious problem. Either eventuality could provoke a more abrupt slowdown than forecast.

Long-Term Growth, Structural Change, and Poverty

This part of the report, as in years past, presents a long-term growth scenario for the global economy and its implications for meeting one of the MDGs: the halving of the proportion of the population living on $1 or less a day by 2015 (compared to 1990 levels). The strong economic growth in developing countries over the last 2 to 3 years, which is expected to continue through 2006, albeit at a somewhat slower pace, is based on solid fundamentals that are likely to carry forward and contribute to long-term economic prospects. In our base scenario this leads to an annual growth of some 3.5 percent in per capita GDP between 2006 and 2015, and contributes to achieving the MDGs. The poverty MDG will be met on a global basis, but a large number of countries will not meet the goal, particularly those in Sub-Saharan Africa. And though growth is necessary to make progress toward achieving the MDGs, in most countries, growth is insufficient without more targeted policies.

At least four factors are responsible for the recent and prospective improvement in growth prospects. As outlined in the first section of this chapter, among the solid fundamental changes in developing countries is an improvement in macroeconomic conditions (e.g., inflation and indebtedness). The recent *World Development Report* stresses the importance of the investment climate, which

has improved in many countries and has led to an acceleration in growth. A third factor, explored in more detail below, includes significant structural changes—that is, economic diversification and a move away from reliance on agriculture, and integration with the global economy; both of these structural changes involve increased urbanization. A fourth factor, pursued in greater detail in chapter 6, is the reduction in trade barriers.

The special focus of the long-term scenario in this report is on structural changes, particularly as they affect employment. Rapid growth will, in and of itself, lead to structural changes; that is, a relative decline in agriculture and a rise in the demand for services. Countries need to think ahead, allocate scarce public investment in a rational manner, and promote education to better position their work force for a changing environment. While structural changes are likely to be important, many developing countries face an equal challenge in the sheer growth of the labor force. Labor force growth rates are likely to decline over the next decade, but in many regions they will average between 1.5 to 2.5 percent per annum. For the poor, both growth and structural change are likely to be beneficial. Growth, to the extent that it lifts all incomes, will inevitably lead to a fall in poverty. Structural change can accelerate the process of poverty reduction. A decline in the rural population could ease wage pressures. A rising urban population provides easier access to essential health and education services and can lead to a rise in transfers to rural areas.

The focus on structural change also links to the broader theme of the report—the shape and impacts of regional trade agreements (RTAs). The RTAs will undoubtedly lead to additional structural shifts, and with associated transitional costs. How do RTAs compare with growth-induced structural shifts? Do RTAs produce structural shifts that are broadly consistent with those induced by a truly open global economy (which would emerge from a multilateral agreement)? And, if not, would the vested interests protected by an RTA impede progress toward a globally more beneficial agreement? These questions will be addressed in chapter 6. The conclusion from this chapter is that the challenge for most developing countries will be the creation of jobs for a rising work force, rather than how to deal with employment shifts across economic activities.

Long-term growth scenario

The global economy is currently rebounding from the downturn suffered in 2001 and 2002. Not all regions are benefiting equally from the rebound—Japan and the United States are leading the way among industrial economies—but there is fairly solid progress in all the main developing regions on an aggregate basis. This year, 2004, is likely to be the peak in the current upward cycle, with economies drifting toward long-term trend growth in 2005 and beyond. Table 1.3 reflects a plausible long-term scenario for the high-income countries and the World Bank's six aggregate developing regions (see box 1.1 for details concerning aggregation). The scenario reflects current views on potential trend growth over the 2006–15 decade. Better policies, an acceleration in investment, and other factors could improve the prospects, particularly for the slower growing regions. There is still a considerable gap in the productivity levels between developing and industrial economies, and a number of developing countries—particularly in Asia—have demonstrated, over the last 20 to 30 years, a sustained ability for rapid growth.

The focus of this forecast section this year is on anticipated structural changes. These have many dimensions—demographic, rural versus urban, sectoral, employment shifts, openness, and income distribution, among others. While most of these shifts have long-term positive impacts, they can also be associated with short-term transitional costs. Public policies can limit the costs of transition, but they can also be significantly reduced—at least in terms of duration—in a fast growing economy where job growth is robust.

Box 1.1 The aggregation paradox

The per capita growth rate for the world reflects the so-called aggregation paradox. The long-term per capita growth rates for high-income and developing countries are, respectively, 2.4 and 3.5 percent per annum, but the global growth rate is only 2.1 percent and is not the average of the growth rates (weighted or un-weighted). The following table highlights the aggregation paradox. The paradox is explained by the relatively high weight of high-income countries GDP in the world total, but their low weight in world population.

