Global Economic Prospects

Overview and Global Outlook

2006

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Contents

Tables

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Overview

THE THEMES OF this year's *Global Economic Prospects* are international remittances and migration, their economic consequences, and how policies can increase their role in reducing poverty. International migration can generate substantial welfare gains for migrants and their families and for the countries involved (countries of origin and destination). The money that migrants send home—remittances—is an important source of extra income for migrants' families and for developing countries: in aggregate, remittances are more than twice as the size of international aid flows. However, migration should not be viewed as a substitute for economic development in the origin country—development ultimately depends on sound *domestic* economic policies.

Over the past two decades, barriers to cross-border trade and financial transactions have fallen significantly, while barriers to the cross-border movement of people remain high. Despite its economic benefits, migration remains controversial and, for some people, threatening. In part, this is because migration, like trade and capital movements, has distributional consequences, whereby net gains for society may mask important losses for some individuals and groups. But migration also sparks resistance because the movement of people has economic, psychological, social, and political implications that the movement of goods or money do not.

This publication has two goals. The first is to explore the gains and losses from international migration from the perspective of developing countries, with special attention to the money that migrants send home. The second goal is to consider policy initiatives that could improve the developmental impact of migration, again with particular attention to remittances. Our focus (for economic purposes) is on international migration from developing countries to high-income countries. Despite their importance, internal migration, migration among developing countries, and the political and social impacts of migration are beyond the scope of this work.

It is important to keep in mind three basic principles. First, migration is a diverse phenomenon, and its economic impact in one location or another depends heavily on the particular circumstances involved. Second, basic data on migration and remittances are lacking, so predicting the impact of policy changes can be problematic. This underlines the need for better data and more research. Third, migration has social and political implications that may be just as important as the economic analysis provided here. These are ably and comprehensively discussed in the recent report of the United Nations' Global Commission on International Migration. For all of these reasons, the analysis and policy recommendations for migration must remain qualified. This report draws conclusions where they can be supported by adequate data and points to an agenda for research where they cannot.

Global economic prospects

The slowdown among industrial economies that began in the second half of 2004 continued in 2005, with GDP growth expected to come in at 2.5 percent, down from 3.1 percent the year before. The pace of the expansion in the high-income countries is forecast to increase slightly over the next two years, with acceleration in Europe offsetting a modest slowing in Japan and stable growth in the United States. Economic activity also slowed in developing economies during 2005. Higher oil prices, domestic capacity constraints, and slower demand for their exports brought GDP growth down from a very strong 6.8 percent in 2004 to an estimated 5.9 percent this year. While GDP growth has remained robust, higher oil prices have sharply slowed real income growth among oil importers from 6.4 to 3.7 percent. Looking forward, continued high oil prices, coupled with inflationary pressures, are expected to restrain growth in most developing countries over the next two years. Nevertheless, GDP in these economies should expand by around 5.5 percent—much more quickly than during the past two decades.

This relatively positive outlook is subject to important downside risks. The outlook for oil prices is particularly uncertain. Low excess capacity has introduced a risk premium into oil prices and will make it more difficult to contain the impact of a future supply shock, should one arise. As a result, a significant supply disruption could slow global growth, with large negative consequences for global economic prospects. The future path of interest rates, which despite recent increases are still low, is another source of uncertainty. Persistent global imbalances, signs of rising inflation, and concerns about the sustainability of government finances in industrialized countries are all factors that could push rates higher and possibly provoke a much more serious slowdown.

The impact of remittances and migration

The impact on migrants

The bulk of the economic gains from migration accrue to migrants and their families, and these gains are often large. Wage levels (adjusted for purchasing power) in high-income countries are approximately five times those of low-income countries for similar occupations, generating an enormous incentive to emigrate. Moreover, to the extent that migrants devote a portion of their income to remittances, the gains are even greater. Essentially migrants can earn salaries that reflect industrial-country prices and spend the money in developing countries, where the prices of nontraded goods are much lower. Migrants, however, incur substantial costs, including psychological costs, and immigrants (particularly irregular migrants) sometimes run high risks; many suffer from exploitation and abuse. The decision to migrate is often made with inaccurate information. Given the high costs of migration—including the risks of exploitation and the exorbitant fees paid to traffickers—the net benefit in some cases may be low or even negative. There are costs, too, for family members left behind—particularly children—although these costs must be balanced against the benefits of the extra income that migrants send back home to their families.

The impact on destination countries

Destination countries can enjoy significant economic gains from migration. The increased availability of labor boosts returns to capital and reduces the cost of production. A model-based simulation performed for this study indicates that a rise in migration from developing countries sufficient to raise the labor force of high-income countries by 3 percent could boost incomes *of natives* in high-income countries by 0.4 percent. In addition, high-income countries may benefit from increased labor-market flexibility, an increased labor force due to lower prices for services such as child care, and perhaps economies of scale and increased diversity.

Nevertheless, there are losers within destination countries. Some workers may see an erosion of wages or employment, although this effect is found to be small in most empirical studies. In the model-based simulation of the impact of increased migration, earlier migrants suffer significant income losses, while the impact on natives' wages is small. (The differential impact is reduced if foreign-born workers are viewed as closer substitutes for natives.) Easing rules that limit labor-market flexibility, and strengthening institutions that provide education and training, will help workers displaced by immigration (both natives and resident migrants) to find work. Note that the simulation results are not intended to incorporate all of the economic impacts of migration, nor do they capture important social and political implications. The goal is not to forecast the overall impact of increased migration, but rather to give us insights into the economic gains that might be expected from changes in policy or circumstances, as well as insights into the channels through which migration affects welfare.

The impact on origin countries

Migration also generates economic benefits for origin countries, the largest being remittances. International remittances received by developing countries—expected to reach $167 billion in 2005—have doubled in the past five years as a result of (a) the increased scrutiny of flows since the terrorist attacks of September 2001, (b) changes in the industry that support remittances (lower costs, expanding networks), (c) improvements in data recording, (d) the depreciation of the dollar (which raises the dollar value of remittances denominated in other currencies), and (e) growth in the migrant stock and incomes. However, records still underestimate the full scale of remittances, because payments made through informal, unrecorded channels are not captured. Econometric analysis and available household surveys suggest that unrecorded flows through informal channels may conservatively add 50 percent (or more) of recorded flows. Several countries with significant migrant populations do not report data on remittances at all, even those sent through formal channels, or they report remittances under other balance of payments entries.

Despite the prominence given to remittances from developed countries, South-South remittance flows make up between 30 and 45 percent of total remittances received by developing countries, reflecting the fact that over half of migrants from developing countries migrate to other developing countries.

While the impact of remittances on growth is unclear, remittances do play an important role in reducing the incidence and severity of poverty (with no significant effect on income inequality). Remittances directly increase the income of the recipient and can help smooth household consumption, especially in response to adverse events, such as crop failure or a health crisis. In addition to bringing the direct benefit of higher wages earned abroad, migration helps households diversify their sources of income (and thus reduce their vulnerability to risks) while providing a much needed source of savings and capital for investment. Remittances appear to be associated with increased household investments in education, entrepreneurship, and health—all of which have a high social return in most circumstances.

Measuring the poverty impact of remittances is difficult: data are scarce, and calculating the income gains from remittances requires assumptions concerning what migrants would have earned if they had stayed at home. Careful analyses of the available household survey data indicate that remittances have been associated with declines in the poverty headcount ratio in several low-income countries—by 11 percentage points in Uganda, 6 in Bangladesh, and 5 in Ghana, for example. In Guatemala, remittances may have reduced the severity of poverty by 20 percent. Cross-country regressions and simulations also indicate that increases in remittances help to reduce the incidence of poverty.

By generating a steady stream of foreign exchange earnings, remittances can improve a country's creditworthiness for external borrowing and, through innovative financing mechanisms (such as securitization of remittance flows), they can expand access to capital and lower borrowing costs. While large and sustained remittance inflows can contribute to currency appreciation, this outcome may be less severe than it is in the case of natural resource earnings, because remittances are distributed more widely and may avoid exacerbating strains on institutional capacity that are often associated with natural resource booms.

Migration has economic implications for origin countries beyond remittances. The small size of migration flows relative to the labor force suggests that the effects of South–North migration on working conditions for low-skilled workers in the developing world as a whole must be small as well. However, in some countries low-skilled emigration can raise demand for the remaining low-skilled workers (including poor workers) at the margin, leading to some combination of higher wages, lower unemployment, less underemployment, and greater labor force participation. Thus low-skilled emigration can offer a valuable safety valve for insufficient employment at home. In the long run, however, developing country policies should aim to generate adequate employment and rapid growth, rather than relying on migration as an alternative to development opportunities.

