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# 1

## Prospects for the Global Economy

Following very strong growth, the world economy slowed in late 2004 and into 2005 as output began to push against capacity constraints. High oil prices cut into the incomes of oil importers, but the expansion remained strong, partly because of favorable conditions in financial markets, including still low inflation, interest rates, and interest-rate spreads. Tightness in the oil market, the threat of even higher fuel prices, and the possibility that interest rates may rise pose major threats to the expansion.

### *Slower but still strong growth*

World GDP is estimated to have increased by 3.2 percent in 2005, down from 3.8 in 2004. Growth is projected to be stable in 2006, before strengthening somewhat in 2007. The slowdown that began in the second half of 2004 was experienced throughout the industrialized world, with growth in Europe still underperforming its potential. In contrast, the economies of the United States and Japan, despite having slowed, are expanding at close to their maximum sustainable rates.

Among large developing economies, GDP in 2005 continued to expand rapidly in China and India (in excess of 9 percent and about 7 percent, respectively), but slowed in Russia as growth in oil production weakened. High oil prices, in combination with domestic capacity constraints and slower import demand from high-income countries, are estimated to

have reduced growth among oil-importing developing countries from 6.9 percent to 6.1 percent. In terms of real incomes, the slowdown was much sharper—from 6.4 percent to 3.7 percent. Despite still growing oil revenues, reduced opportunities to expand production in the petroleum sector meant that output growth in oil-exporting developing countries also eased, from 6.6 percent to 5.6 percent.

During 2006 the expansion among high-income countries is projected to be stable, at about 2.5 percent, before picking up a bit in 2007. This reflects a combination of improved performance in Europe and stable growth in the United States and Japan. In the United States, higher oil prices and tighter monetary policy are expected to offset the positive stimulus to growth from past depreciations. The projected pickup in Europe occurs despite a significant drag on growth from high oil prices whose effects are expected to be more than offset by low interest rates, pent up investment demand, and a dissipation of most of the negative consequences following the euro's real-effective appreciation. In Japan, strengthening domestic demand and supportive macroeconomic policies should enable growth to remain close to potential, despite high oil prices.

Growth in developing economies is projected to slow modestly from an estimated 5.9 percent in 2005 to 5.5 percent by 2007. In East and South Asia, the expansion is projected to moderate somewhat but remain

very strong, particularly in China and India. In the Middle East and in both North and Sub-Saharan Africa, strong oil revenues should buoy internal demand among oil exporters and partially offset capacity constraints that will slow production growth. The projected easing of growth in Latin America and the Caribbean reflects weaker non-oil commodity prices as well as a return to trend growth in several countries that rebounded very strongly in 2004. In Europe and Central Asia, the waning of the growth bonus following EU accession and capacity constraints in oil-producing countries are expected to contribute to a modest slowing of the expansion.

#### *Tight commodity markets*

Weaker global growth should reduce the strain in non-oil commodity markets. Already there are signs of stabilization, and even of decline, in the prices of agricultural products, where supply has responded to high prices. Metals and shipping prices also show signs of easing, although to a lesser extent.

In oil markets, the projected slowdown is not expected to be sufficient to generate a substantial easing of prices. While crude oil supply is growing marginally faster than demand, supply conditions are expected to remain tight. As a result, crude oil prices, which currently embody a large risk premium, are not expected to fall rapidly. The baseline assumes that no major supply disruptions occur and that there will be a gradual decline in oil prices toward \$40 per barrel by 2010. This implies an average price of \$56 for a barrel of oil in 2006 and \$52 in 2007.

Future spikes in oil prices form a potential risk to global prospects. A price hike generated by a sustained negative supply shock would be particularly disruptive, because output would be constrained directly by the reduced availability of oil and petroleum-based inputs. This would be in contrast to the recent past, when prices rose in the context of rapidly growing supply. A supply shock that reduced oil deliveries by 2 million barrels per day

could push prices to more than \$90 a barrel for more than a year, resulting in a 1.5 percent reduction in global growth by the second year following the shock. The terms-of-trade impact for low-income oil-importing economies would reduce incomes in these countries by more than 4 percent of their GDP (much more than for high-income countries) because their economies are relatively oil intensive, and because a supply shock-induced increase in oil prices is unlikely to be accompanied by higher non-oil commodity prices.

#### *Global imbalances remain an issue*

Global current account imbalances and the U.S. current account deficit (which is expected to exceed \$750 billion in 2005) remain important medium-term problems. During late 2004 and early 2005 tensions eased somewhat. Rising interest rate differentials relative to European short- and long-term assets made private sector purchases of dollar-denominated assets more attractive. As a result, the dollar appreciated some 2.5 percent in real-effective terms during the first seven months of 2005, and reserve accumulation by foreign central banks became less important in the financing of the current account deficit.

This respite appears to have been short-lived. To some extent, the increased private flows represented a one-off portfolio adjustment toward U.S. assets by investors. Beginning in the second quarter of 2005, the flows diminished, and the dollar faced renewed downward pressure. As a result, foreign reserve accumulation once again became a critical component in the financing of the U.S. current account deficit, restoring the risk that a change in behavior on the part of foreign central bankers could prove destabilizing. Recent decisions by China and Malaysia to widen the range of currencies to which their own currencies are pegged could help ease future pressures, especially if the scope for appreciation included in the regime is exercised in practice. Globally, policy should continue to focus on increasing public and private savings in deficit

countries and increasing spending (notably on investment goods) in surplus countries.

*Low interest rates are a source of uncertainty*

The future path of long-term interest rates and spreads, which have been at historically low levels for an extended period, is an important uncertainty. A number of factors have helped maintain interest rates at low levels, including several years of very loose monetary policy throughout the developed world; increased aging-related savings in Europe; balance-sheet consolidation in the United States and Asia; and a low inflationary environment—thanks, in part, to increased competition following the entry into global markets of China and members of the former Soviet bloc. Most of these factors are temporary and are expected to gradually abate, resulting in a steady rise in long-term rates in the baseline. Indeed, yields on 10-year U.S. Treasuries have risen 50 basis points since September.

However, these temporary factors could continue to hold sway, reversing or bringing to a halt the recent increase in long-term rates (as they have in the past). This would prompt stronger-than-projected demand, but also exacerbate capacity constraints. As a result, oil prices could get pushed higher, which would provoke a more brutal inflationary cycle, and ultimately, a recession.

Alternatively, these forces could dissipate more rapidly, causing long-term interest rates to rise more quickly toward long-term equilibrium levels, which would provoke a more pronounced slowdown. While not the most likely scenario, the recent rise in long-term yields and inflation suggest that a higher interest-rate scenario is a real possibility.

Finally, this environment of slowing growth and global imbalances raises the risk of rising protectionism. In this regard, policy-makers need to make a concerted effort to ensure that the Doha round reaches a successful conclusion so that developing countries specializing in the export of agricultural products can benefit from trade liberalization in the

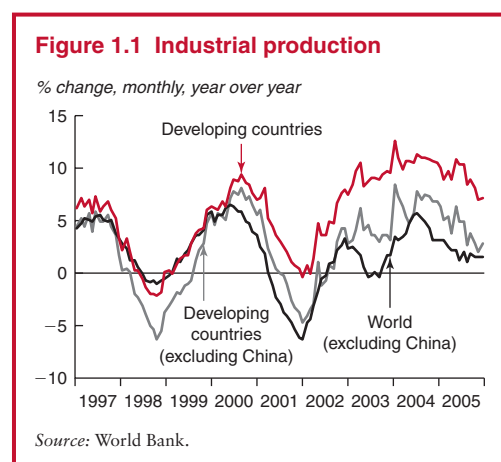
same way that other countries have profited from freer trade in the manufacturing and raw materials sectors.

**Global growth**

The global economy slowed markedly in 2005, but still continued to expand at an estimated 3.2 percent pace, compared with 3.8 percent in 2004 (table 1.1). The slowdown was widespread, reaching virtually every economic region. It was precipitated by higher oil prices, resource-sector capacity constraints, tightening monetary policy in the United States, and in some countries, the maturation of the investment cycle following a year of very fast growth.