	High-income	Develop-ing	World
Population (million)			
2006	970	5,340	6,320
2015	990	5,900	6,900
Growth rate[a]	0.3	1.1	1.0
GDP ($billion)			
2006	31,200	8,200	39,400
2015	39,500	12,300	51,800
Growth rate[a]	2.7	4.6	3.1
GDP per capita ($)			
2006	32,090	1,530	6,240
2015	39,700	2,080	7,510
Growth rate[a]	2.4	3.5	2.1

a. Growth rates are percent per annum.

Structural Changes over Two Decades

Looking back on the last 20 years of development, many developing regions have already witnessed significant structural shifts. Perhaps foremost is the decline of agriculture as a source of income and employment. In East Asia and the Pacific, agricultural value added has declined from a 28 percent share in 1982 to only 15 percent in 2002, and manufacturing, other industrial, and services have risen (see figure 1.14). Services, according to these figures, still represented less than 40 percent of GDP in 2002, well below the nearly 65 percent share in the high-income countries of East Asia. Thus there is still significant scope for further structural shifts.

The value added shares also belie the relative employment share in agriculture, which tends to be much higher. Take, for example, Thailand, where agriculture's share of value added is below 10 percent, but still employs around 50 percent of the total labor force. In the high-income countries, the relevant shares are around 2 percent of value added and less than 4 percent of employment.[15] Higher agricultural productivity and relative wage differentials will continue to drive an exodus from agriculture into other sectors. And the change can come rapidly. In the Republic of Korea, the percent of employment in agriculture dropped from 32 percent in 1982 to 10 percent in 2001. The agricultural transformation is present in some of the other developing regions as well; for example, in South Asia the percent of employment in agriculture dropped from 40 percent in 1982 down to 27.2 percent in 2002, and in Latin America and the Caribbean, the percent of employment in agriculture dropped from 14.4 percent down to 10.6 percent over the same two-decade period. There has been no significant shift in either the Middle East and North Africa or Sub-Saharan Africa regions. At the same time, neither of those two regions witnessed much economic growth, with only 0.4 percent per capita growth per annum in the former, and a loss of 0.3 percent per annum in the latter.

In all regions, save East Asia, one can see a climb in the share of services. This is not surprising because services are assumed to be income elastic and a relative rise in the consumption share of services is understood. This effect is reinforced by the relatively high rate of productivity growth in manufacturing. All else being equal, this reduces the price of manufactures relative to services and hence enhances the value share of services. Perhaps what is more surprising is the variation across regions.

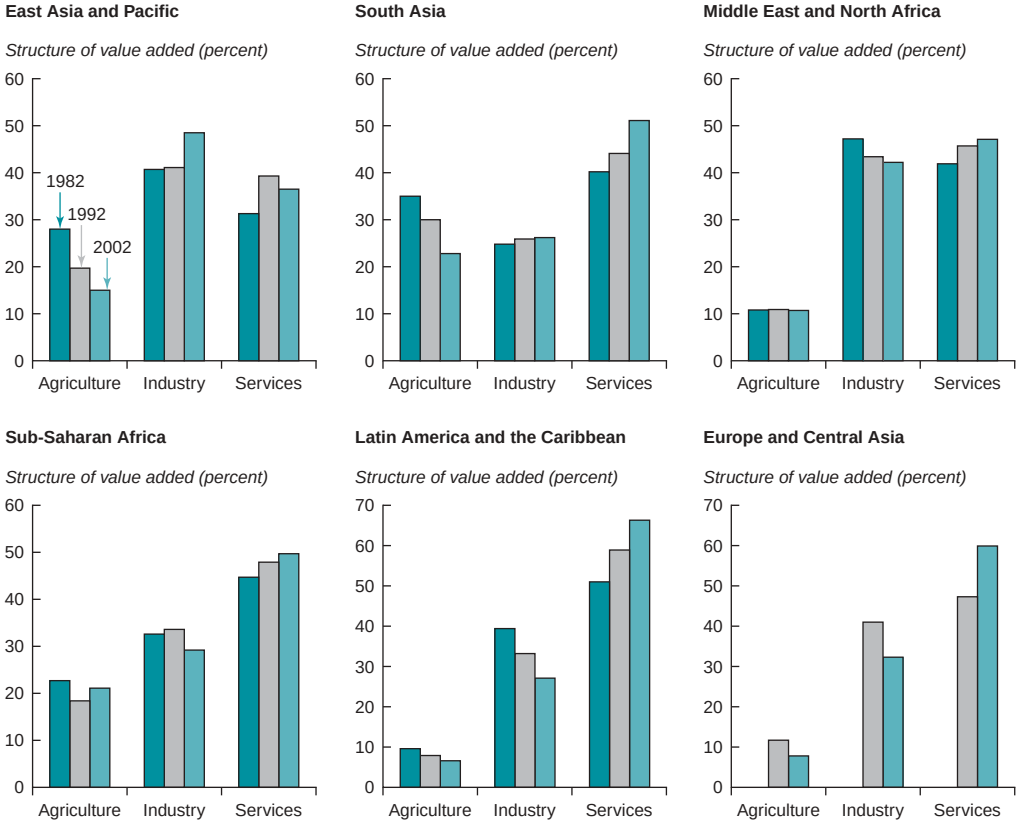
Table 1.3 Long-term prospects: Forecast growth of world GDP per capita