High-skilled emigration has more complex implications. Like low-skilled migration, it can greatly benefit migrants and their families and help relieve labor market pressures. However, a well-educated diaspora can improve access to capital, technology, information, foreign exchange, and business contacts for firms in the country of origin. The return of expatriates and the maintenance of close contacts with high-skilled emigrants have played an important role in the transfer of knowledge to origin countries. At the same time, large outflows of high-skilled workers can reduce growth in the origin country for these reasons: (a) the productivity of colleagues, employees, and other workers may suffer because they lose the opportunity for training and mutually beneficial exchanges of ideas; (b) the provision of key public services with positive externalities, such as education and health (particularly for the control of transmissible diseases), may be impaired; (c) opportunities to achieve economies of scale in skill-intensive activities may be reduced; (d) society loses its return on high-skilled workers trained at public expense; and (e) the price of technical services may rise. Highly educated citizens, if they stayed in their countries, could help to improve governance, improve the quality of debate on public issues, encourage education of children, and strengthen the administrative capacity of the state—contributions that would be lost through high-skilled emigration.

It is impossible to reliably estimate the net benefit, or cost, to origin countries of high-skilled emigration because data are limited and a myriad of individual country circumstances enter into the calculus of that benefit or loss. We can only offer two rough observations, which reflect the wide variation in high-skilled emigration rates among countries:

- Very high rates of high-skilled emigration are found in countries that represent a small share of the population of the developing world. Many of those countries have poor investment climates that likely limit the productive employment of high-skilled workers. Of course, the loss of high-skilled workers may aggravate the poor investment climate and limit the potential benefits of economic reform.
- Some countries find it difficult to provide productive employment for many high-skilled workers because of their small economic scale or because misguided educational policies have resulted in a large supply of university graduates for whom no suitable jobs exist.

Policies to improve the developmental impact of remittances and migration

Migration policies

Greater emigration of low-skilled emigrants from developing to industrial countries could make a significant contribution to poverty reduction. The most feasible means of increasing such emigration would be to promote managed migration programs between origin and destination countries that combine temporary migration of low-skilled workers with incentives for return. Temporary programs have several advantages, and some disadvantages, relative to permanent migration. From the perspective of the destination country, managed, temporary migration programs ease social tensions by limiting permanent settlement; they limit the potential burden on public expenditures because immigrants are guaranteed a job and are less likely to bring dependents; and they allow for controlled variation of the number of immigrants in response to changes in labor-market conditions, thus limiting adverse effects on low-skilled native workers. However, temporary migration can be less efficient than permanent migration for firms in destination countries because of high training costs. From the origin-country perspective, managed, temporary migration may be the only means of securing deliberate increases in low-skilled emigration and may raise remittances and improve the skills of returning workers. On the other hand, managed migration programs do not guarantee future access to labor markets (and thus to remittances), because it is easier for destination countries to suspend temporary programs than to expel immigrants. Overall, however, such programs do represent a feasible approach to capturing the efficiency gains from labor migration.

Origin countries that are adversely affected by high-skilled emigration face challenges in managing it better. Service requirements for access to publicly financed education can be evaded and are likely to discourage return; and proposals for the taxation of emigrants to the benefit of the origin country have made little progress. Origin countries can help to retain key workers by improving working conditions in public employment and by investing in research and development. Origin countries can also take steps to encourage educated emigrants to return by identifying job opportunities for them, cooperating with destination countries that have programs to promote return, permitting dual nationality, and helping to facilitate the portability of social insurance benefits.

By providing authoritative information on migration opportunities and risks, governments could help avoid unfortunate, costly-to-reverse migration decisions and limit the abuse of vulnerable migrants. Labor recruiters can play a valuable role in promoting migration, but emigrants' lack of information often enables recruiters to capture the lion's share of the rents generated by constraints on immigration and imperfect information. Origin countries with effective public sector institutions might consider the regulation of recruitment agents to limit rents and improve transparency.

Remittance policies

Governments in destination and origin countries can sharpen the developmental impact of remittances through the application of appropriate policies. Access of poor migrants and their families to formal financial services for sending and receiving remittances could be improved through public policies that encourage expansion of banking networks, allow domestic banks from origin countries to operate overseas, provide identification cards to migrants, and facilitate the participation of microfinance institutions and credit unions in providing low-cost remittance services. Remittances, in turn, can be used to support financial products—housing and consumer loans and insurance—for poor people.

A second set of promising policies could improve competition in the remittance transfer market and thereby lower fees. The price of remittance transactions is often unnecessarily high for the small transfers typically made by poor migrants. The *cost* of such transactions is often well below the fees paid by customers. Reducing transaction charges increases the disposable income of poor migrants and increases their incentives to remit, because the net receipts of recipients increase. The overall result would be stronger remittance flows to developing countries.

Competition among providers of remittance services could be increased by lowering capital requirements on remittance services and opening up postal, banking, and retail networks to nonexclusive partnerships with remittance agencies. Disseminating data on remittance fees in important remittance corridors and establishing a voluntary code of conduct for delivering fair-value transfers would improve transparency and reduce prices for remittance transactions. Governments could help reduce costs by supporting the introduction of modern technology in payment systems. Alleviating liquidity constraints by providing a credit line either to the sender or the recipient, based on past remittance activity, would enable senders to take advantage of the lower fee rates available only for larger remittances. Reducing exchange-rate distortions could also lower the cost of remittance transactions. Finally, regulatory regimes need to strike a better balance between preventing financial abuse and facilitating the flow of funds through formal channels.

Several origin countries have attempted to improve the developmental impact of remittances by introducing incentives to increase flows and to channel them to more productive uses. Such policies are more problematic than efforts to expand access to financial services or reduce transaction costs, because they pose clear risks. Tax incentives to attract remittance inflows, for example, may also encourage tax evasion, while matching-fund programs to attract remittances from migrant associations may divert funds from other local funding priorities. Efforts to channel remittances to investment, meanwhile, have met with little success. Fundamentally, remittances are private funds that should be treated like other sources of household income. Efforts to increase savings and improve the allocation of expenditures should be accomplished through improvements in the overall investment climate, rather than by targeting remittances. Similarly, because remittances are private funds, they should not be viewed as a substitute for official development aid.

Organization of this study

As is customary in this report, chapter 1 reviews recent developments in and prospects for the global economy and their implications for developing countries. Chapter 2 uses a model-based simulation to evaluate the potential global welfare gains and distributional impact from a hypothetical increase of 3 percent in high-income countries' labor force caused by migration from developing countries. Chapter 3 surveys the economic literature on the benefits and costs of migration for migrants and their countries of origin, focusing on economically motivated migration from developing to high-income countries. We then turn to remittances, the main theme of the report. Chapter 4 investigates the size of remittance flows to developing countries, the use of formal and informal channels, the role of government policies in improving the development impact of remittances, and, for certain countries, their macroeconomic impact. Chapter 5 addresses the impact of remittances at the household level, in particular their role in reducing poverty, smoothing consumption, providing working capital for small-scale enterprises, and increasing household expenditures in areas considered to have a high social value. The last chapter investigates policy measures that could lower the cost of remittance transactions for poor households and measures to strengthen the financial infrastructure supporting remittances.

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, policymakers 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.

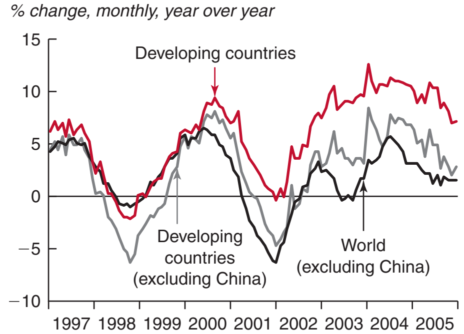
Global growth

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[1] slowed growth in the United States to

Figure 1.1 Industrial production



Source: World Bank.

Table 1.1 The global outlook in summary

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

	2003	2004	2005e	2006f	2007f
Global Conditions					
World trade volume	5.9	10.2	6.2	7.0	7.3
Consumer prices					
G-7 countries[a,b]	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)[c]	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[d]	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
Real GDP growth[e]					
World	2.5	3.8	3.2	3.2	3.3
Memo item: world (PPP weights)[f]	3.9	5.0	4.4	4.3	4.4
High income	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
Developing countries in	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
Memorandum items					
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 macroeconomic 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.

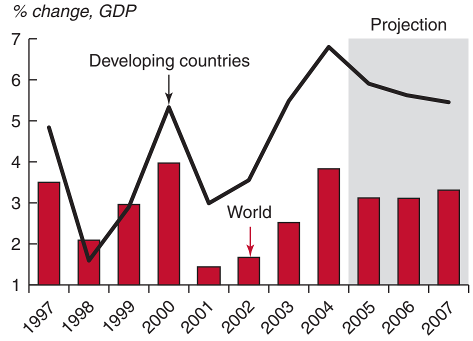
Looking forward, the increase in oil prices observed in 2005 is expected to slow global growth by about one quarter of a percentage point in 2006, compared with what it would have been had prices remained stable. In the United States, the pace of the expansion is projected to remain broadly stable, because 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.[2] 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.