*Outturns and prospects in high-income countries*

Growth among industrialized economies in 2005 is estimated at 2.5 percent, substantially lower than the 3.1 percent recorded the year before. Industrial production and trade flows among high-income countries were particularly weak. Growth rates of the former declined from over 5 percent in mid-2004 to less than 1.5 percent in the middle of 2005 (figure 1.1). High oil prices, rising short-term interest rates, and an unusually disruptive hurricane season<sup>1</sup> slowed growth in the United States to



**Table 1.1 The global outlook in summary***Percentage change from previous year, except interest rates and oil price*

	2003	2004	2005e	2006f	2007f
<i>Global Conditions</i>					
World trade volume	5.9	10.2	6.2	7.0	7.3
Consumer prices					
G-7 countries <sup>a,b</sup>	1.5	1.7	2.2	2.0	1.7
United States	2.3	2.7	3.4	3.0	2.4
Commodity prices (USD terms)					
Non-oil commodities	10.2	17.5	11.9	-5.9	-6.3
Oil price (US\$ per barrel) <sup>c</sup>	28.9	37.7	53.6	56.0	51.5
Oil price (percent change)	15.9	30.6	42.1	4.5	-8.0
Manufactures unit export value <sup>d</sup>	7.5	6.9	2.4	2.4	2.1
Interest rates					
\$, 6-month (percent)	1.2	1.7	3.8	5.0	5.2
€, 6-month (percent)	2.3	2.1	2.2	2.1	2.8
<i>Real GDP growth<sup>e</sup></i>					
<b>World</b>	2.5	3.8	3.2	3.2	3.3
Memo item: world (PPP weights) <sup>f</sup>	3.9	5.0	4.4	4.3	4.4
<b>High income</b>	1.8	3.1	2.5	2.5	2.7
OECD countries	1.8	3.0	2.4	2.5	2.7
Euro area	0.7	1.7	1.1	1.4	2.0
Japan	1.4	2.6	2.3	1.8	1.7
United States	2.7	4.2	3.5	3.5	3.6
Non-OECD countries	3.7	6.3	4.3	4.2	4.0
<b>Developing countries in</b>	5.5	6.8	5.9	5.7	5.5
East Asia and Pacific	8.1	8.3	7.8	7.6	7.4
Europe and Central Asia	6.1	7.2	5.3	5.2	5.0
Latin America and Caribbean	2.1	5.8	4.5	3.9	3.6
Middle East and N. Africa	5.2	4.9	4.8	5.4	5.2
South Asia	7.9	6.8	6.9	6.4	6.3
Sub-Saharan Africa	3.6	4.5	4.6	4.7	4.5
<i>Memorandum items</i>					
Developing countries					
excluding transition countries	5.3	6.8	6.1	5.8	5.6
excluding China and India	4.1	6.0	4.9	4.7	4.6

Note: PPP = purchasing power parity; e = estimate; f = forecast.

a. Canada, France, Germany, Italy, Japan, the UK, and the United States.

b. In local currency, aggregated using 1995 GDP weights.

c. Simple average of Dubai, Brent, and West Texas Intermediate.

d. Unit value index of manufactured exports from major economies, expressed in U.S. dollars.

e. GDP in 1995 constant dollars; 1995 prices and market exchange rates.

f. GDP measured at 1995 PPP weights.

an estimated 3.5 percent, compared with 4.2 percent the year before. The slowdown was not as marked as it could have been, because low long-term interest rates boosted domestic demand, and the cumulative effect of past dollar depreciations improved net exports.

In Europe, the growth slowdown was less pronounced, but the expansion, at an estimated

1.2 percent (1.1 percent in the euro zone), was much weaker. The relatively low oil-intensity of European economies and relaxed macro-economic policy stance help explain why the slowdown in Europe was not more pronounced. In Japan, GDP is estimated to have increased 2.3 percent. Rising domestic demand and household incomes, as a result of tighter labor market conditions and reduced

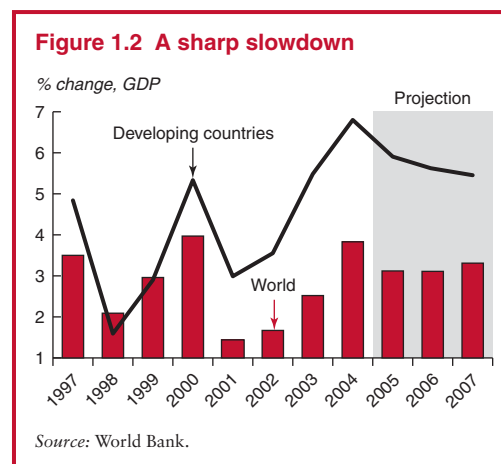
industrial restructuring, compensated for much slower Chinese import demand.

Looking forward, the increase in oil prices observed in 2005 is expected to slow global growth by about one quarter of a percentage point in 2006, compared with what it would have been had prices remained stable. In the United States, the pace of the expansion is projected to remain broadly stable, because the negative effects of further expected increases in interest rates and high oil prices will be partly offset by a deficit-financed pickup in post-hurricane investment and additional increases in the contribution of the external sector to growth. In Europe, economic activity is projected to accelerate despite a significant drag on growth from high oil prices, because of low interest rates, pent up investment demand, and a dissipation of most of the negative consequences following the euro's real-effective appreciation. Meanwhile, in Japan, the negative consequences of higher oil prices are expected to be substantially offset by strengthening domestic demand and continued supportive macroeconomic policies.

#### *Developing economy outturns and prospects*

Despite a slowdown of almost a full percentage point, growth in developing economies remained very robust, at an estimated 5.9 percent in 2005 (figure 1.2). In part this reflects the strong performance of China and India, where output continued to expand at rapid rates (in excess of 9 percent and about 7 percent, respectively). The slowdown among the oil-importing countries (excluding China and India) was sharper, from 5.6 percent to 4.3 percent.<sup>2</sup> At the same time, dwindling spare capacity in the petroleum sector caused growth in oil-exporting developing countries to ease from 6.6 percent to 5.7 percent, even though oil revenues continued to rise.

High oil prices, rising interest rates, and building inflationary pressures are expected to restrain growth in most developing regions in 2006 and 2007 (figure 1.3). As a group, however, low- and middle-income countries should

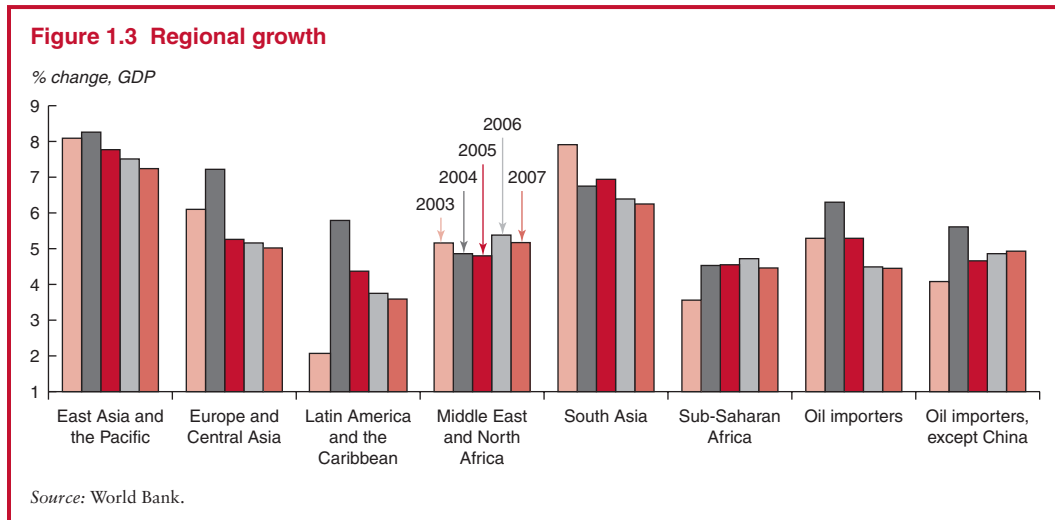


again outperform high-income economies by a wide margin through 2007.

#### *Regional outlooks*

**Detailed descriptions of economic developments in developing regions can be found in the Regional Outlooks section of <http://www.worldbank.org/globaloutlook>.**

The economies of the East Asia and Pacific region continued to expand rapidly in 2005. Regional GDP is estimated to have increased by 7.8 percent, down from 8.3 percent in 2004. Growth in China remained very strong—despite a substantial slowing in both private consumption and investment demand—because exports continued to grow rapidly, and import growth declined by half. China appears to have been a major beneficiary of the expiration of quotas on textiles (see the global trade discussion below), which contributed to rapid export growth in the first half of the year. Since then, the re-imposition of quotas by the United States and the European Union (EU) have attenuated this positive force. For other countries in the region, the slowdown in Chinese imports, weak global high-tech demand, and elevated oil prices have translated into reduced export growth, rapidly rising



producer prices, and a deterioration of current account balances.

Even higher oil prices on average in 2006,<sup>3</sup> the longer-term implications of reduced investment levels of China, and a tightening of monetary policy are expected to slow regional growth to 7.6 and 7.4 percent in 2006 and 2007, respectively. The changes in the currency regimes of China and Malaysia are not expected to have a major impact on growth. Nevertheless, as discussed below, these regimes should improve financial stability both domestically and internationally.

Economic activity in the **Europe and Central Asia** region decelerated sharply in 2005, with GDP growing by an estimated 5.3 percent, down from 7.2 percent in 2004. Slower increases in oil production, a peaking of the investment cycle (especially among economies that recently joined the EU), and less robust world demand for the region's exports contributed to the slowdown, which was particularly intense in a number of the larger economies of the region. Russia decelerated from 7.2 percent to 6.0 percent; Ukraine from 12.1 percent to 4.4 percent; Poland from 5.4 percent to 3.5 percent; and Turkey from 8.9 percent to 4.8 percent.

Higher oil prices constrained domestic demand in oil-importing countries, but oil

revenues in oil-exporting countries helped offset much slower growth in the oil sector itself. Reflecting these capacity constraints and the very strong growth recorded last year, inflationary pressures have built up in many countries in the region, notably Russia. Turkey, where improved macroeconomic policy has pushed inflation below 10 percent, represents an important exception. The expected acceleration of demand in Europe, continued high oil prices—which for many countries in the region are a positive factor—and additional gains in European market share, suggest that growth for the region as a whole should remain relatively stable—at about 5 percent in 2006 and 2007, which is close to the region's potential growth rate.