Real GDP per capita, annual average percentage change

	1980s	1990s	2000–06	2006–15
World total	1.3	1.1	1.6	2.1
High-income countries	2.5	1.8	1.7	2.4
OECD	2.5	1.7	1.7	2.3
United States	2.2	1.9	1.8	2.5
Japan	3.5	1.1	1.7	1.9
European Union	2.1	1.8	1.5	2.3
Non-OECD countries	3.5	4.1	1.6	3.5
Developing countries	0.6	1.5	3.4	3.5
East Asia and the Pacific	5.8	6.3	6.0	5.3
Europe and Central Asia	1.0	−1.8	5.2	3.5
Latin America & the Caribbean	−0.9	1.5	0.8	2.4
Middle East North Africa	−1.6	1.1	2.4	2.6
South Asia	3.3	3.2	4.2	4.1
Sub-Saharan Africa	−1.2	−0.5	1.2	1.6

Note: Aggregations are moving averages, reweighted annually after calculations of growth in constant prices.
Source: World Bank.

Figure 1.14 A rise in services



Source: World Bank.

In the high growth regions—East Asia and South Asia—there are two contrasting patterns. In South Asia the employment in agriculture shifted mostly to services, with a small increase in industrial output. In East Asia, employment in agriculture shifted more evenly between industry and services. And there appears to have been a structural break in the 1990s with an acceleration of industrial output. This is consistent with the sharp rise in the trade to GDP ratio doubling from 36 percent in 1982 to 72 percent in 2002, and with East Asia as a hub of assembly and manufacturing activities (see figure 1.15). There are, of course, exceptions in each region. The Philippines, for example, has a sharp rise in services and a decline in manufacturing—perhaps as a result of its regional comparative advantage in back office operations, call centers, and other services requiring specialized language skills. In South Asia, India's services dominate, but growth is much lower in Bangladesh and Pakistan, where textile and clothing exporters may be taking advantage of their relatively generous quotas to the main importing markets.

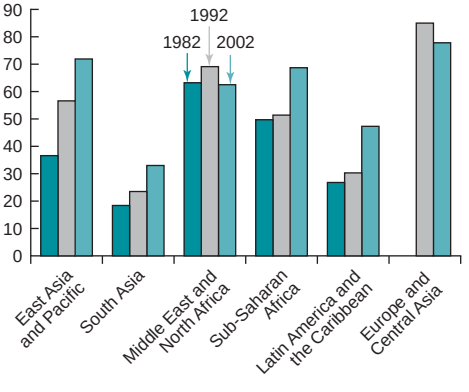
Three of the other regions—Latin America and the Caribbean, the Middle East and North Africa, and Sub-Saharan Africa—show less growth overall, but are also more dependent on natural resource production, and those relative prices have been declining over most of the period. Natural resources appear under industrial production, so even if volume growth has been positive, with declining relative prices the natural resources share in output could be declining. And apart from Latin America and the Caribbean, these regions have also not really benefited from global production sharing in the more integrated global economy. The Middle East and North Africa Region has barely seen any shift in its trade to GDP ratio. For both Sub-Saharan Africa and Latin America and the Caribbean, however, the ratio has increased markedly, particularly in the 1990s—from 50 percent to 69 percent for Sub-Saharan Africa, and from 27 to 47 percent for Latin America and the Caribbean. The more recent rise in Latin America can be partly explained by the implementation of a raft of regional agreements, including NAFTA and MERCOSUR. At the same time Latin America's degree of openness is lower than that of East Asia, and in general it has been less coopted into global production networks.

The transformation in the economies of Europe and Central Asia over the last 15 years is a result of an abrupt structural shift. The dominance of industry as part of an economic strategy of planned economies was eliminated. Services in the transition economies quickly filled the gap, which led to significant dislocation for a period, but is now forming the basis of more rational and sustained growth.