Figure 1.2 A sharp slowdown



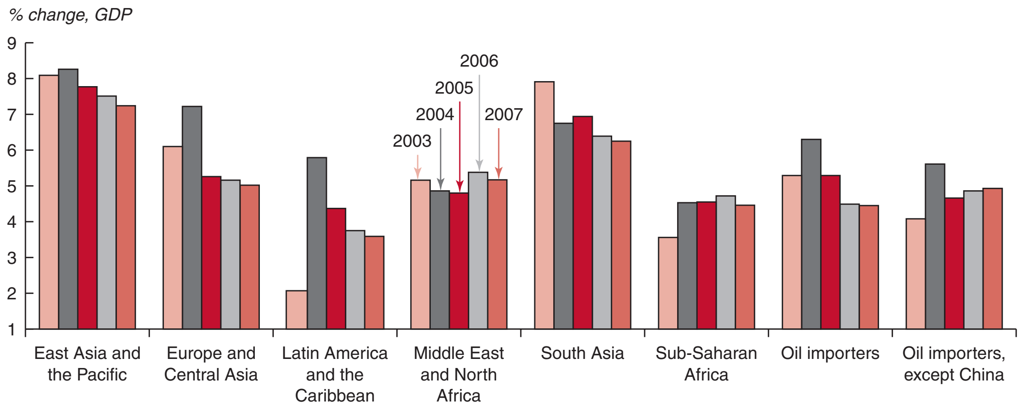
Source: World Bank.

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

Figure 1.3 Regional growth



Source: World Bank.

producer prices, and a deterioration of current account balances.

Even higher oil prices on average in 2006,[3] 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.[4] 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.[5] 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

			Forecast	
	1980s	1990s	Medium-term 2001–06	Long-term 2006–15
World Total	1.3	1.2	1.5	2.1
High-income countries	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
Developing economies	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.[6]

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

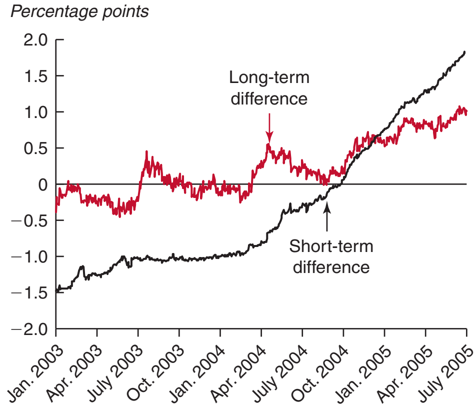
	Millions of people living on					
	less than $1 per day			less than $2 per day		
Region	1990	2002	2015	1990	2002	2015
East Asia and the Pacific	472	214	14	1,116	748	260
China	375	180	11	825	533	181
Rest of East Asia and the Pacific	97	34	2	292	215	78
Europe and Central Asia	2	10	4	23	76	39
Latin America 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

	Percent of population living on					
	less than $1 per day			less than $2 per day		
Region	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.

Figure 1.4 Dollar-euro interest rate differentials



Source: World Bank.

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).

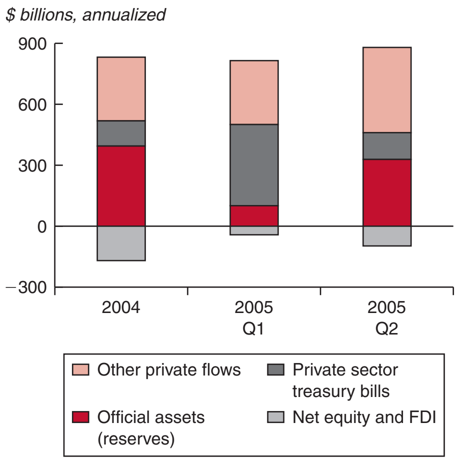
These growing interest rate differentials increased the financial incentive to hold dollar- versus euro-denominated assets, temporarily producing stronger net private sector capital inflows in the first quarter of 2005 as investors adjusted their portfolios. Not only did these inflows help strengthen 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.

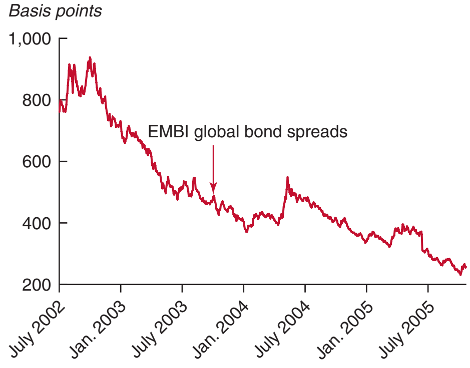
Until global imbalances are resolved, the dollar is likely to continue to come under

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



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

Figure 1.6 Emerging market spreads



Source: World Bank; Datastream.

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).

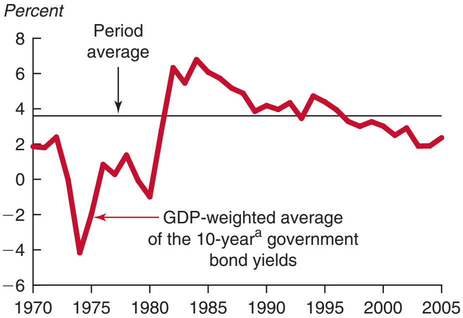
The recent decision of the Chinese and Malaysian authorities to move from an exchange rate regime linked to the dollar alone to one focusing on a basket of currencies represents a major and welcome move toward a more flexible currency regime. While it will not resolve current account imbalances, it should 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.[7] How effective the new regimes will be, depends importantly on how they are 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.[8]

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.

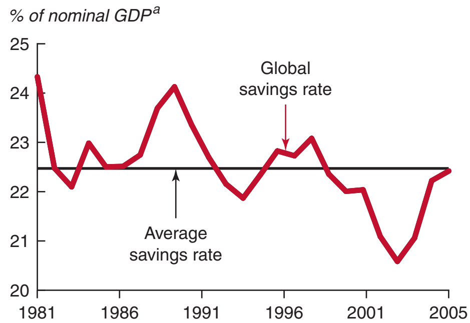
Figure 1.7 Real long-term interest rates in G-7 countries



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[9] (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.[10]

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.

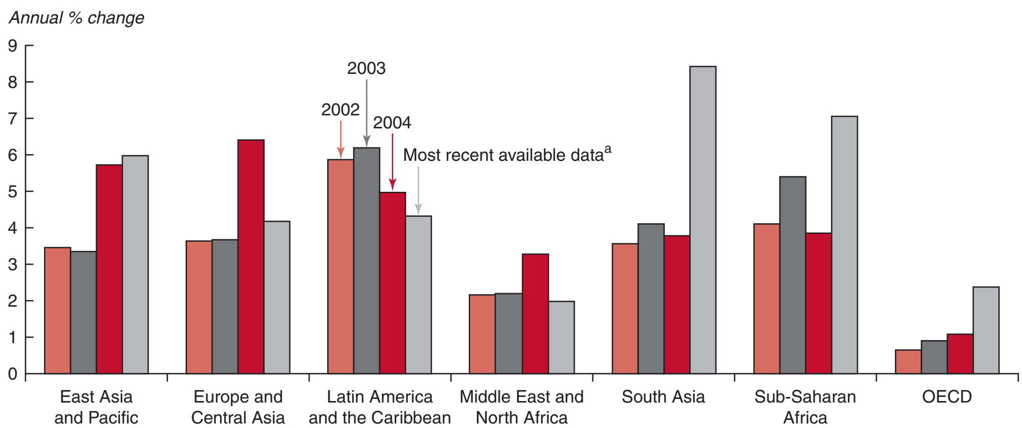
In high-income countries, there are only limited signs of rising inflation. In the United States, where output is close to potential, inflation has been rising steadily. It jumped to 4.7 percent in September 2005, but the increase is not expected to be permanent, because it reflects very high gasoline 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.[11]

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

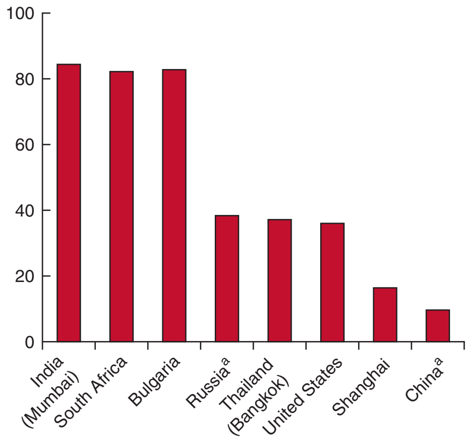
Figure 1.9 Inflation rates



Source: World Bank.

a. Data concern August 2005, except for East Asia (September), the Middle East and North Africa (June), and Sub-Saharan Africa (March).

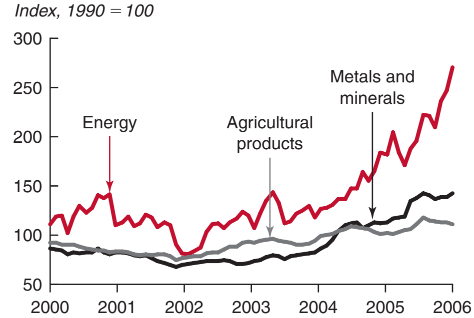
Figure 1.10 Cumulative real increase in housing prices, 2005



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.