Economic activity in **Latin America and the Caribbean** is estimated to have increased by some 4.5 percent during 2005, substantially slower than the 5.8 percent recorded in 2004 but much faster than the region's 0.4 percent average growth rate during the preceding three years. Supply constraints and tight monetary policy are estimated to have slowed GDP growth in Brazil to some 3.8 percent (down from 4.9 percent in 2004), while in Mexico five fewer working days in 2005 than in 2004 are expected to contribute to a significant slowing.<sup>4</sup> Excluding these countries, regional

growth in 2005 is estimated at a robust 5.9 percent, boosted by both strong world demand for the region's exports (particularly oil, coffee, and copper, which account for 65 percent of the regions' commodity exports) and low interest rates. Domestic factors that contributed to the strong performance include past efforts to open the region up to international trade, more responsible budget policy, the introduction of more flexible exchange rate regimes, and lower inflation.

Slower global growth is already easing tensions in the non-oil commodity markets that have driven the recovery in the Latin America and Caribbean region, and this trend is expected to continue. Moreover, while many countries in the region benefit from high oil prices, many others, particularly those in the Caribbean, are heavily oil dependent and face substantial income losses.<sup>5</sup> As a result, regional GDP growth is projected to decline to 3.6 percent by 2007.

High oil prices and strong oil demand continue to be key drivers for the economies of the **Middle East and North Africa**, where GDP is estimated to have increased by 4.8 percent in 2005. Very high oil revenues generated double-digit advances in public spending, which have helped to increase GDP in oil-producing economies by an estimated 5.4 percent. Strong demand from these economies spilled over to the labor-abundant economies of the region through higher remittances and increased intraregional tourism flows. However, weak growth in Europe, high oil bills, and a one-off negative effect from the removal of quotas under the Agreement on Textiles and Clothing (ATC) reduced growth of regional oil-importing countries from 4.6 percent in 2004 to about 4.0 percent in 2005.

Looking forward, high oil prices are expected to continue feeding demand in oil-producing countries, whose economies should expand by 5.4 percent in 2006 and 5.1 percent in 2007. In the oil-importing economies, growth is expected to accelerate to about the same level, supported by stronger European growth and a weaker negative effect from

the ATC. The region's strong performance reflects, in part, past reforms, such as steps to improve transparency in the oil sector in Algeria, as well as banking-sector reform, reductions in customs duties, privatization, and regulatory reform in other Maghreb countries. These efforts, and in particular, the substantial reforms underway in Egypt, help to raise the region's growth potential by improving both infrastructure and the overall investment climate. While heartening, the pace of reform outside of Egypt appears to have waned, perhaps because high oil prices have reduced the sense of urgency attached to reform in oil-exporting countries.

In contrast to the slowdown elsewhere in the world economy, growth in **South Asia** is estimated to have picked up a bit in 2005, coming in at 6.9 percent, compared with 6.8 percent in 2004. This mainly reflects improved performance in Pakistan, where GDP is estimated to have increased 8.4 percent (up from 6.6 percent in 2004), thanks to a broad-based acceleration in the manufacturing and agricultural sectors. Like Pakistan, other countries in the region have enjoyed very strong export performance, in part because of the recent removal of ATC quotas. However, the sharp rise in oil prices and solid regional growth over the past several years have contributed to an acceleration of inflation. Addressing this issue will require a further tightening of monetary policy, which, in combination with rising oil bills, is expected to result in a modest deceleration of economic activity to about 6.3 percent by 2007.

GDP in **Sub-Saharan Africa** is estimated to have increased 4.6 percent in 2005, bolstered by very strong growth among resource-rich countries. Output in South Africa, the region's largest economy, is estimated to have accelerated to 4.2 percent, lifted by high metal prices, strong confidence, low nominal interest rates and the rand's recent depreciation. The economies of oil-exporting countries, including Nigeria (the region's second largest economy), grew an estimated 5.5 percent in 2005, reflecting rapid increases in petroleum

production and investment inflows. Growth in some oil-exporting countries may exceed 25 percent in 2006 and 2007, as new oil fields come on stream. However, the pace of the expansion will taper off in other countries as they reach capacity constraints.

In West Africa, strong commodity prices in 2005, improved rainfall, and more vigorous use of insecticides are expected to lift regional growth. In East and Southern Africa the expansion is projected to slow somewhat, partly because the removal of quotas under the ATC will continue to put textile exports under pressure. Political strife and insecurity in Côte d'Ivoire and the Great Lakes region are likely to impact growth there. Countries are increasingly passing higher crude-oil prices through to consumers with the aim of containing budget deficits but will cut into consumer demand and add to inflationary pressures.

The balance of payments and economic consequences of higher oil prices are expected to intensify over the next year as other commodity prices, which have attenuated the terms-of-trade impact of high oil prices, ease. Despite higher oil prices and increased pass-through, inflation is expected to remain in the

single digits as a result of lower food prices and prudent monetary policies. Recent economic reforms, and increased donor support—as more countries reach the Heavily Indebted Poor Country (HIPC) completion point—will also help support growth, which is projected to be at or above 4.5 percent over the medium term.

### Long-term prospects and poverty forecast

The recent strong economic performance of developing economies and the relatively rapid growth projected for these economies over the medium term owe much to the economic reforms undertaken over the past several years. Improved macroeconomic policies, reflected in lower inflation, trade liberalization (average tariffs have fallen from 30 percent to less than 10 percent since the 1980s), more flexible exchange rate regimes, and lower fiscal deficits have reduced uncertainty and improved the overall investment environment. More microeconomic structural reforms, such as privatization and regulatory reform initiatives, have also played a key role.

**Table 1.2 Long-term prospects**

*Real GDP per capita, annual average percentage change*

	1980s	1990s	Forecast	
			Medium-term 2001–06	Long-term 2006–15
World Total	1.3	1.2	1.5	2.1
<i>High-income countries</i>	2.5	1.8	1.6	2.4
OECD	2.5	1.8	1.6	2.4
United States	2.3	2.0	1.8	2.5
Japan	3.4	1.1	1.1	1.9
European Union	2.1	1.8	1.4	2.3
Non-OECD	3.5	4.0	2.0	3.5
<i>Developing economies</i>	0.7	1.5	3.7	3.5
East Asia & Pacific	5.8	6.3	6.4	5.3
Europe & Central Asia	0.9	–1.8	5.0	3.5
Latin America & Caribbean	–0.9	1.6	1.2	2.3
Middle East & North Africa	–1.1	1.0	2.5	2.6
South Asia	3.3	3.2	4.5	4.2
Sub-Saharan Africa	–1.1	–0.5	1.8	1.6

Source: World Bank.



These factors are expected to contribute to better long-term growth performance as compared with past decades (table 1.2). Consistent with recent improvements in economic performance, per capita incomes in developing countries are projected to grow some 3.5 percent a year, more than twice as fast as the 1.5 percent growth rates recorded during the 1990s. Projected future growth rates are higher than during the 1980s and 1990s in every developing region except East Asia, where they are expected to decline somewhat due to an aging population.

Table 1.3 reports poverty projections based on these real per capita income growth rates and the (re)distribution of income within the population. The table indicates that over the next 15 years the share of the

population living in extreme poverty is expected to decline in all developing regions.<sup>6</sup>

With the exception of Sub-Saharan Africa, all regions are expected to achieve their Millennium Development Goal of reducing poverty by 50 percent from its 1990 level. In East Asia, the target has already been achieved. Moreover, based on the current long-term forecast, extreme poverty would be almost eliminated by 2015 in both the East Asia and Pacific and the Europe and Central Asia regions. Overall, the number of people living on \$1 a day or less will fall to around 620 million, from 1.2 billion in 1990 and an estimated 1.0 billion in 2002.

Despite these heartening prospects, there is no room for complacency. The percent of the population in developing economies living at

**Table 1.3 Regional breakdown of poverty in developing countries**

Region	Millions of people living on					
	less than \$1 per day			less than \$2 per day		
	1990	2002	2015	1990	2002	2015
East Asia and the Pacific	472	214	14	1,116	748	260
China	375	180	11	825	533	181
Rest of East Asia and the Pacific	97	34	2	292	215	78
Europe and Central Asia	2	10	4	23	76	39
Latin America and the Caribbean	49	42	29	125	119	106
Middle East and North Africa	6	5	3	51	61	40
South Asia	462	437	232	958	1,091	955
Sub-Saharan Africa	227	303	336	382	516	592
Total	1,218	1,011	617	2,654	2,611	1,993
Excluding China	844	831	606	1,829	2,078	1,811
Region	Percent of population living on					
	less than \$1 per day			less than \$2 per day		
	1990	2002	2015	1990	2002	2015
East Asia and the Pacific	29.6	14.9	0.9	69.9	40.7	12.7
China	33.0	16.6	1.2	72.6	41.6	13.1
Rest of East Asia and the Pacific	21.1	10.8	0.4	63.2	38.6	11.9
Europe and Central Asia	0.5	3.6	0.4	4.9	16.1	8.2
Latin America and the Caribbean	11.3	9.5	6.9	28.4	22.6	17.2
Middle East and North Africa	2.3	2.4	0.9	21.4	19.8	10.4
South Asia	41.3	31.3	12.8	85.5	77.8	56.7
Sub-Saharan Africa	44.6	46.4	38.4	75.0	74.9	67.1
Total	27.9	21.1	10.2	60.8	49.9	32.8
Excluding China	26.1	22.5	12.9	56.6	52.6	38.6

Source: World Bank.

or below \$2 per day is projected to remain disturbingly high. Moreover, notwithstanding that inroads have been made recently, the incidence of extreme poverty in Sub-Saharan Africa in 2002 was actually higher than in 1990. While current projections suggest 8 percent of the subcontinent's population will be lifted above the extreme poverty line by 2015, some 38 percent of Africans will still be living in extreme poverty. Worse, the absolute number of Africans living at or below the \$1-a-day level is projected to increase. And, because per capita incomes elsewhere are projected to grow faster, the continent will continue to fall farther behind the rest of the world—unless steps are taken to greatly improve economic growth in Africa.