Looking ahead it is clear that there is the potential for significant change. While the rate of urbanization has been persistent over the last two decades, there is a long way to go, particularly in Asia and Africa, before attaining the 80 percent level of the industrial countries (figure 1.16). The income gap is also huge, even if incomes are measured in purchasing power parity (PPP) terms. In East Asia, per capita incomes averaged just over $1,000 (1995 dollars) in 2002, compared with nearly $31,000 in the industrial countries—roughly a 30 to 1 differential. Even assuming

Figure 1.15 Rising openness to trade

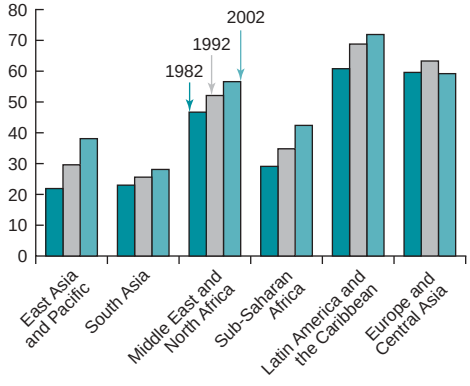
Trade (exports and imports) to GDP ratio (percent)



Source: World Bank.

Figure 1.16 Increased urbanization

Urban population as a share of total population (percent)



Source: World Bank.

a PPP exchange rate of 5 would still lead to a significant 6 to 1 ratio in per capita incomes. In Latin America, the richest developing region with a per capita average income of $3,700, would have a ratio similar to East Asia using a PPP exchange rate of around 2.

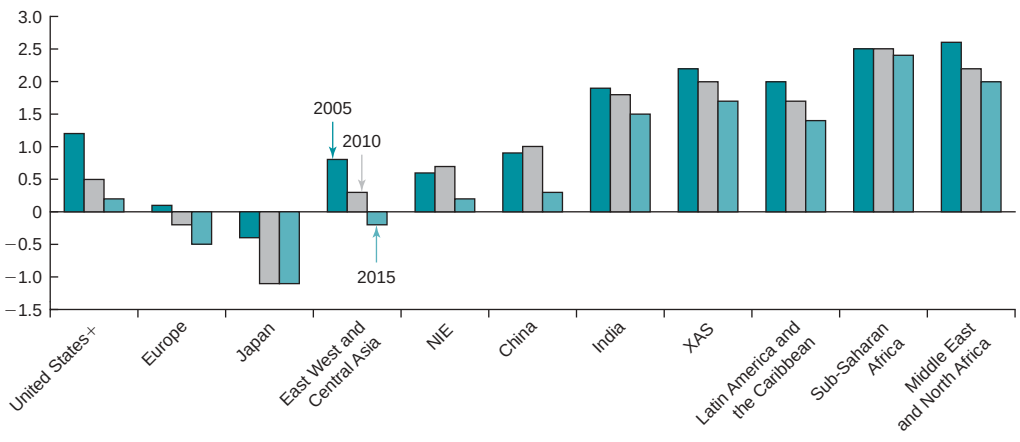
Structural Change in the Future

Table 1.3 presents the long-term growth rates. This section focuses on some of the consequences of growth and other underlying assumptions of the long-term scenario on structural changes, particularly regarding labor shifts—both in volume terms and across sectors.[16]

In the aggregate, and assuming no change in labor force participation rates, labor supply growth will slow down sharply in most regions after 2010—with the exception of the Middle East and North Africa and Sub-Saharan Africa regions (figure 1.17).[17] In Western and Eastern Europe, Russia, and Japan, the labor supply would most likely shrink (even before 2010), putting additional pressure on underfinanced pension schemes. Additionally, it is the regions with the highest labor force growth rates that also tend to have the lowest per capita growth rates, so these regions are on a knife-edge in terms of their capacity to absorb high rates of new workers. These same regions typically have relatively low labor force participation rates, particularly of females; thus increases in

Figure 1.17 Growth rate of labor supply declining

Population between the ages of 15 and 65 (percent)



Note: United States+ includes Australia, Canada, New Zealand, and the United States. NIEs are newly industrialized economies. XAS represents other major countries in East and South Asia.

Source: World Bank.