Figure 1.11 Commodity prices



Source: World Bank.

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.[12]

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).

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.

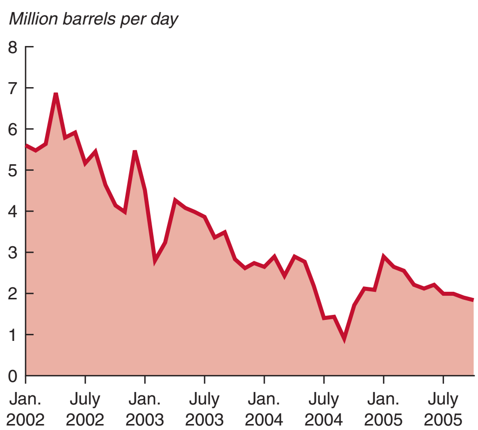
In line with the projected slowdown in global growth and increased supply, prices of agricultural products and metals and minerals are projected to decline somewhat in 2006.

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,[13] and inventories have begun to accumulate, although they remain low.[14]

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.

Figure 1.12 Levels of spare oil capacity



Source: World Bank.

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[15] and shorter lags before demand substitution can have an effect.[16] 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.[17] 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
Cumulative price change			
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
Total terms-of-trade effect (% of GDP)			
Oil Importers			
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.[18] 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.

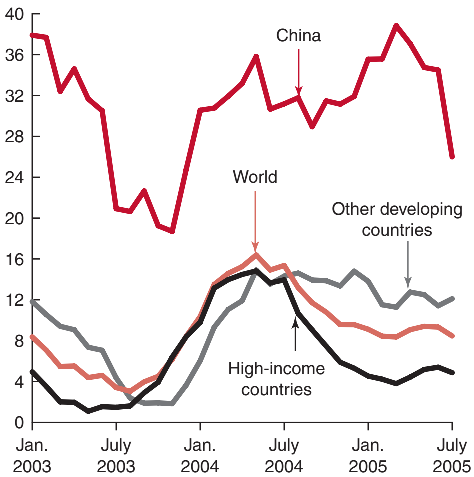
Drawing from this experience, the impact of the latest hike in oil prices on poor oil importers is a concern, principally because it has not been accompanied by as much strength in non-oil commodity prices. Indeed, the estimated terms-of-trade shock from price movements since January 2004 is more than 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.

Figure 1.13 World trade volumes

Annual growth rates, 6-month moving average



Source: World Bank.

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.

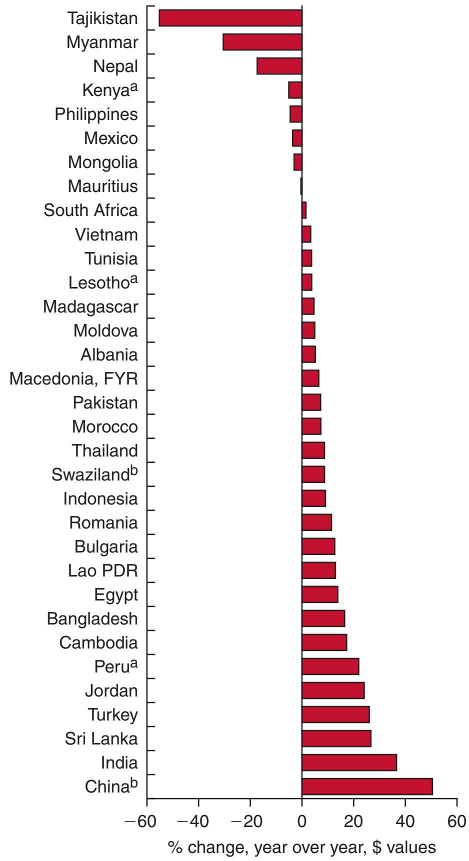
Commodity markets have significantly shaped developments in world trade. The merchandise exports of oil-exporting countries, which had been rising at some 5.8 percent in 2004, increased by an estimated 5.2 percent in 2005. The deceleration among developing oil importers (excluding China) was steeper 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).[19] 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 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

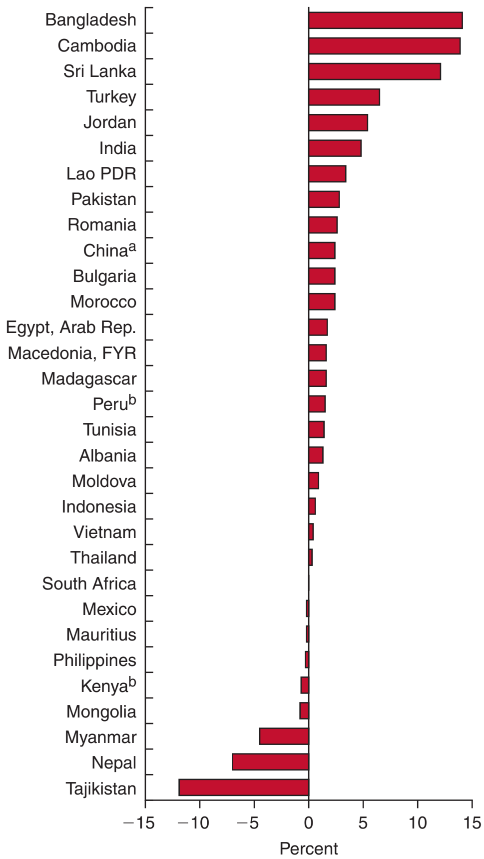
Figure 1.14 Change in textile exports to the developed world, first half of 2005



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.

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,[20] 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.[21]

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
Price of oil	90	70	44	40
(Change from base line)	34	28	3	0
Change in GDP % of baseline				
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
Impact on inflation rate				
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
Impact on real interest rates (levels)				
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
Impact on current account balance (% of GDP)				
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
Impacts on low-income current account–constrained countries (1)				
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.[22] 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
A. A 200 basis-point increase in interest rates and in spreads					
Interest rates (change of Q4 level from baseline)					
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
GDP (% change from baseline)					
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
Inflation (change in inflation rate)					
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. Persistently low interest rates					
Interest rates (change of Q4 level from baseline)					
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
GDP (% change from baseline)					
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
Inflation (change in inflation rate)					
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

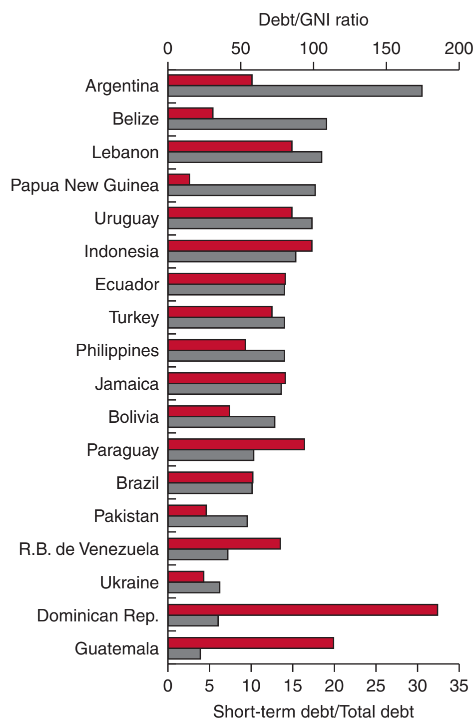
Source: World Bank.

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 substitution 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.[23] 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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Appendix
Regional Economic Prospects

East Asia and Pacific regional prospects

Recent developments

GDP in the East Asia and Pacific region increased about 7.8 percent in 2005, down from 8.3 percent the year before (table A.1). This robust growth at the aggregate level masks divergent performance among individual countries, with economic activity in China having grown 9.3 percent and countries in the rest of the region up a more moderate 5.1 percent.