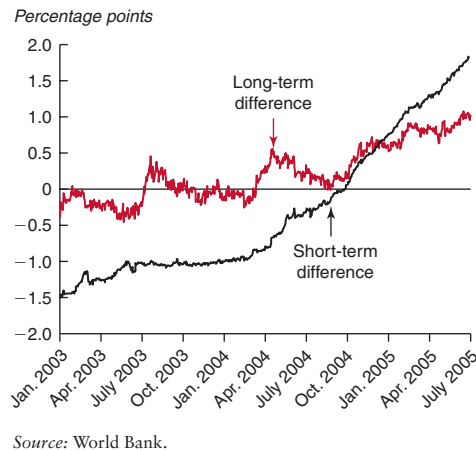
### International finance

The significant adjustments of international exchange rates over the past several years paused in 2005. In particular, notwithstanding the persistence of the U.S. current account deficit (expected to exceed \$750 billion this year), the dollar's trend decline with respect to major currencies came to an end. Initially, the currency appreciated against its trading partners by some 3.5 percent in real-effective terms as of July 2005. It then lost value in August and September, before showing signs of strengthening in October.

The strengthening of the dollar during the first seven months of 2005 is partly explained by rising U.S. short-term interest rates (as the Federal Reserve Bank continued its policy of gradual tightening) and falling long-term rates in Europe (possibly in response to the continent's relatively weaker economic performance). By July, these developments had generated a 300 basis-point swing in the difference between U.S. and European short rates, along with a 75 basis-point gap in favor of long-term U.S. bonds (figure 1.4).

These growing interest rate differentials increased the financial incentive to hold dollar-versus euro-denominated assets, temporarily producing stronger net private sector capital

**Figure 1.4 Dollar-euro interest rate differentials**

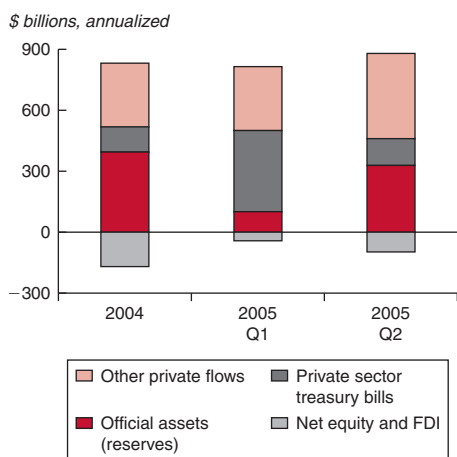


inflows in the first quarter of 2005 as investors adjusted their portfolios. Not only did these inflows help strengthen the dollar, they also financed a large share of the U.S. current account deficit (figure 1.5). As a result, the dollar was much less reliant on the accumulation of reserves by foreign central banks (foreign official asset purchases) than in 2004.

In the second quarter of 2005, however, private inflows eased, and foreign central banks once again assumed a large role in the financing of the dollar. Moreover, toward the end of July the dollar came under renewed downward pressure and depreciated some 1.7 percent in real-effective terms during August and September. The dollar began to appreciate again only after the long-term interest rate started to rise again. By October 2005, the long-term interest rate differential had widened to about 120 basis points.

The apparent sensitivity of the dollar and the financing of the U.S. current account deficit to interest-rate differentials highlight the problems posed by the large financing requirements of the U.S. current account deficit.

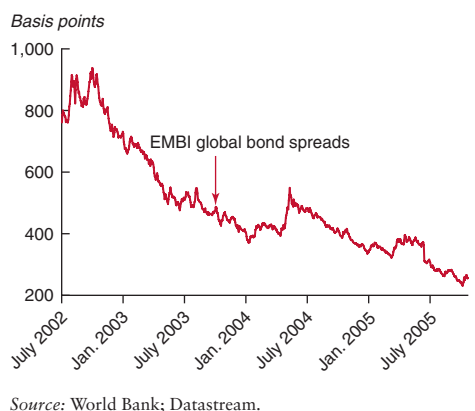
Until global imbalances are resolved, the dollar is likely to continue to come under

**Figure 1.5 Financing of the U.S. current account deficit**

Source: U.S. Department of Commerce; BEA; U.S. Treasury Bulletin.

downward pressure, unless foreign central banks accumulate substantial quantities of dollars or interest-rate differentials widen further. In the baseline, interest rate differentials are projected to widen further, and the dollar is projected to decline gradually, falling by about 5 percent per year. Should central banks cease to be willing to accumulate reserves at current rates, there could be a disruptive hike in interest rates or a more precipitous fall in the dollar (World Bank 2005).

The recent decision of the Chinese and Malaysian authorities to move from an exchange rate regime linked to the dollar alone to one focusing on a basket of currencies represents a major and welcome move toward a more flexible currency regime. While it will not resolve current account imbalances, it should increase the stability of the renminbi and ringitt with respect to the currencies of their trading partners (other than the United States) and reduce the amount by which the dollar would have to depreciate relative to other currencies to achieve a given level of adjustment.<sup>7</sup> How effective the new regimes will be, depends importantly on how they are

**Figure 1.6 Emerging market spreads**

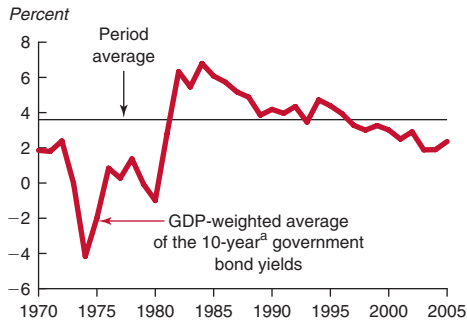
managed. While technically the announced rules could allow the renminbi to depreciate as much as 9 percent per month, similar possibilities for flexibility existed under the former regime but were not exercised.

#### *Interest rates and spreads remain low*

The recent period of very low real interest rates has been particularly beneficial to developing economies. Together with narrower risk premia (figure 1.6), low rates have allowed developing countries to reduce their financing costs, restructure their debt, and pursue strong investment growth. Early repayment of Paris Club debt has already reached \$22 billion in 2005, and among emerging-market economies, virtually all financing requirements for this year had been met by August.<sup>8</sup>

Short-term rates have been rising, and they can be expected to continue to rise as monetary policy tightens, initially in the United States, but eventually in Europe as well. In contrast and notwithstanding recent increases, longer-term interest rates have remained low longer than expected (figure 1.7), while spreads on more risky emerging market and corporate assets have fallen even further.

**Figure 1.7 Real long-term interest rates in G-7 countries**



Source: World Bank.

Note: For data prior to 1972, exclude Italy, a 10-year or nearest government bond yields.

**Figure 1.8 World savings rate**



Source: World Bank.

a. Sum of national savings divided by the sum of national GDP expressed in U.S. dollars at market exchange rates.

Many reasons for these low interest rates have been proposed (see IMF 2005 for a recent overview), including the following:

- Excess liquidity stemming from an extended period of very low short-term interest rates in almost all developed economies.
- A low inflation environment, thanks to improved credibility of monetary policy, and the disinflationary impact of increased competition following the entry into global markets of China and members of the former Soviet bloc.
- An increase in global savings, due to
  - increased savings in Europe following heightened recognition of the need to prepare for the impending retirement of the baby-boom generation; and
  - increased corporate savings in dynamic East Asia (caused by corporate restructuring following the currency crisis) and in the United States (following the stock market decline in 2000).

However, while global savings have increased recently, this follows a period where they declined substantially, making it difficult to argue that the world savings rate is currently too high (figure 1.8). Rather, investment

activity, principally in the developed world, has failed to keep pace with savings as they have returned to historical levels (see IMF 2005).

Most of these explanations for lower long-term rates involve temporary factors, implying that long-term rates will eventually rise toward their long-run equilibrium level<sup>9</sup> (frequently defined as the long-run potential growth rate of the economy). In this context, the question is not so much why long-term rates are low, but how much longer they will remain so. In the baseline, increased investment in Europe and tighter monetary policy result in a gradual rise in interest rates, which will nevertheless remain below recent estimates of the long-term growth potential of the U.S. economy. The final section of this chapter explores some of the economic implications should interest rates stay low for an extended period of time or, alternatively, should they rise more quickly than anticipated.

**Signs of rising inflation**

Low interest rates have contributed directly to the strong economic performance of recent years. Growth has, in turn, provoked a pickup in inflation in many developing countries. The largest hikes have been in commodity prices (see below). However, producer price inflation

has jumped by more than 4 percentage points in some regions and exceeds 5 percent in every developing region except Sub-Saharan Africa.<sup>10</sup>

Consumer price inflation has also been rising (if less spectacularly). Weighted by GDP, aggregate inflation among developing economies increased from 4.0 percent in the fourth quarter of 2003 to 5.4 percent by July of 2005. It has since eased somewhat. Regionally, inflation has picked up strongly in South Asia, Sub-Saharan Africa, and East Asia (figure 1.9). Inflation in developing countries is projected to continue rising in 2005, as growth remains at or above trend rates, and the pass-through from high oil prices continues to exert upward pressure on prices.