Table 1.4 Labor market structure, 2005–15

	Growth between 2005–15: percent per annum				Growth decomposition		
	Agric	Manuf	Services	Total	Structure	Expansion	Total
Australia, Canada & New Zealand	−0.7	−0.8	0.7	0.4	3.45	3.90	6.88
United States	−1.1	−0.6	0.8	0.5	2.95	5.62	8.34
Japan	−3.0	−2.2	−0.6	−1.0	3.62	9.35	8.70
Korea and Taiwan	−1.9	−0.6	1.0	0.5	4.18	5.65	9.17
Hong Kong (China) and Singapore	0.0	−0.5	1.0	0.7	4.80	7.28	11.65
EU with EFTA	−2.6	−1.5	0.2	−0.2	4.92	2.28	3.12
Brazil	0.8	0.5	1.4	1.2	3.52	13.09	16.28
China	0.5	0.4	1.3	0.8	5.12	8.44	12.02
India	0.1	1.6	2.4	1.7	9.27	19.89	28.02
Indonesia	1.1	1.8	1.6	1.5	8.32	17.18	22.73
Mexico	−0.2	1.6	2.5	2.0	7.00	22.78	28.84
Russia	−1.0	−1.1	0.0	−0.4	4.97	4.35	2.43
SACU	−0.7	−0.2	0.9	0.6	3.82	6.87	10.36
Vietnam	1.7	1.9	2.0	2.0	5.69	22.23	26.20
Rest of East Asia	0.7	1.2	2.1	1.7	4.72	19.36	23.09
Rest of South Asia	1.8	1.3	2.7	2.4	4.60	27.22	31.38
EU accession countries	−0.8	−1.1	0.2	−0.2	6.51	2.41	4.67
Rest of ECA	−0.3	0.3	1.1	0.8	6.15	8.88	14.43
Middle East	2.3	1.6	2.5	2.3	5.26	26.43	30.79
North Africa	0.8	2.0	2.5	2.0	7.27	23.74	29.83
Rest of Sub-Saharan Africa	2.0	2.2	3.0	2.6	4.50	30.19	34.08
Rest of LAC	2.1	0.9	2.2	1.8	5.36	20.74	25.41
Rest of the world	0.8	1.2	2.1	1.7	4.15	19.45	23.12

Source: World Bank simulations.

participation rates will lead to additional labot market weakness.

With high-income demand elasticity for services and relatively higher labor productivity in manufacturing, labor demand growth will tend to be higher in services than in manufacturing and/or agriculture (see table in endnote 17). This effect is quite pronounced in the industrial countries, where labor demand growth between 2005 and 2015 will be negative, on average, in agriculture and manufacturing in all high-income regions, with all of the net growth occurring in services (with the exception of Japan, where labor force growth could potentially decline by 1 percent per annum on average). The shift toward services also occurs in developing countries, but with continued high growth in manufacturing and less growth in agriculture.

Table 1.4 also shows a summary measure of the structural changes. It decomposes the total change in the structure of the labor force into two components. The first is the "structural" component, which measures the quantity of labor force movement across sectors, assuming no change in the volume of labor. The second is an "expansion" component, measuring the overall growth in the labor force. In the case of India, for example, the numbers suggest that the labor force will grow by about 20 percent between 2005 and 2015, or about 1.8 percent per annum. And in each year, about 0.9 percent of the initial labor force will move across sectors. Thus the total annual movement of 2.5 percent per annum is composed roughly of 2/3 expansion and 1/3 by intersectoral movements. It should be clear from the decomposition that for most of the developing regions, there will be more labor movement from the expansion of the labor force than from structural change, with the notable exceptions of Russia and the other countries in Europe and Central Asia—and, perhaps somewhat more surprisingly, China. For the industrial regions with low or declining labor growth, clearly the structural

shifts will be relatively the same order of magnitude as the expansion component. But the shifts are relatively small on an annual basis, perhaps 0.3 to 0.5 percent of the labor force.

Chapter 6 of this report will re-address one issue related to structural shifts in the context of RTAs. Do RTAs lead to structural changes that are inconsistent with the structural changes from a broad multilateral agreement? For example, a country signing an RTA may have a local comparative advantage in a given sector, but not a global comparative advantage. In this case, would the country need to undergo two potentially costly adjustments, should a multilateral agreement be signed subsequent to an RTA? And would the vested interests that benefit from the RTA hamper the ability to achieve a broader multilateral agreement, with positive aggregate benefits, but hurt the sectors that thrived under the preferential arrangement?