Responding to administrative controls on investments, domestic demand in China slowed during the first half of 2005. However, GDP growth remained strong, because import demand increased by only 14 percent in dollar terms, while exports maintained their rapid growth of 29 percent. In the third quarter, domestic demand growth recovered. As a result, import growth picked up, which, combined with slower exports, reduced the contribution of net exports to growth. Nevertheless, net exports were responsible for more than one-third

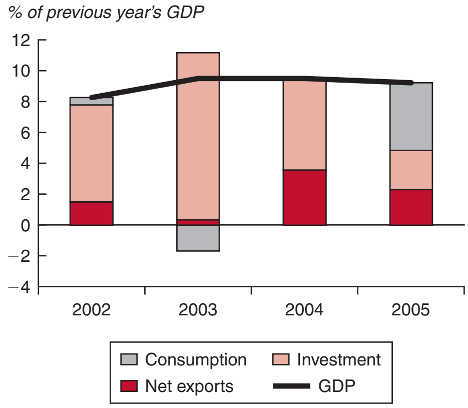
Table A.1 East Asia and Pacific forecast summary
Annual percent change (unless otherwise indicated)

					Estimate	Forecast		
	1991–2000[a]	2002	2003	2004	2005	2006	2007	2007–2015[a]
GDP at market prices (1995 US$)[b]	7.6	7.0	8.1	8.3	7.8	7.6	7.4	6.1
GDP per capita (units in US$)	6.6	6.0	7.2	7.3	7.0	6.8	6.5	5.3
PPP GDP[c]	8.2	7.4	8.6	8.7	8.4	8.0	7.7	
Private consumption	6.7	5.4	6.0	7.2	5.1	6.4	6.3	
Public consumption	7.7	7.4	5.5	6.0	1.5	4.1	3.6	
Fixed investment	8.8	13.5	16.3	7.2	6.7	12.0	10.2	
Exports, GNFS[d]	10.7	14.8	17.4	20.5	16.6	11.6	11.0	
Imports, GNFS[d]	10.1	15.9	16.9	19.0	12.1	13.4	11.8	
Net exports, contribution to growth	0.3	0.2	0.8	1.4	2.7	0.0	0.4	
Current account balance/GDP (%)	0.8	3.5	3.5	3.9	4.8	4.7	4.0	
GDP deflator (median, LCU)	5.9	4.1	3.2	4.4	5.2	4.3	4.3	
Fiscal balance/GDP (%)	−1.4	−3.3	−2.6	−1.7	−1.5	−1.2	−0.9	
Memorandum items: GDP								
East Asia, excluding China	4.2	4.8	5.6	6.0	5.1	5.5	5.7	

Source: World Bank.

Notes: a. Growth rates over intervals are compound averages; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 1995 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services.

Figure A.1 Contributions to China's growth



Source: World Bank.

of total growth in 2005 (figure A.1), and the current account surplus is expected to reach more than 6 percent of GDP, or about $120 billion.

A slowdown in global demand for high-tech products and the more moderate expansion in demand from China had major impacts on other East Asian developing economies. Chinese import growth (in dollar terms) from these economies fell from 35–40 percent, to about 15 percent in the first half of 2005, yielding a substantial reduction in the contribution of net exports to growth.

Higher oil prices also played a role in the slowdown in regional domestic demand and contributed to more than a 3 percent of GDP deterioration in the current account balance of regional oil importers (excluding China). High oil prices generated cumulative terms-of-trade losses of 1–2 percent of East Asian GDP in 2004–5, or approximately 0.5–1 percent a year. Several oil importers (Cambodia, Korea, Lao PDR, Philippines, and Thailand) experienced more significant losses of between 1.5–2 percent of GDP in each of the two years. The impacts on growth, while significant, were more muted than these first-order effects. Thailand, for example, estimates that high oil prices reduced its 2005 growth by half a percentage point.

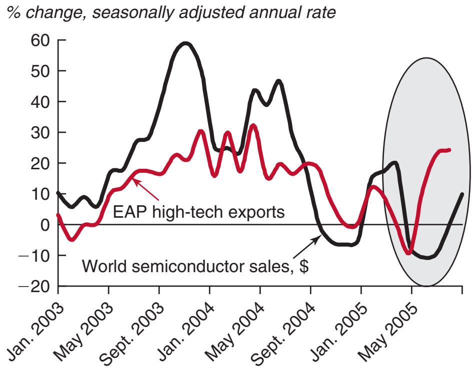
Consumer and business confidence in the region have generally held up. While central banks have gradually tightened monetary policy, interest rates in real terms remain low by historical standards. Private consumption and investment growth did not slow as sharply as during previous oil price shocks. In part, this reflects government interventions that limited the pass-through of higher oil prices via various forms of explicit and implicit subsidy. However, as the fiscal burden of these subsidies has increased, several governments have undertaken adjustments to bring domestic hydrocarbon prices in line with market prices. The most significant adjustment was made by Indonesia on September 30. Price increases ranged from 88 percent for gasoline to 186 percent for kerosene. A cash compensation program softened the impact on the poor.

Medium-term outlook

Growth in the region is projected to slow further over the next two years, with GDP expanding by about 7.4 percent in 2007. The pace of the Chinese expansion is projected to ease somewhat, as a result of both more rapid domestic demand and a return of export growth to more sustainable levels as the transitional boost to trade, reforms, and investment associated with accession to the World Trade Organization wears off. Within the rest of the region, economic activity is expected to strengthen somewhat. GDP should expand by about 5.7 percent in 2007, as a projected upturn in world demand for the region's exports, notably high-tech goods[1] (see figure A.2), partially offsets the dampening effect of high oil prices.

It is anticipated that high oil prices and strong import demand in China will result in a deterioration of the region's current account position from a 4.8 percent of GDP surplus this year to 4.0 percent in 2007. While high oil prices are projected to increase regional inflation to around 5.2 percent this year, prudent monetary policy and flexible markets should prevent an inflationary spiral from developing.

Figure A.2 Signs of a turnaround in global high-tech markets



Source: World Bank; Semiconductor Industries Assn (SIA), Haver and Datastream.

Risks and uncertainties

This relatively benign outlook is subject to significant risks. Further substantial oil price increases would likely pose a more significant drag on growth by depressing confidence and by inducing more substantial monetary tightening. Although East Asia's reliance on the United States as an export market has declined over the last decade, the dependence remains significant. A severe adjustment of global macroeconomic imbalances involving recession in the United States would have a serious impact on East Asian exports and growth.

China's economy is projected to continue growing strongly. However, the recent oscillations in investment demand and the large contribution of the external sector to growth this year raise some concerns about the sustainability of this high growth over the medium term. The resurgence of domestic demand, particularly consumer demand, contained in the baseline scenario may be difficult to achieve. Without it, given the already high levels of investment, a sharp cyclical downswing cannot be ruled out. Such a downswing would be painful, both for China and for its major trading partners in the region.

Longer-term prospects

Regional growth prospects for the next decade remain very favorable. Since the 1997 financial crisis, GDP has expanded 6.8 percent a year on average, and real per capita incomes have risen by more than 6 percent a year. While much of this strength reflects the very rapid growth in China (8.1 percent on average), the rest of the region also enjoyed robust per capita income growth of about 4.5 percent. Over the period 2006–15, regional per capita incomes are projected to continue rising rapidly, by about 5.3 percent a year in real terms.

While China is likely to see a rebalancing of aggregate demand from investment toward a greater reliance on consumption, there is scope for increasing investment rates in many other economies within the region. Here, structural reforms could improve the investment climate by increasing the transparency and predictability of government policies, simplifying business regulations, improving cost-effective delivery of infrastructure and logistics services, and strengthening institutions for upgrading worker skills. Financial market instruments, such as local government bonds, corporate debt, asset securitization, and venture capital funds, have seen strong growth since the crisis. These could be further fostered by reforms that strengthen market infrastructure, raise accounting and auditing standards, and rationalize the policy, legal, and regulatory frameworks for these types of markets. Ongoing efforts to strengthen insolvency laws and foreclosure practices remain particularly important. Reforms to strengthen public sector governance could significantly improve states' ability to deliver key public goods and services.

Europe and Central Asia regional prospects

Recent developments

GDP in the Europe and Central Asia region increased by an estimated 5.3 percent in 2005, close to trend growth, but was much slower

Table A.2 Europe and Central Asia forecast summary

Annual percent change (unless otherwise indicated)

					Estimate	Forecast		
	1991–2000[a]	2002	2003	2004	2005	2006	2007	2007–2015[a]
GDP at market prices (1995 US$)[b]	−1.1	4.7	6.1	7.2	5.3	5.2	5.0	3.5
GDP per capita (units in US$)	−0.4	4.8	6.2	7.3	5.3	5.2	5.1	3.6
PPP GDP[c]	−1.3	4.8	6.4	7.5	5.5	5.4	5.2	
Private consumption	0.4	5.9	6.5	8.4	6.8	6.3	6.2	
Public consumption	−0.5	2.5	2.4	2.2	2.9	3.0	2.9	
Fixed investment	−6.7	2.9	10.4	14.7	5.6	7.2	6.7	
Exports, GNFS[d]	3.9	8.1	11.5	13.5	9.3	9.5	8.8	
Imports, GNFS[d]	2.3	9.4	14.5	14.7	11.3	10.9	9.9	
Net exports, contribution to growth	0.6	−0.4	−1.1	−0.5	−1.0	−0.8	−0.7	
Current account balance/GDP (%)	−0.5	0.5	−0.1	0.8	1.8	1.4	1.0	
GDP deflator (median, LCU)	120.3	4.0	5.1	6.4	6.2	5.3	4.6	
Fiscal balance/GDP (%)	−2.6	−4.5	−4.2	−1.6	−0.2	−0.2	−0.2	
Memorandum items: GDP								
Transition countries	2.5	4.4	4.6	6.6	4.4	4.6	4.6	
Central and Eastern Europe	2.5	2.8	4.0	5.4	4.2	4.4	4.7	
Commonwealth of Independent States	−3.2	5.0	7.7	7.9	6.2	5.8	5.4	

Source: World Bank.