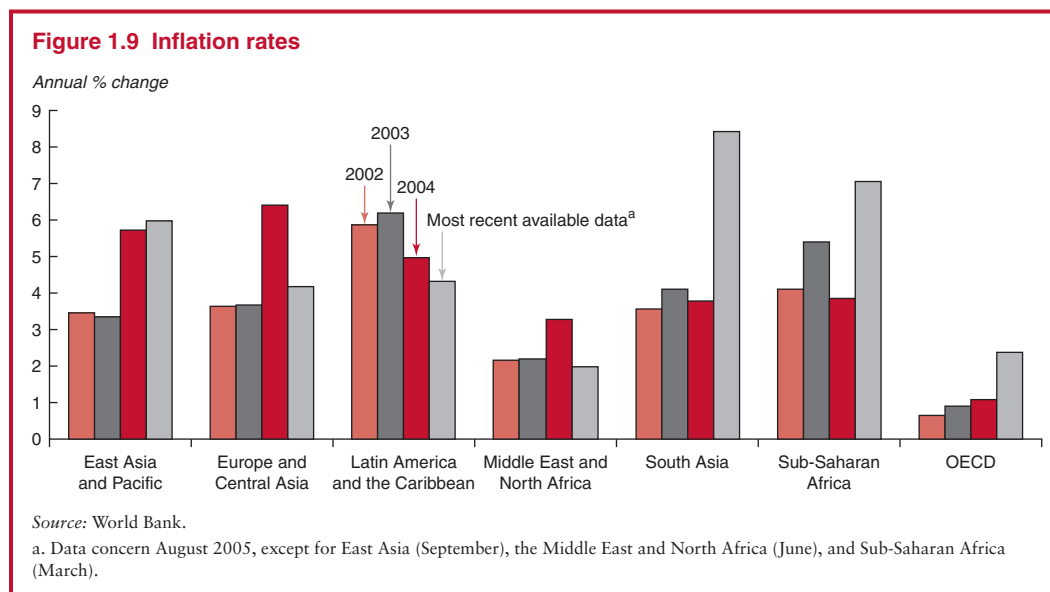
In high-income countries, there are only limited signs of rising inflation. In the United States, where output is close to potential, inflation has been rising steadily. It jumped to 4.7 percent in September 2005, but the increase is not expected to be permanent, because it reflects very high gasoline prices that month, which have since declined. Nevertheless, data pointing to rising wages and lower

productivity growth suggest that core inflation, which has been more stable, may begin to rise soon. In Europe, high oil prices have limited disinflation despite significant slack and the appreciation of the euro.

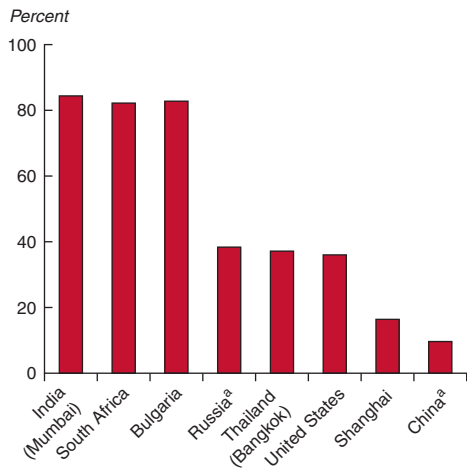
These same factors should continue to limit price inflation in Europe. However, in the United States, high oil prices plus the projected further depreciation of the dollar are expected to generate additional upward price pressure.

Low interest rates have resulted in higher prices of interest-sensitive assets in markets with strong financial intermediation—notably in the United States and some European countries—contributing to strong consumer demand (World Bank 2005, IMF 2005). As interest rates rise, housing prices are expected to plateau and even decline, which has already begun in the United Kingdom. As they do so, the rate at which household wealth increases will moderate and its contribution to consumer demand should abate.<sup>11</sup>

Data indicate that house prices have also been rising rapidly in a number of middle-income countries, such as Bulgaria, India,



**Figure 1.10 Cumulative real increase in housing prices, 2005**



Source: World Bank; BIS.  
 a. Data for Russia and China reflect increases between 2000 and 2004; data for other countries reflect increases between 2000 and 2005.

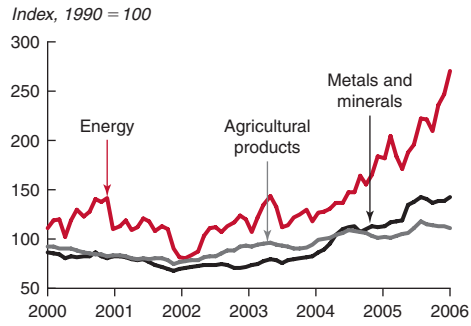
Indonesia, Malaysia, and South Africa (figure 1.10). While fast economic growth and changes in the regulatory environment have certainly played a role in these countries, so have low interest rates. Unfortunately, data limitations prevent a thorough analysis of the causes and consequences of rising housing prices in low- and middle-income economies.<sup>12</sup>

### Commodity markets

After several years of rising commodity prices, there are indications of a stabilization and even reversal of gains in the markets for agricultural products and for metals and minerals (figure 1.11).

Agricultural prices have been declining most of this year and are down 5 percent since March 2005. However, prices of agricultural raw materials are rising, partly because of higher prices for commodities that are close substitutes for crude oil-based products (for example, natural rubber prices are up 41 percent because of increases in synthetic rubber costs).

**Figure 1.11 Commodity prices**



Source: World Bank.

Although metals and minerals prices rose during the first months of the year, they have since stabilized, and in October 2005, they were at the same level as in March 2005. Conditions in some metals and minerals markets remain tight, due to low inventories. In the case of copper and aluminum, prices remain elevated (partly reflecting higher energy content in the production of these goods). Demand has weakened markedly for lead, tin, and zinc.

Analysis of past non-oil commodity cycles suggests that this one may have run its course. Already it distinguishes itself from previous episodes by having lasted longer, in part, because energy prices have also been high, which was not always the case during previous episodes. In so far as high fuel prices increase production costs in both agriculture and metals and minerals, they may have reduced the supply response, keeping prices higher longer.

In line with the projected slowdown in global growth and increased supply, prices of agricultural products and metals and minerals are projected to decline somewhat in 2006.

#### *Limited spare capacity to keep oil prices high*

In contrast with other commodity prices, oil prices continued to strengthen during the

first nine months of 2005. During this period, they averaged some \$52 per barrel, a 38 percent increase compared with the average for 2004. These increases occurred despite an easing of conditions in the oil market. Demand growth slowed from more than 3.5 percent in 2004 (the highest growth since the late 1970s) to a 1.4 percent annualized rate during the first three quarters of 2005. As a result, supply is actually increasing faster than demand,<sup>13</sup> and inventories have begun to accumulate, although they remain low.<sup>14</sup>

Rising prices over the first eight months of the year reflected the market's concern that existing spare capacity was insufficient to deal with a major disruption to supply or an increase in demand (figure 1.12). In some sense, hurricane Katrina was the kind of serious shock the market feared. Although oil prices spiked briefly to more than \$70 a barrel, they are back below \$60, following the release of some 29 million barrels of crude oil from the stockpiles of the International Energy Agency and the U.S. government. Moreover, gasoline prices in the United States have returned to the levels observed before hurricane Katrina, and market concerns have switched from a focus on inadequate oil supply to insufficient

refining capacity, particularly of lower-quality crude oil.

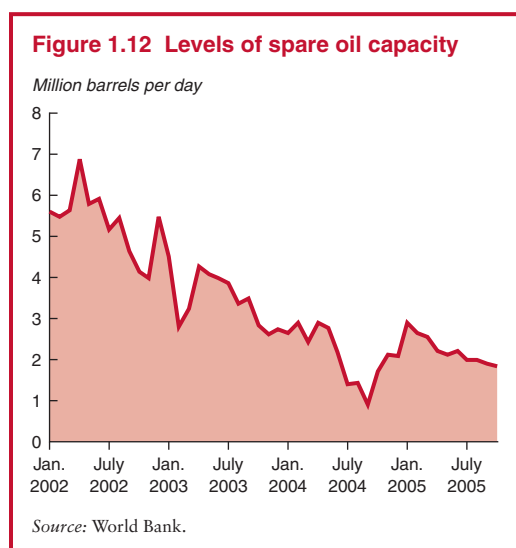
Spare production capacity is now about 2 million barrels per day (mbpd), compared with almost 6 mbpd three years ago, and capacity will remain tight over the near term. This reflects long lags in bringing significant new quantities of oil into production<sup>15</sup> and shorter lags before demand substitution can have an effect.<sup>16</sup> Moreover, approximately half of the expected new capacity is being produced by OPEC, suggesting that the organization will continue to exercise significant market power over the near term.

In this environment, prices are likely to remain volatile, as small events or even minor changes in expectations may provoke significant price swings. As a result, the World Bank has adopted a technical assumption for the future path of oil prices based on a slow decline toward \$40 per barrel by 2010. This implies an average price of \$56 in 2006 and \$52 in 2007, which is somewhat higher than the current consensus forecast. The economic consequences of alternative scenarios, notably a sharp negative supply shock, are discussed in the final section of this chapter.