Poverty Forecast

Developing country economic performance has been strong since 2002, and this is projected to continue over the next two years and beyond (tables 1.1 and 1.3). This pattern of high growth would in all likelihood lead to a halving of the number of poor (i.e., the percentage of poor living on $1 or less a day) in developing countries between 1990 and 2015 (table 1.5)—one of the key MDGs. At the global level, the target to be achieved in 2015 is around 14 percent (one-half of 27.9), and the forecast is for a headcount index of 10.2 percent. This translates into a forecast of

Table 1.5 Regional breakdown of poverty in developing countries

	Number of people living on less than $1 per day (millions)					
	GEP2004			GEP2005		
Region	1990	2000	2015	1990	2001	2015
East Asia and Pacific	470	261	44	472	271	19
China	361	204	41	375	212	16
Rest of East Asia and Pacific	110	57	3	97	60	2
Europe and Central Asia	6	20	6	2	17	2
Latin America and the Caribbean	48	56	46	49	50	43
Middle East and North Africa	5	8	4	6	7	4
South Asia	467	432	268	462	431	216
Sub-Saharan Africa	241	323	366	227	313	340
Total	1,237	1,100	734	1,218	1,089	622
Excluding China	877	896	692	844	877	606
	$1 per day head count index (percent)					
	GEP2004			GEP2005		
Region	1990	2000	2015	1990	2001	2015
East Asia and Pacific	29.4	14.5	2.3	29.6	14.9	0.9
China	31.5	16.1	3.0	33.0	16.6	1.2
Rest of East Asia and Pacific	24.1	10.6	0.5	21.1	10.8	0.4
Europe and Central Asia	1.4	4.2	1.3	0.5	3.6	0.4
Latin America and the Caribbean	11.0	10.8	7.6	11.3	9.5	6.9
Middle East and North Africa	2.1	2.8	1.2	2.3	2.4	0.9
South Asia	41.5	31.9	16.4	41.3	31.3	12.8
Sub-Saharan Africa	47.4	49.0	42.3	44.6	46.4	38.4
Total	28.3	21.6	12.5	27.9	21.1	10.2
Excluding China	27.2	23.3	15.4	26.1	22.5	12.9

Table 1.5 Regional breakdown of poverty in developing countries (continued)

	Number of people living on less than $2 per day (millions)					
	GEP2004			GEP2005		
Region	1990	2000	2015	1990	2001	2015
East Asia and Pacific	1,094	873	354	1,116	864	230
China	800	600	256	825	594	134
Rest of East Asia and Pacific	295	273	98	292	271	95
Europe and Central Asia	31	101	48	23	93	25
Latin America and the Caribbean	121	136	124	125	128	122
Middle East and North Africa	50	72	38	51	70	46
South Asia	971	1,052	968	958	1,064	912
Sub-Saharan Africa	386	504	612	382	516	612
Total	2,653	2,737	2,144	2,654	2,735	1,946
Excluding China	1,854	2,138	1,888	1,829	2,142	1,812
	$2 per day head count index (percent)					
	GEP2004			GEP2005		
Region	1990	2000	2015	1990	2001	2015
East Asia and Pacific	68.5	48.3	18.2	69.9	47.4	11.3
China	69.9	47.3	18.4	72.6	46.7	9.7
Rest of East Asia and Pacific	64.9	50.8	17.6	63.2	49.2	14.7
Europe and Central Asia	6.8	21.3	10.3	4.9	19.7	5.2
Latin America and the Caribbean	27.6	26.3	20.5	28.4	24.5	19.6
Middle East and North Africa	21.0	24.4	10.2	21.4	23.2	11.9
South Asia	86.3	77.7	59.2	85.5	77.2	54.2
Sub-Saharan Africa	76.0	76.5	70.7	75.0	76.6	69.2
Total	60.8	53.6	36.4	60.8	52.9	32.0
Excluding China	57.5	55.7	42.0	56.6	54.9	38.6

Source: World Bank.

622 million persons living $1 or less a day in 2015, compared with 1.2 billion in 1990 and an estimated 1.1 billion in 2001.[18] With respect to the somewhat higher poverty line of $2 a day, the headcount should improve to 32 percent in 2015—not quite a halving of the estimated 61 percent headcount index in 1990—and corresponding to almost 2 billion poor.

However, progress is highly uneven across and within countries. The global target will largely be achieved because of the significant progress on poverty reduction in China and India. Sub-Saharan Africa lags far behind, and though poverty rates are much lower in some of the other regions, for example Latin America and the Caribbean, progress over the last 15 years has been insufficient to be on track to achieve the income poverty target in 2015 without more rapid growth or policies that are better targeted to the poor. Within regions, progress has also been uneven. Despite the huge overall reduction in East Asia, several countries, for example, Cambodia, Lao PDR, and Papua New Guinea, are off track to meet the goal. In Sub-Saharan Africa, there are only eight countries—representing 15 percent of the subcontinent's population—that will potentially make significant progress toward achieving the income poverty target. Within countries, such as China, there are large pockets of poor people, and reducing poverty in these pockets is difficult because they are often concentrated in remote, hard-to-reach locations. Links to the

national and/or global economy are weak, and provision of public services—education, health, water and sanitation—is difficult and expensive.