Notes: a. Growth rates over intervals are compound averages; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 1995 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services.

than in 2004, when it grew 7.2 percent (table A.2). The slowdown, which began in mid-2004, was most marked in the Ukraine and Turkey, where growth is estimated to have declined from unsustainably high rates of 12.1 and 8.9 percent, respectively, to still robust rates of 4.4 and 4.8 percent in 2005. Excluding these countries from the aggregate, the slowdown was more modest, from 6.6 to 5.4 percent. Two exceptions to the regionwide deceleration were Azerbaijan, where growth has been underpinned by a rapid rise in oil production, and the Czech Republic, where strong export volumes have more than offset sluggish demand conditions.

High oil prices, an easing of the investment boom associated with EU accession, and a return to more sustainable growth rates were among the most important reasons for the slowing of growth in oil importing countries. These factors contributed to a weakening in domestic demand that was most apparent in Poland, Turkey, and Ukraine. Unrest in Uzbekistan and the Kyrgyz Republic had an additional negative impact on confidence and growth in those countries. Overall, growth among oil importers (excluding Turkey and Ukraine) slowed from 5.7 to 4.4 percent.

Capacity constraints, and a less rapid increase in oil revenues, served to slow growth in regional oil exporters as well, where GDP increased 6.3 percent in 2005, down from 7.4 percent the year before. In Russia, slower investment in the oil sector compounded these effects; however, in aggregate, investment growth has strengthened, which, coupled with robust private consumption, has maintained demand growth at high levels, even as the expansion of exports and industrial production has eased.

In Turkey, weaker domestic demand was tied, in part, to higher taxes cutting into consumption spending and some dampening of confidence following the French and Dutch rejections of the proposed EU constitution early in the year. Since then, Turkey and Croatia have begun formal accession negotiations with the EU, which is expected to lift growth in the fourth quarter. Turkey has remained on track to meet IMF targets and is expected to complete its first review of the IMF's new stand-by facility by end-2005.

Overall, the regional current account surplus has widened to 1.8 percent of GDP in 2005, up from 0.8 percent in 2004. Higher revenues improved the current account position of oil exporters by some 2.7 percent of their GDP, while weaker domestic demand and import growth limited the deterioration of oil importers' current account balance to an estimated 0.4 percent of GDP. In Turkey, the current account deficit is expected to reach 6.1 percent of GDP this year, a level associated with past financial crises. However, in addition to oil imports, a significant proportion of the deficit reflects imports of investment goods (as opposed to consumption), which augurs better for the longer-term sustainability of the deficit.[2] While largely financed by strong FDI inflows, current account deficits remain very high in a number of countries across the region, including in Azerbaijan, Bosnia and Herzegovina, Bulgaria, Estonia, Georgia, Hungary, Latvia, Lithuania, FYR Macedonia, and Romania.

Inflationary pressures in the region are generally on the rise, driven by high oil prices, and in some cases by strong private consumption growth. In Russia, for instance, inflation was boosted by social spending (funded by high oil rents), and is expected to reach 10 percent by end-2005, well above the original target of 8.5 percent. In Turkey, inflation remained stable and on target, and, despite high oil prices, core inflation has continued declining. The upward trend in prices in many countries in the region was partially offset by a return to trend inflation rates in the new EU member states, following a jump in 2004 in base prices associated with their accession.

Overall, the stance of monetary policy remained stable. Some countries, such as Poland, responded to the weakening of growth by relaxing policy, while in others, such as Russia, rising inflation sparked a modest tightening of policy. Exchange rates also remained broadly stable, with those of the new member states generally following the euro. However, changes in current account positions were reflected in the movements of the Russian ruble (appreciation) and Turkish lira (depreciation).

Medium-term outlook

Regional growth is expected to stabilize over the next two years, slowing moderately to about 5.0 percent in 2007. Growth among oil importers is projected to accelerate from 4.5 percent to 4.7 percent, as oil prices ease, and the projected expansion in industrialized Europe takes hold. A stabilization and even fall of oil revenues, as prices ease, will slow the pace of growth among oil exporters from 6.3 percent to 5.5 percent. Moderately lower oil prices should also help improve the current account positions of oil importers and contribute to a deceleration of inflation in 2006 and 2007.

At the subregional level, growth among the economies of the Commonwealth of Independent States (CIS) is projected at 5.8 and 5.4 percent in 2006 and 2007, respectively. They will continue to outpace Central and Eastern European countries (including Turkey), where growth is forecast to expand by about 4.4 percent in 2006 and 4.7 percent in 2007. The circulation of oil rents via fiscal linkages is projected to stimulate strong private consumption in Russia, in particular, because there are significant pressures to tap into high oil rents. Growth in Azerbaijan and Kazakhstan will benefit from rapidly expanding oil production and export volumes. Neighboring countries, including Turkey, are expected to benefit from continued healthy import demand emanating from the region's oil-exporting economies, and some, such as Georgia, from a rise in revenues from oil transit fees.

Among the Central and Eastern European economies, continued strong investment inflows, especially for the new EU member states, are projected to support growth. These countries will also continue to benefit from increased market penetration into the EU, although this trend is likely to moderate as integration progresses. Similar forces and the benefits of accession-inspired reforms should bolster investment and GDP growth in Bulgaria, Croatia, and Romania, which may join the EU in 2007 or 2008. The overall outlook in Turkey remains healthy, and the country remains on track to meet IMF program targets. Fiscal consolidation and recent reforms have placed the country on a much stronger footing, although its current account deficit is expected to remain high.

Risks and uncertainties

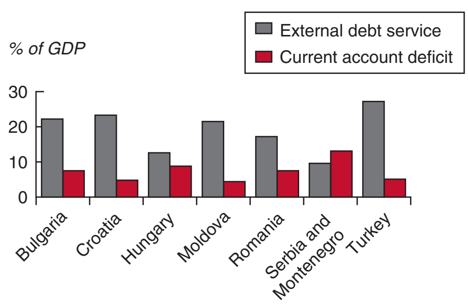
For the middle-income countries of the region, the most serious risk to this relatively benign outlook stems from the possibility that interest rates may rise much more rapidly than projected. Higher interest rates would slow the pace of investment growth and external demand, two major drivers of regional growth (figure A.3). In addition, for the highly indebted countries in the region, higher interest rates would exacerbate already high current account deficits as well as place governments' fiscal positions under strain. This is especially worrisome because fiscal policies in many countries are already under pressure from high social security and pension obligations.

For the less-developed, oil-importing economies, which tend to be more energy intensive, the possibility that oil prices may rise further could be the more serious risk. Estimates suggest that, for a number of countries,[3] a further $30 hike in oil prices could impose an additional terms-of-trade shock of between 2 and 8 percent of GDP, implying substantial disruptions in domestic demand and worrisome consequences for poverty alleviation efforts (figure A.4).

Hydrocarbon-exporting countries, such as Azerbaijan, Kazakhstan, and Russia, face policy challenges tied to their windfall oil revenues. They must ensure good governance of these revenues and diversify their economic activity so that they can reduce their dependence on extractive industries.

An additional risk is that less supportive economic conditions could strain fragile political institutions in some Central Asian states, leading to significant economic disruption.

Figure A.3 External positions could come under pressure with rising interest rates



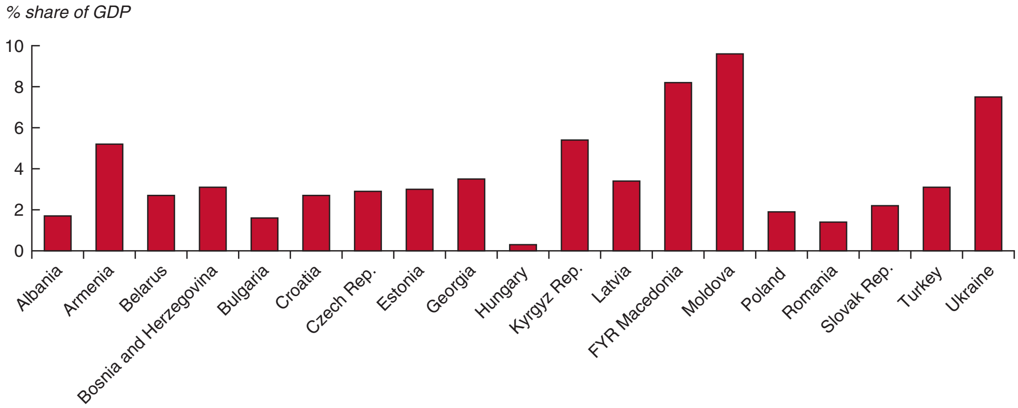
Source: World Bank.
Note: Data are for 2004.

Longer-term prospects

GDP in the Central and Eastern European countries over the next 15 years is projected to expand much more quickly than during the first 10 years of transition. Growth should continue to be led by high investment rates (both foreign and domestic), rising intraregional trade, and expansion in world market share as these countries continue to reap the benefits of the extensive structural reforms they have implemented. Performance is expected to improve especially in Bulgaria and Romania as they implement structural reforms in preparation for joining the EU—sometime during 2007–8. Turkey and Croatia should also benefit, although their accession is not expected before 2010. If implemented, continued improvements in the policy environment, including greater macroeconomic stability, should help to underpin the projected higher growth rates.