*The impact of oil prices on developing economies*

The world economy in general and developing countries in particular have shown considerable resilience to higher oil prices. This reflects increases in non-oil commodity prices and a very robust global economy, which have, until recently, muted the impact of higher oil prices.

The first round of oil price hikes (1999–2000) adversely affected low- and middle-income countries. The price increase was very large in percentage terms (rising from just under \$12 to almost \$30 per barrel between the first quarter of 1999 and the end of 2000) but smaller than the most recent increases in dollar terms (table 1.4). Current account deficits among low-income oil-importing African countries increased by 0.5 percent of GDP on average.<sup>17</sup> Moreover, government deficits in those countries that did not pass on the price



**Table 1.4 Terms-of-trade impacts of commodity price changes**

	1999-00	2001-03	2004-05
<i>Cumulative price change</i>			
Oil	120.3	18.9	88.0
Agricultural products	0.3	15.7	8.9
Metals and minerals	25.0	10.2	47.9
Manufactures	-5.0	3.0	10.4
<i>Total terms-of-trade effect (% of GDP)</i>			
<i>Oil Importers</i>			
Low and Middle income	-1.8	-0.1	-0.9
Low income	-3.8	-0.9	-2.9
Sub-Saharan Africa	-2.5	1.4	-1.2
South Asia	-3.9	-1.5	-2.7
Highly indebted poor countries	-4.3	1.5	-3.3

Source: World Bank.

Note: Periods Jan. 1999–Dec. 2000, Dec. 2000–Dec. 2003, Dec. 2003–July 2005.

hikes rose by about the same amount.<sup>18</sup> Among those countries with limited access to international finance, non-oil imports fell by 3.8 percent in 2000, partly because insufficient foreign exchange was available to finance imports at previous levels.

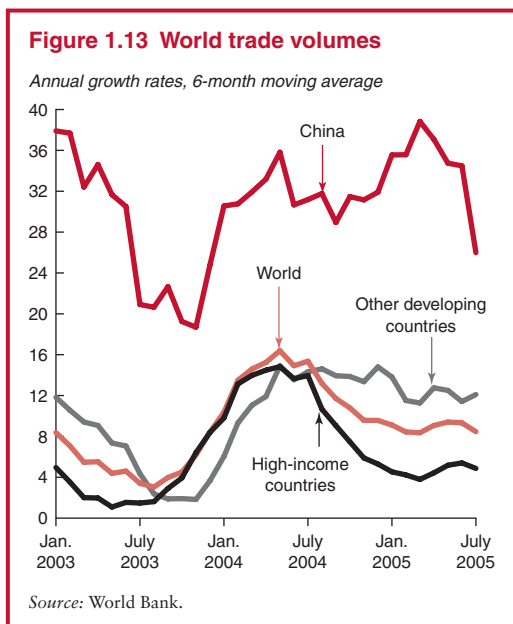
During the second bout of (more gradual) price increases (2001–3) the same countries performed much better. Current account positions actually improved as a percent of GDP, and there were no discernible slowdown in non-oil imports. Part of this improved performance is explained by real exchange rate movements (which diminished the domestic currency cost of the oil-price hike) and by a number of non-oil commodity prices that also increased rapidly during that time, thus providing the necessary foreign currency to meet the additional oil burden without cutting into non-oil imports. On average, high non-oil commodity prices reduced the negative terms-of-trade shock from higher energy costs by more than half.

Drawing from this experience, the impact of the latest hike in oil prices on poor oil importers is a concern, principally because it has not been accompanied by as much strength in

non-oil commodity prices. Indeed, the estimated terms-of-trade shock from price movements since January 2004 is more than three times as large for various groups of low-income countries than the cumulative shock over the preceding three years. As a result, non-oil imports from poor, current account-constrained countries are expected to come under pressure in the coming months. Moreover, the impact on oil-importing poor countries could be significantly aggravated if oil prices remain at or close to current levels and if non-energy commodity prices return to pre-shock levels.

### World trade

The expansion of world trade slowed significantly during 2005 (figure 1.13). While merchandise exports were growing at a 16 percent or more annualized pace in the middle of 2004, they subsequently slowed and were expanding at an 8.5 percent pace during the third quarter of 2005.





Most of the deceleration concerned the exports of high-income economies, volumes of which grew by less than 4 percent (annualized) in the first quarter of 2005, before strengthening more recently. Merchandise export volumes of developing countries (excluding China) were relatively robust, increasing at an estimated 12 percent pace toward the middle of 2005. Chinese exports, boosted by the removal of ATC quotas, grew at a 24 percent pace.

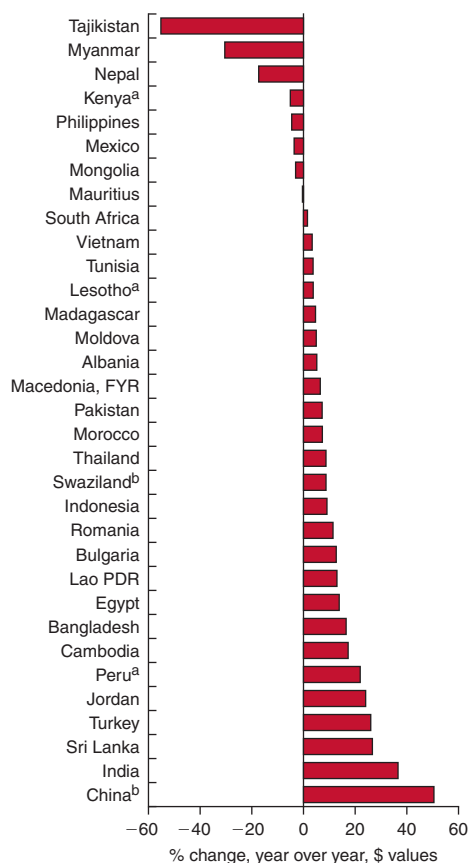
Commodity markets have significantly shaped developments in world trade. The merchandise exports of oil-exporting countries, which had been rising at some 5.8 percent in 2004, increased by an estimated 5.2 percent in 2005. The deceleration among developing oil importers (excluding China) was steeper in percentage terms (from 15 percent to 11 percent), but growth rates remained much higher. Growth in the production of non-oil commodities in general is moderating, both because demand is easing and because of supply constraints.

As a reflection of the slowdown already observed, international trade is forecast to slow down relative to 2004 as a whole. Merchandise trade volumes are expected to increase by around 7.7 percent. The goods and service trade is expected to increase 6.2 percent in 2005 before strengthening somewhat in 2006–7.

Exports of developing economies continue to be heavily influenced by developments in the volatile high-tech market. After falling sharply in the third quarter of 2004, global sales of semiconductors and other high-tech products picked up before weakening once again in the second quarter of 2005. This volatility is apparent in East Asian export volumes (high-tech products represent as much as two-thirds of the exports of some economies in this region).<sup>19</sup> High-frequency data suggest a strengthening of demand for these products, implying a pick up in export flows from the region.

Trade growth for some countries was heavily influenced by the removal of quotas under the ATC of the Multifiber agreement in

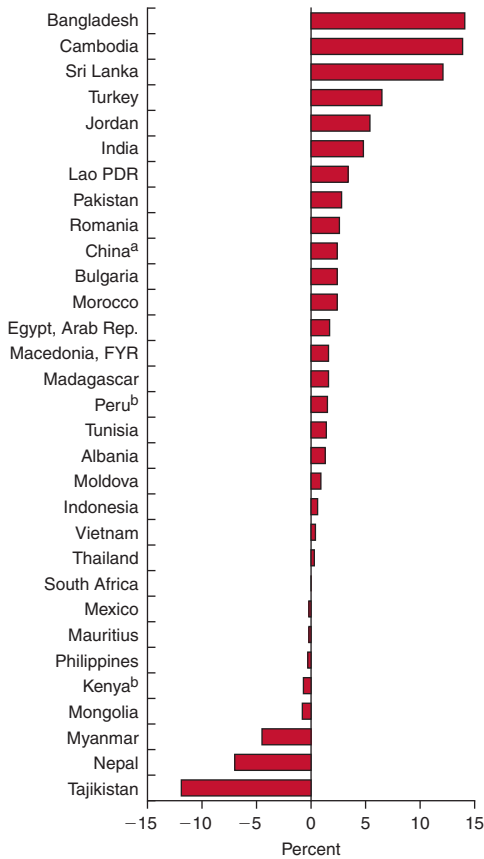
**Figure 1.14 Change in textile exports to the developed world, first half of 2005**



Source: World Bank, IMF, U.S. Department of Commerce, and EuroStat.  
 a. Data refer to the first five months of each year only.  
 b. Data for China include Hong Kong and Macao.

January 2005 (figure 1.14). While the removal of quotas was done in phases, and ten years of adjustment time provided, backloading of the removal of quotas meant that they were still binding when they were finally removed. As a result, there were significant changes in patterns of trade among affected goods in 2005, most notably in the form of increased exports from China (and other countries, whose market share had been artificially held back under the old quota scheme) to the detriment of

**Figure 1.15 Estimated change in textile exports as share of total merchandise exports**



Source: World Bank, IMF, U.S. Department of Commerce, and EuroStat.