This year's poverty forecast, as in years past, reflects changes in two key dimensions. First, new country surveys lead to a re-evaluation of the level of poverty in 1990 and in the most recent base year, 2001. At the global level, the $1/day headcount index for 1990 has been shaved slightly from 28.3 percent in last year's report, to 27.9 percent in this year's report. There is also a very modest decline in the estimated level of poverty for 2001. The new surveys also force a re-evaluation of the link between income growth and poverty reduction. Using the latest survey information and last year's economic forecast, the forecasted decline in poverty is somewhat more rapid, with the headcount index declining to 10.4 percent (from 21.1 percent in 2001), instead of 12.5 percent (from 21.6 percent in 2000).[19] The second key dimension is the change in the long-term economic forecast. The changes overall are relatively modest. However, the somewhat improved performance anticipated between 2003 and 2006 generates better average growth for the forecast period 2001–15 and drops the headcount index for 2015 from 10.4 percent to 10.2 percent.

While progress on income poverty in parts of the world, particularly East and South Asia, has been spectacular if not historic, there is no room for complacency. As mentioned earlier, there are significant pockets of poverty even within the more successful countries. Moreover, there are other dimensions of poverty in which progress has been more limited, and almost all developing countries are off track. In East Asia, for example, the region scores relatively well for achieving 100 percent primary school completion rates, with China and Vietnam already having achieved the target and the Philippines on track.[20] But Thailand and Indonesia are off track, as are some of the poorer countries in the region. For the child mortality MDG, the situation is more worrying. Four countries are on track to achieve the target—Indonesia, Lao PDR, Malaysia, and the Philippines. All other countries are off track, and two—Cambodia and Papua New Guinea—are seriously off track. The situation is also dire for births attended (linked to maternal mortality) and access to safe water. These examples also illustrate that the other MDG targets are less directly correlated to income levels.[21] For example, Lao PDR and Indonesia are on track for the child mortality target, but Thailand is not.

Concluding Remarks

The rapid growth of developing economies, mostly concentrated in East and South Asia, has produced a spectacular, if not historic, fall in poverty that will enable the achievement of the poverty MDG on a global basis, although many countries will be seriously off-target. The rapid growth has been associated with large structural shifts—greater openness, more urbanized populations, and a sharp fall in agricultural employment. These trends will persist in the future as growth rates remain high, and incomes and productivity levels in developing countries are still well below industrial country averages—even taking into account PPP adjustments. As an example of potential structural shifts, take China's level of urbanization. Its rural population may not approach the 20 percent level of industrial countries, but a 50 percent share in 2015 could lead to a cumulative migration in the range of 140 to 175 million persons between 2005 and 2015. Such large shifts will require considerable public and private resources and their efficient allocation. Chapter 6 addresses a complementary issue—structural changes induced by changes in trade policies, notably the impacts of preferential trade agreements.

Notes

1. The investment to GDP ratio in the United States is currently 21 percent, close to its peak of 21.5 percent during the Internet bubble, and well above historical peaks of less than 18 percent.

2. The weighted average of the dollar's fluctuations relative to world currencies.

3. West-Texas Intermediate was much higher in October 2004 ($56). The overall average was depressed by the price of other oil (notably from Dubai), which was lower because producers increased the supply of lower quality oil.

4. Lau (2003) estimates that because of the re-export nature of its trade, the domestic value-added content of Chinese exports may be as little as 20 percent.

5. Net equity and foreign direct inflows of foreign private investors declined by 73 percent between 2001 and 2003. At the same time, net outflows by American private investors increased by 10 percent. As a result, total flows have reversed, from a significant inflow of $35 billion in 2001 to a $195 billion outflow in 2003. Since then, these trends have continued, with total outflows representing $267 billion in the second quarter of 2004.

6. See endnote 5.

7. Calculated as the change in U.S. t-bills held by the central banks of these countries divided by the net increase in t-bills held by official lenders (see http://www.treas.gov/tic/mfhhis01.txt).

8. Mussa (2004) suggests that a further 20 percent depreciation might be required to bring the U.S. economy into external balance.

9. These results are consistent with those published by the OECD for developing countries (see Dalsgaard and others 2001).

10. Even after Ricardian equivalence-based changes to private saving. Nevertheless, Brooks and others (2003) show that, taken alone, neither a 2 percentage point cut in fiscal spending, nor a 10 percent effective depreciation would be sufficient to restore external balance in the United States. They argue that a combination of depreciation, stronger world demand, and a larger fiscal contraction would be required.