Although the structural reform process in many CIS countries is progressing, it is still less advanced than in the Central and Eastern European countries. As a result, long-term growth prospects for the subregion are lower. Indeed, some CIS countries have demon-

Figure A.4 Impact of high oil prices: estimated loss in terms of trade, given a $30 oil price increase



Source: World Bank.
Note: Scenario assumes a full pass-through and no demand response.

strated significant resistance to the kinds of reforms that have served their Western neighbors so well. High oil prices have recently provided an impetus to growth, which has facilitated the introduction of a number of reforms to oil-exporting countries and contributed to an increase in investment outlays (particularly in the energy sector). However, oil-related wealth may reduce the appetite for reform. As energy prices come off their recent highs, countries in the region will increasingly need to rely upon productivity-enhancing and product- and labor-market reforms to spur much-needed investment.

While poverty rates in the region are lower than those in most other developing regions, many Central and Eastern European countries face significant challenges in meeting the Millennium Development Goals, especially those tied to the environment and health. For example, the region has one of the fastest growing HIV/AIDS rates in the world. And, while poverty has been reduced markedly in the region (40 million people moved out of poverty between 1999 and 2003), hurdles remain, including overcoming widespread poverty in Central Asia and in the Caucasus. Success in reducing poverty rates has varied across the region. The greatest improvements, including a reduction of inequality, were achieved in the larger CIS countries, such as Kazakhstan, Russia, and Ukraine, largely because of high GDP growth. Smaller reductions were achieved in the new member states of the EU and smaller CIS economies, such as Tajikistan. Progress could have been better, given high growth, but job creation—the key to pulling people out of poverty—has lagged across much of the region. Improvement in this area requires expansion of economic reforms to improve the investment climate and work incentives.

Latin America and Caribbean regional prospects

Recent developments

GDP in the Latin American and Caribbean region increased by 4.5 percent in 2005, down from 5.8 percent the year before (table A.3). The slowdown was sharpest in Argentina, Uruguay, and Republica Bolivariana de Venezuela, which grew very quickly in 2004

Table A.3 Latin America and Caribbean forecast summary

Annual percent change (unless otherwise indicated)

					Estimate	Forecast		
	1991–2000[a]	2002	2003	2004	2005	2006	2007	2007–2015[a]
GDP at market prices (1995 US$)[b]	2.8	−0.6	2.1	5.8	4.5	3.8	3.6	3.6
GDP per capita (units in US$)	1.3	−2.0	0.6	4.3	3.1	2.4	2.3	2.4
PPP GDP[c]	3.0	0.1	2.1	5.5	4.4	3.8	3.6	
Private consumption	3.6	−2.0	1.2	5.4	3.7	3.5	3.3	
Public consumption	2.0	−0.3	1.3	1.2	3.8	3.5	2.3	
Fixed investment	3.2	−7.1	0.5	12.8	11.0	8.3	6.1	
Exports, GNFS[d]	7.9	2.2	5.2	12.4	6.2	6.6	7.5	
Imports, GNFS[d]	8.9	−6.4	2.3	12.4	9.5	9.0	8.2	
Net exports, contribution to growth	−0.2	1.9	0.6	0.2	−0.7	−0.5	−0.2	
Current account balance/GDP (%)	−2.8	−0.8	0.7	1.2	0.9	0.0	−0.7	
GDP deflator (median, LCU)	10.0	5.9	9.0	8.2	7.6	6.3	4.7	
Fiscal balance/GDP (%)	−2.7	−3.0	−2.7	−1.6	−1.8	−1.9	−1.3	
Memorandum items: GDP								
LAC excluding Argentina	3.1	1.2	1.1	5.2	3.8	3.8	3.6	
Central America	4.0	2.7	2.2	3.1	3.0	2.9	2.9	
Caribbean	4.3	4.3	3.0	2.3	3.4	4.6	4.1	

Source: World Bank.

Notes: a. Growth rates over intervals are compound averages; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 1995 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services.

and have now regained much of their lost output following deep recessions. Excluding these countries, regional growth slowed less, from 4.7 to 3.9 percent, with much of the slowdown explained by weak first quarter results in Brazil and Mexico (growth in these countries has since picked up). Other countries (Bolivia, Chile, Colombia, Peru, and most of those in Central America) continued to grow at the same rates as in 2004. Thus, despite the more moderate rate of expansion, growth in the region remained strong and well above the 2.5 percent average growth of the preceding 20 years.

This strong performance reflects supportive external conditions and an improved domestic policy environment. While down from last year's highs, global GDP and trade growth remain robust at 3.1 and 6.2 percent, respectively. This rapid growth and capacity constraints pushed commodity prices to high levels (although some non-oil commodity prices were easing),[4] and these boosted regional incomes and domestic demand.

Low interest rates and a substantial reduction in investors' perceptions of the risk associated with the region also contributed to improved investment (up 11.0 percent) and increased capital inflows. Spreads on Latin American bonds fell to about 300 basis points as of October 2005, less than half their average level during 2000–3.

While a global liquidity glut was partly responsible for these declines, reduced financing requirements, more reliance on domestic debt, trade liberalization, the adoption of more flexible exchange rates, and more prudent fiscal management—in addition to falling debt-to-GDP ratios (table A.4)—underpinned these declines in risk premia. Indeed, in contrast to U.S. corporate bonds, whose risk premia increased recently, the risk premia on Latin American sovereigns remained broadly stable as the Federal Reserve Bank has tightened monetary policy (Figure A.5).

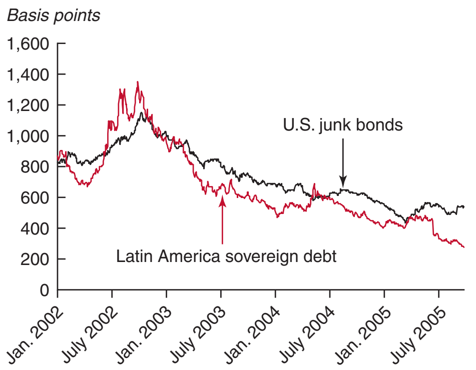
Intense activity levels and high oil prices have resulted in rising inflation in several countries,[5] but it is declining in several others.

Table A.4 Latin America and Caribbean debt ratios

	Debt as % of GDP			Debt serv. as % of exports		
	1995	2000	2004	1995	2000	2004
Argentina	38	52	112	36	87	–
Bolivia	79	69	–	30	43	18
Brazil	23	40	35	44	100	47
Chile	34	50	47	26	29	28
Colombia	27	41	39	35	33	42
Ecuador	69	86	56	27	32	43
El Salvador	27	32	40	14	9	19
Guatemala	25	18	19	12	8	9
Honduras	121	88	100		18	15
Jamaica	79	59	71	20	20	21
Mexico	58	26	21	29	33	17
Nicaragua	324	174	–	44	26	–
Panama	77	55	65	4	11	17
Paraguay	29	40	45	6	12	18
Peru	57	54	44	18	30	28
Uruguay	28	41	87	25	36	50
R. B de Ven.	47	33	34	25	18	18
Unweighted Average	67	56	54	25	32	26

Source: World Bank.
Note: – Data not available.

Figure A.5 Regional interest rate spreads remain low



Source: Datastream.

For the region as a whole, inflation has eased over the past six months and stood at around 5 percent in September 2005, well below the 7.4 percent peak recorded in the second quarter of 2003.

Medium-term outlook

Across the region, GDP is projected to slow further—to around 3.6 percent by 2007. This is partly a reflection of a return to more sustainable growth rates (capacity utilization rates in many countries are at historically high levels) and partly the influence of external factors. High oil prices are expected to constrain domestic demand in oil importers—especially in the Caribbean region, where dependence on imported oil for electrical generation is particularly acute.

The extent of the net income loss associated with high oil prices in this region is expected to be much sharper this year and in years to come, because non-oil commodity prices are not expected to increase as they did during 2000–3. In particular, increased global supply and liberalization of EU sugar prices are expected to soften commodity prices and export earnings for the agricultural exporters in general and especially for the Caribbean countries.

For metals and minerals exporters, prospects are better. Although there are signs of easing in world demand for some of these commodities, inventories remain tight, and prices are expected to begin easing only in 2006. Growth among exporters of these commodities is projected to slow somewhat, as the contribution to growth from commodity-sector incomes and production declines.

Economic activity is also expected to slow among regional oil exporters because of capacity constraints in the production of oil and a stabilization of oil revenues. GDP in these countries, as a group, is projected to expand by 3.9 and 3.6 percent in 2006 and 2007, respectively.

Overall, high oil prices and the easing of non-oil commodity prices are expected to cause the current account balances of oil importers to deteriorate by about 0.8 percent of GDP in 2006, in addition to the estimated 1.9 percentage point deterioration in 2005. Rising imports among oil exporters should limit the improvement in their current account balances, and as a result, the current account deficit of the region as a whole is projected to remain close to balance in 2006 and 2007.