Note: Data reflect the change in textile and clothing exports between 2004 and 2005 as a percent of total merchandise exports.

a. Data for China include Hong Kong and Macao.

b. Data refer to the first five months of each year only.

those exporters that had benefited most from the old quota system.

Using U.S. and European imports of textiles as a proxy for developments in the world as a whole, China,<sup>20</sup> India, Jordan, Peru, Sri Lanka, and Turkey saw the dollar value of their exports increase between the first half of 2004 and the same period in 2005 by more than the 20 percent average increase in high-

income imports over the same period. The textile sectors in Kenya, Myanmar, Nepal, the Philippines, and Tajikistan, on the other hand, saw the dollar value of their exports decline by 4 or more percent.

However, many of these countries are not large exporters of textiles. As a result, these figures may exaggerate the overall economic impact of the relaxation of textile quotas. Expressed as a percent of these countries' total merchandise exports, the biggest gains were experienced by Bangladesh, Cambodia, Jordan, India, Pakistan, Sri Lanka, and Turkey, while the largest losses were those of Kenya, Nepal, Myanmar, Mongolia, and Tajikistan (figure 1.15).

### Risks and uncertainties

Low interest rates, moderate inflation, and the robust growth projected in the baseline constitute a relatively benign scenario. However, the outlook is dominated by downside risks.

#### *An oil-market supply shock could cause serious disruption*

The most important potential risk comes from the oil market. As global demand and supply are projected to increase broadly in step, excess capacity (currently estimated at 1.9 million barrels per day) will remain very constrained. In this context, the market can be expected to continue reacting to events in a relatively volatile manner. Rather than gradually declining, as in the baseline scenario, prices could remain at current levels, rise further, or even fall.

More fundamentally, with spare production capacity so low, the market is particularly vulnerable to a supply shock. Because no country can easily ramp up production, if output in another producing country were to fall significantly, world supply would fall, provoking a decline in economic activity to the extent that the global economy could not quickly adopt an alternative energy source.<sup>21</sup>

Table 1.5 presents results from a simulation of the impact of a 2-million-barrels-per-day

**Table 1.5 Impact of a 2 million bpd negative supply shock**

	2006	2007	2008	2009
<i>Price of oil</i>	90	70	44	40
(Change from base line)	34	28	3	0
<i>Change in GDP % of baseline</i>				
World	-1.0	-1.5	-1.1	0.2
High income	-0.7	-1.3	-1.3	-0.3
Middle income	-1.6	-1.6	-0.1	1.4
Large low income	-1.7	-2.8	-1.8	0.7
<i>Impact on inflation rate</i>				
World	2.6	0.6	-0.9	-0.2
High income	1.4	0.0	-1.0	-0.4
Middle income	5.8	2.0	-0.9	0.5
Large low income	2.8	0.9	-0.7	-0.2
<i>Impact on real interest rates (levels)</i>				
World	1.0	0.2	-0.1	0.1
High income	1.0	0.1	-0.2	0.0
Middle income	1.1	0.7	0.2	0.2
Large low income	0.5	0.1	0.1	0.4
<i>Impact on current account balance (% of GDP)</i>				
World	-1.1	-0.5	-0.1	-0.1
High income	-1.1	-0.7	-0.2	-0.2
Middle income	-0.9	-0.2	-0.5	-0.3
Large low income	-1.9	-0.2	1.7	1.0
<i>Impacts on low-income current account-constrained countries (1)</i>				
Terms of trade	-4.1	..	..	
GDP	-0.3	0.1	0.0	
Domestic demand	-2.7	-1.1	0.0	
Current account balance	-1.2	0.9	0	

Source: World Bank.

Note: Impacts on low-income, current account-constrained economies were estimates based on the terms-of-trade impact using a purpose-built VAR model. Other estimates were simulated using the World Bank's macroeconomic simulation model.

negative supply shock.<sup>22</sup> The disruption is assumed to last throughout the projection period, causing prices to rise to \$120 for an initial period of three months before easing to \$80 for three quarters. Thereafter, supply and demand adjustments result in a gradual decline in oil prices toward \$40.

Global output responds to the initial shock by contracting, as compared with the baseline, by 1.5 percent of GDP after two years, while inflation picks up rapidly. On average, the current account position of oil-importing countries deteriorates by about 1.1 percent of GDP. The impact is more severe in large low-

income and middle-income countries, both because of higher energy intensities and a greater inflationary impact, which requires a larger contraction to eliminate.

While the impact in terms of GDP for current account-constrained low-income countries is smaller, it is more severe in terms of domestic consumption and investment. Such countries have limited access to international capital markets, and their capacity to pay higher oil prices is limited by their export revenues. If these revenues are stable, they are forced to reduce domestic demand and non-oil imports in order to pay their higher oil bill. As a consequence, when oil prices rise, oil consumption remains relatively constant in volume terms (being generally inelastic in the short run), but the oil bill rises. To compensate, non-oil imports and domestic demand tend to decline in unison—leaving GDP relatively unchanged. For these countries, the terms-of-trade shock of the initial increase in oil prices is estimated at 4.1 percent of their GDP, which would translate into a 2.7 percent decline in domestic demand, with potentially serious impacts on poverty.

#### *The future path of interest rates represents an additional source of uncertainty*

Persistent global imbalances continue to be a serious source of uncertainty. The current account deficit of the United States and its financing requirements are very large, and the willingness of investors to finance it is sensitive to both interest-rate differentials and exchange-rate expectations. As net foreign liabilities accumulate, markets will become increasingly sensitive to adverse shocks or changes in sentiment, and the dollar is likely to come under downward pressure once again, which would put upward pressure on interest rates.

Table 1.6 explores the possible implications of higher interest rates. In this scenario, faced with sustained downward pressure on the dollar, investors demand higher returns on U.S.-denominated assets to offset further expected depreciations. This, combined with concerns

**Table 1.6 Interest rate scenarios**

	2005	2006	2007	2008	2009
<b>A. A 200 basis-point increase in interest rates and in spreads</b>					
<i>Interest rates (change of Q4 level from baseline)</i>					
World	1.8	1.4	-0.6	0.2	1.3
High income	1.7	1.1	-1.1	-0.3	0.9
Low and middle income	2.0	2.7	1.9	2.6	3.1
<i>GDP (% change from baseline)</i>					
World	-0.1	-1.7	-2.9	-1.9	-0.6
High income	0.0	-1.5	-2.7	-2.5	-1.0
Low and middle income	-0.2	-2.4	-3.5	-3.0	-1.5
<i>Inflation (change in inflation rate)</i>					
World	0.0	-0.3	-1.1	-1.1	-0.3
High income	0.0	-0.3	-1.5	-1.6	-0.5
Low and middle income	0.0	-0.3	0.7	1.2	0.9
<b>B. Persistently low interest rates</b>					
<i>Interest rates (change of Q4 level from baseline)</i>					
World	-0.7	-0.5	0.6	0.1	-0.6
High income	-0.7	-0.5	0.8	0.1	-0.6
Low and middle income	-0.8	-0.8	-0.1	-0.1	-0.7
<i>GDP (% change from baseline)</i>					
World	0.0	0.8	1.4	0.3	-0.5
High income	0.0	0.8	1.4	0.4	-0.5
Low and middle income	0.0	1.0	1.4	-0.1	-0.7
<i>Inflation (change in inflation rate)</i>					
World	0.0	0.2	0.6	0.6	0.1
High income	0.0	0.2	0.8	0.8	0.2
Low and middle income	0.0	0.1	-0.2	-0.5	-0.3

Source: World Bank.

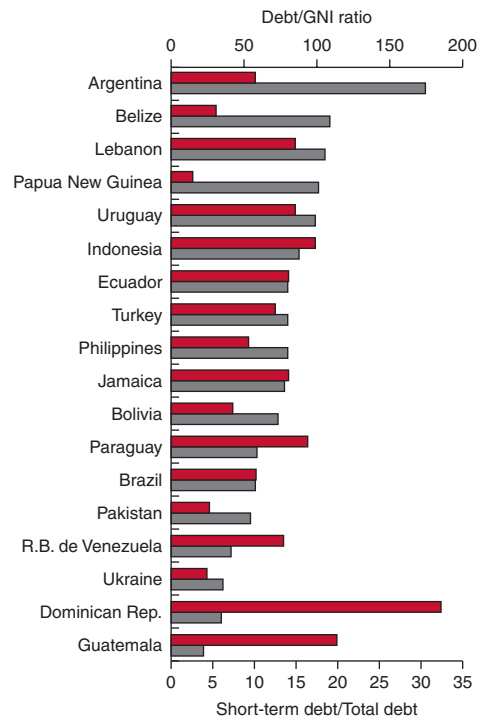
about rising debt and pension liabilities in industrialized countries, and a more rapid dissipation of the temporary factors depressing long-term interest rates, causes them to increase by some 200 basis points in high-income countries. Risk premia in developing economies increase by an additional 200 basis points as investors' appetites for risk decline.

The world economy reacts to the substantial tightening of monetary conditions by reducing global growth by half for a period of two years, as higher interest rates cut into investment and consumption demand, both through classic transmission mechanisms and via the impact of interest rates on housing

prices and consumer wealth. Slower growth eases inflationary pressure and global tensions, including in the oil market. As monetary policy loosens in response to increasing output gaps, growth starts to pick up again, bringing output back to the levels in the baseline by the end of the simulation period.