11. Under higher interest rates, the desired stock of capital declines, which requires a prolonged period of slower growth before the economy adjusts to the new lower levels of output and capital.

12. In October 2004, this average price was $46.8 comprised of $53 for West-Texas Intermediate, $49.5 for Brent, and $37.7 for Dubai oil.

13. Dalsgaard and others (2001) estimate similar impacts for OECD countries.

14. Growth in steel demand fell 36 percent during the 3-month period ending in July, while copper imports were flat.

15. World Bank 2003b.

16. Unlike the previous section, which focused on the structure of value added, this section focuses on labor. The focus on labor provides a better perspective on the poverty dimension of structural shift. The historical analysis focused on output because of the greater availability and reliability of the data. Historical data on employment patterns has many gaps, and the data that does exist is often not compatible across countries.

17. The baseline scenario and the induced structural changes are predicated on a number of assumptions. First, growth in the labor supply is equated with growth of the working age population. For all regions, this implies a slowing of labor force growth, albeit with high growth in some developing regions. At the same time, the labor force is assumed to be flexible and thus will reinforce anticipated structural shifts. Second, savings are similarly influenced by demographics. In many developing countries this will translate into a slight acceleration in savings as the ratio of youth to workers declines, and a decline in industrial countries as the ratio of elderly to workers rise (explored in more detail in World Bank 2003a). Investment growth will largely be driven by domestic savings, as it has in the past; however, with modest increases in net capital flows toward developing countries, with the exception of East Asia, which has been a major source of international capital over the last five years.

Third are the assumptions regarding productivity growth; based on previously observed trends, these are divided into three broad economic sectors. In agriculture, it is assumed that the past growth of roughly 2.5 percent per annum is maintained through 2015 (see, for example, Martin and Devashish 1999). Maintaining this high rate of agricultural productivity will require continued and perhaps increasing investment in agricultural research and extension, combined with rising investment in agricultural infrastructure, particularly for water resource management. This rate of productivity growth in agriculture is consistent with a modest secular decline in agricultural prices, relative to the general price trend, as observed in the past. The other two broad sectors are manufacturing and services. Again, based on past trends, it is assumed that productivity growth in manufacturing will be higher than in services. This has two impacts: (1) it reduces the price of manufactures relative to services, all else being equal, and thus enhances the share of services in value terms; and (2) for the same level of output, it reduces the

Income elasticities in the Linkage model

	Ag. and food	Energy	Industrial goods	Services
United States	0.01	0.58	0.78	1.14
Japan	0.04	0.64	0.68	1.24
Europe	0.08	0.72	0.71	1.29
Rest of high-income	0.16	0.86	0.80	1.26
Low-income	0.52	1.40	1.08	1.41

demand for employment in the manufacturing sectors, and thus allows for a shift of labor toward services.

Fourth are the demand assumptions—the other side of the coin regarding structural changes. High-income countries have already witnessed a large decline in the demand for agriculture and food relative to income. Demand for services has increased relative to income and the demand for other goods. And there is no reason for these trends not to continue in the future. Thus the forward-looking scenarios assume that income elasticities over the next 10 years will largely reflect their current levels, though highly differentiated across commodities and regions (see table).

18. The absolute number of poor won't necessarily be halved due to population growth.

19. A more subtle change in the methodology has also been incorporated in this year's poverty forecast. The poverty forecast is based on the growth of the survey-based per capita consumption, assuming distribution neutrality (with some exceptions). However, it has been observed in the past that survey-based consumption growth deviates from consumption growth as measured in the national accounts. A conversion factor has been used to adjust for this deviation, which for most countries implied an elasticity of 0.9. In other words, if national income consumption grows at 10 percent, the assumed growth in survey-based consumption is 9 percent. More recent econometric evidence suggests that the long-run elasticity is 1, but that there are short-term deviations from the long-run elasticity. Because of the robustness of the long-run relationship, the new forecast assumes an elasticity of 1. Thus, all else being equal, this year's forecast will be lower than in the past because of higher implied consumption growth.

20. See World Bank 2004.

21. The World Bank, in its effort to improve its ability to monitor and forecast the other dimensions of the Millennium Development Goals, is developing and testing a new tool to forecast some of the MDGs. The tool will link economic growth with expenditures on health, education, and infrastructure. It will also capture some of the complementarities across targets, for example the degree to which improvements in access to safe water can improve health outcomes. A pilot study is currently being undertaken for Ethiopia and first results will be described in the *Global Monitoring Report 2005*.

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