Higher interest rates would also affect financing conditions for developing countries by increasing future borrowing costs. For many countries this will not pose a serious short-term risk, because they have taken advantage of low rates to reduce the share of short-term debt relative to their overall debt and to prefinance some of their future borrowing needs. For others, particularly those with large debt-to-GDP ratios or those that have accumulated large short-term debt positions (figure 1.16), a rapid rise in interest rates

**Figure 1.16 Some countries are particularly at risk**



Source: World Bank.

could pose a real threat—particularly if the rise in base interest rates also provokes a return of spreads to more usual levels.

Alternatively, if excess liquidity and global savings prevent long-term interest rates from rising as quickly as in the baseline scenario, the resulting higher levels of demand could increase tensions in commodity markets, including the oil market. In addition, lower interest rates could cause a number of economies, including the United States, to overheat, generating additional inflation that forces a further tightening of monetary policy. As a result, while growth would be initially higher, the subsequent tightening of policy could provoke a stronger-than-projected slowdown.

The depth of the cycle would depend importantly on the extent of the wealth effect generated by low interest rates on housing prices. The more pronounced, the deeper the cycle. Moreover, because asset prices become even more out of step with their long-run levels, an even longer period of slow growth could be required to re-establish equilibrium.

### *Policy challenges*

Policy can help reduce both the economic severity of such unfavorable outturns and the likelihood that they will materialize.

High oil prices will naturally induce substitution toward alternative energy sources and conservation. In the current context, where the increase in oil prices is expected to endure, countries that have not passed on recent price hikes to consumers (and industry) may wish to revise their policies. Not only are the budgetary costs of such subsidies likely to be difficult to support, but these policies also impede adjustment.

Moreover, countries with restrictive rules concerning the exploitation of oil reserves might wish to re-examine them. Such policies may deny these countries access to technical expertise and financial capital, thereby preventing them from investing in new production to the extent that they might otherwise. This may slow the aggregate supply response and encourage greater conservation and sub-

stitution toward alternative energy sources—to the ultimate detriment of oil-producing countries.

In the developed world, efforts to increase energy efficiency by developing more fuel-efficient technologies, such as hybrid cars, could well pay important dividends. These technologies are already economic in some countries, where gasoline is heavily taxed, and could generate substantial savings in overall fuel demand.<sup>23</sup> In addition to the ecological benefits, making such technology available in developing economies, where the increase in transportation-related energy demand is highest, would be particularly effective in limiting overall demand.

Finally, efforts to improve cooperation between users and suppliers concerning the quality and transparency of oil market data could help reduce unwarranted volatility and perhaps contribute to lower prices by reducing the oil-price risk premia.

To further dissipate the risk from global imbalances, policies need to promote both public and private savings in countries with large current account deficits. Recent measures to tighten fiscal policy in the United States are headed in this direction, but more tightening is required. Tighter monetary policy is helping. Higher interest rates in the United States promote private sector financing of the deficit but also promote private sector saving. In Europe, policymakers should seek to maintain low interest rates in an effort to stimulate demand. As output picks up, fiscal policy (rather than monetary policy) should be used to restrict demand, if necessary. Indeed, given unfunded public pension liabilities in these countries, such a fiscal tightening is necessary in its own right.

Developing economies should react flexibly, seeking to maintain real effective exchange rates in line with their fundamentals, rather than a particular alignment with any one currency. In this regard, recent steps by some countries to adopt an exchange rate regime that reflects their overall trade patterns are positive and could be emulated by other

countries. Petro-dollars could help reduce the likelihood of a disruptive resolution of global imbalances if they are recycled into the global economy in a way that reduces tensions. In particular, the financing of investment expenditures both domestically and in other developing countries would help stimulate demand outside of the United States, reducing that country's current account deficit. To the extent that these funds are invested in U.S. financial securities, they could also help finance the U.S. current account deficit.

Finally, global weakness could trigger increased protectionism or a slowing of trade liberalization (which has been the basis for much of developing countries' recent success). The supply disruptions in Europe provoked by the re-imposition of quotas on Chinese imports of textiles, following their liberalization at the beginning of this year, is a good illustration of how trade restrictions work to the detriment of both exporting and importing countries. Not only should countries resist the temptation to intervene in already liberalized domains, concerted efforts need to be made to achieve meaningful liberalization in the agricultural and service sectors in the Doha process. To date, liberalization has largely omitted the politically sensitive agricultural sector, depriving many developing countries of the benefits from trade liberalization that more manufacturing-oriented economies have enjoyed.

## Notes

1. The Congressional Budget Office (2005) estimates that hurricane Katrina reduced growth in the United States by 0.4 and 0.9 percent (annual rates) in the third and fourth quarters.

2. The importance of China to aggregate statistics is also visible in the industrial production data. Growth rates for all developing countries showed little slowing, but excluding China, annualized growth rates declined from about 7.5 percent in mid 2004 to less than 5 percent a year later.

3. Although oil prices are projected to decline during 2006, they will be higher, on average, than in 2005.

4. The number of working days each year varies, generally because certain holidays do or do not fall on

weekends. Occasionally, these fluctuations can have an important impact on annual GDP growth. While five fewer days corresponds to roughly a 2.5 percent reduction in working time, in general, the actual reduction in production is less pronounced.

5. These losses are estimated at more than 5 percent of GDP for Antigua and Barbuda, Belize, Guyana, Honduras, Nicaragua, and Jamaica.

6. This year's projections differ somewhat from 2004's partly because of a shift in the base year for calculations from 2001 to 2002, which reduces the poverty level of the starting year in all regions that have experienced positive per capita growth. In addition, new survey data was employed for a large number of countries (more than half in the Europe and Central Asia region), including important new household surveys in a number of Latin American countries in the place of labor force survey data used in the past. Finally, revisions to national income estimates of GDP, inflation, and consumption play a role. For more information concerning the changes to the poverty forecast, please visit the Long-term Prospects and Poverty Forecasts section of <http://www.worldbank.org/globaloutlook>.

7. The extent to which the new regime will contribute to increased stability in world markets will also depend on the extent to which other Asian currencies follow suit, and how much flexibility is permitted in practice.

8. As of August 2005, overall financing for emerging market sovereign debt was already 74 percent funded; this share reached 93 percent for emerging Europe and Turkey, and 100 percent for Latin America.

9. Long-term interest rates tend to be determined by the long-term growth potential of the economy and expected inflation. Historically, temporary factors have caused them to deviate from this measure, sometimes for extended periods of time. However, they have always tended to return to this level.

10. In the first half of 2005, producer price inflation exceeded 15 percent in the Europe and Central Asia region, was more than 9 percent in Latin America and the Caribbean, about 7 percent in the Middle East and North Africa, and around 6 percent in both East and South Asia.

11. The stock of housing in the United States is estimated by the Federal Reserve Bank to be equal to \$15.2 trillion, or about 138 percent of GDP. A 10 percent change in the value of that stock would represent 13.8 percent of GDP, or 19 percent of consumption. Econometric estimates suggest that the long-term marginal propensity to consume from housing wealth is 0.05 (see, for example Catte and others 2004 and Benjamin, Chinloy, and Jud 2004), implying a reduction in consumption of 1.35 percent.

12. Very few low- and middle-income countries have housing data similar to the data available in high-income countries; and what does exist tends to be limited to wealthy neighborhoods in single cities. Moreover, there is little information on home ownership ratios, and mortgage-market completeness—all critical components in determining housing-market wealth effects.

13. The U.S. Department of Energy estimates that both oil and gasoline consumption fell by 2.5 or more percent in September 2005.

14. In the second quarter, stocks equaled 54 days worth of consumption versus an average of more than 58 days during the first half of the 1990s.

15. Some oil fields can be brought into production within 1 year, but others would take as long as 10 years. Three to five years would be needed to bring in two million barrels per day over and above expected increases in demand.

16. Opportunities for demand substitution may be less plentiful than in the 1970s because of the substantial conservation steps undertaken then. Nevertheless, use of fuel-efficient cars and less intensive use of existing cars can have substantial impacts on overall demand.

17. Simple average of 32 oil-importing Sub-Saharan economies.

18. Among countries that did not pass prices through fully, fuel subsidy spending rose substantially, for instance in the Central African Republic, Guinea Bissau, Malawi, and the Seychelles.

19. In 2003, high-tech products represented 13 percent of Thailand's exports, but more than 50 percent of Taiwanese, Malaysian, and Philippine exports.

20. China here is taken as the sum of Hong Kong, Macao, and China, based on the assumption that prior to liberalization some of the exports from Hong Kong and Macao had actually originated in China, and therefore, the changes in their market share reported in official statistics are exaggerated.

21. During the 1980s (and before), OPEC acted as a swing producer, stepping up production in response to shortfalls elsewhere. With its spare capacity now measured at less than 2 million barrels per day, its capacity to act as a swing producer is limited.

22. Beccue and Huntington (2005) estimate that the probability of such a disruption occurring during the next 10 years is high (70 percent for one lasting 6 months and 35 percent for one of 18 months).

23. In the United States, for example, hybrid cars currently offer approximately an 80 percent improvement in fuel efficiency. Were these vehicles to gain a 10 percent share of new car sales, new energy demand would be reduced by about 12 percent (c. 0.3 percentage points) per year for about seven years.

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