A number of countries (particularly the oil exporters) subsidize various petroleum prices, implying a substantial fiscal cost,[6] as energy prices have increased. Therefore, for oil importers, general government deficits are projected to deteriorate unless the authorities reduce the rate of subsidization. For oil exporters, the problem manifests itself more in terms of foregone revenues, failure to pay down debt, and (because domestic prices remain low) an energy inefficient economic structure.

Political election cycles may affect growth prospects in the medium term. Among major Latin American countries, Brazil, Colombia, Mexico, and Peru will have elections in 2006 (Republica Bolivariana de Venezuela's election is scheduled for December 2005; and Bolivia, Costa Rica, Dominican Republic, and El Salvador will have elections in 2006–7). While some pre-electoral upsurge in government spending will probably be observed, the real risk from the political cycle is that few substantive structural reforms are likely to be initiated or concluded in these countries until elections are complete.

Risks and uncertainties

The future path of interest rates and risk premia represent a key risk for the region, particularly for highly indebted countries and those already facing large current account deficits. Such an increase could be triggered by an oil shock (see chapter 1), concerns about the sustainability of developed countries' fiscal policies, or the financing of the U.S. current account deficit. Most countries in the region have taken advantage of low interest rates to restructure debt and reduce their exposure to interest-rate risk. Historically, high reserves to external short-term debt ratios imply greatly reduced liquidity risks. Lower indebtedness, more reliance on domestic debt, and more developed derivative markets imply that both corporate and sovereign balance sheet risks (especially currency risks) are much lower than what they had been, say, in the mid-1990s. Moreover, there are no credit booms currently in the region as there were during past expansions. Because the banks are better capitalized, regulated, and supervised, an eventual interest rate hike and capital flows reversal is less likely to lead to financial crises than in the past.

Nevertheless, a 200-basis-point rise in world interest rates, and the accompanying global slowdown, would have serious consequences for the region. Simulations suggest that such a hike in interest rates could cause a contraction of regional GDP (with respect to the baseline) of around 2 percent for the next several years, with potentially severe consequences for regional poverty. The most significant impacts would likely be felt in highly indebted countries, such as Brazil, Colombia, and Uruguay, where higher interest rates would generate large additional fiscal costs and require spending cuts that would exacerbate the slowdown.

While the region as a whole is an oil exporter and would experience higher oil prices as a positive terms-of-trade shock, a further increase in oil prices following a major supply disruption forms an important risk for oil importers. Oil exporters are also likely to be affected, but indirectly. Estimates suggest that a 2-million-barrel per day cut in world oil supply could cause a contraction in global demand that would lead to a reduction in regional GDP of 1.3 percent as compared with the baseline, and generate a rapid pickup in inflation. For the countries of the Caribbean and Central America that are dependent on oil for electrical generation, the impacts are likely to be especially large because non-oil consumption and investment would likely be curtailed in order to pay for an increased oil bill—and the consequences would be serious for poverty alleviation. Current account and fiscal balances in some of these countries have already been placed under serious strain by the rise in oil prices; however, there has been a tendency for increased remittances to offset some of these costs in some countries.

Longer-term prospects

During the period 2006–15, regional GDP is projected to increase by 3.6 percent a year, and per capita incomes are expected to rise by 2.3 percent on average. Prospects for achieving this kind of healthy expansion have been improved by the substantial reduction over the past several years of the fiscal imbalances and perverse price incentives that have held back growth. As a result, the area is on track to meet its Millennium Development poverty goals. However, it has been underperforming other developing regions, notably Asia, but also Europe and Central Asia.

For economic performance to improve further, governments will need to consolidate recent policy improvements and put in place key structural micro-policies (in particular, upgrading infrastructure and education and reducing the cost of doing business) to improve competitiveness. This will require a continued emphasis on macroeconomic stabilization policies and structural policy reform. Policy should concentrate on restraining government spending during upturns, such as the current commodity price boom, and focusing on medium-term budgetary planning. A more stable spending and tax regime will curtail the tendency for fiscal policy to respond procyclically in the region with spending rising during the good times only to be cut back during periods of slower growth.

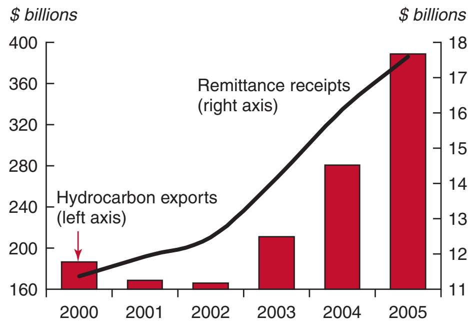
Economic growth and resource allocation would also be improved by increasing the efficiency of public spending and moving resources toward growth-enhancing projects, such as infrastructure development, poverty eradication, education, and health enhancement.

Middle East and North Africa regional prospects

Recent developments

GDP in the Middle East and North Africa region is estimated to have increased by 4.8 percent in 2005, down slightly from 4.9 percent

Figure A.6 Oil export earnings balloon, lofting worker remittances in MENA



Source: World Bank, IMF, national agencies.

the year before (table A.5). Growth among developing oil exporters in the region accelerated from 5.0 percent to 5.4 percent. These gains reflect still rapid increases in oil production and increased spending from high oil revenues, up some 35 percent, reaching $113 billion, or 20 percent of regional GDP[7] (figure A.6).

Growth among regional oil importers slowed noticeably from 4.6 to 4.0 percent. Weak demand in Europe and market share losses associated with the removal of quotas on textiles and clothing slowed export growth in Egypt, Lebanon, and Morocco. In contrast, Jordan and Tunisia appear to have improved their market share following the phase-out of quotas (figure A.7). In Egypt, economic activity accelerated as a result of strong revenues from remittance inflows, tourism, and Suez Canal dues, while in Jordan, the advance in investment and construction continued, boosted by Gulf-war-related spending. Growth in Morocco was affected by a severe drought.

The boom in oil revenues contributed to increased remittance flows to labor-abundant economies in the region of 9.2 percent, on the heels of double digit gains (13–14 percent) over 2003–4. In addition, positive spillovers arrived in the form of strong tourism revenues as Gulf–region visitors took advantage of

Table A.5 Middle East and North Africa forecast summary

Annual percent change (unless otherwise indicated)

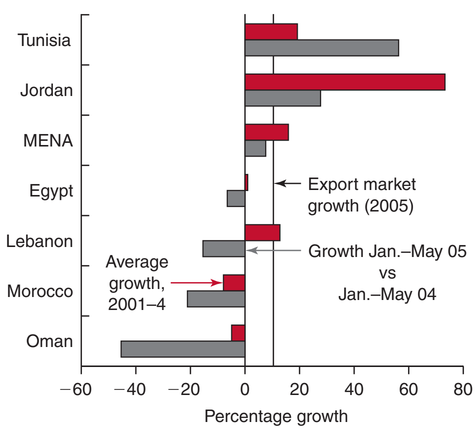
					Estimate	Forecast		
	1991–2000[a]	2002	2003	2004	2005	2006	2007	2007–2015[a]
GDP at market prices (1995 US$)[b]	−0.8	4.6	5.2	4.9	4.8	5.4	5.2	4.5
GDP per capita (units in US$)	−2.0	2.8	3.4	3.1	3.0	3.6	3.4	2.8
PPP GDP[c]	1.2	4.8	5.3	4.9	4.9	5.4	5.2	
Private consumption	−0.8	3.8	4.7	4.2	4.0	4.9	4.6	
Public consumption	−4.5	3.3	3.2	3.6	4.2	4.2	4.3	
Fixed investment	0.2	6.1	7.2	5.6	11.7	10.5	9.3	
Exports, GNFS[d]	−2.8	0.4	2.8	5.5	6.1	5.7	6.1	
Imports, GNFS[d]	−3.4	3.7	2.6	11.7	10.6	8.6	7.8	
Net exports, contribution to growth	0.3	−0.9	0.0	−1.6	−1.4	−1.0	−0.7	
Current account balance/GDP (%)	0.0	3.3	4.5	4.6	7.6	8.0	5.9	
GDP deflator (median, LCU)	6.3	3.0	11.8	7.5	11.0	5.1	6.4	
Fiscal balance/GDP (%)	−1.3	−2.3	−0.8	−0.1	3.4	4.4	3.7	
Memorandum items: GDP								
MENA geographic region[e]	3.4	3.0	6.1	5.1	5.2	4.9	4.6	
Resource poor-labor abundant[f]	3.9	3.0	4.2	4.6	4.0	5.4	5.3	
Resource rich-labor abundant[g]	3.1	6.1	6.2	5.2	5.5	5.3	5.1	
Resource rich-labor importing[h]	3.3	0.4	7.4	5.4	5.8	4.2	3.7	

Source: World Bank.

Notes: a. Growth rates over intervals are compound averages; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 1995 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services.
e. Geographic region includes high-income countries: Bahrain, Kuwait, and Saudi Arabia.
f. Egypt, Jordan, Morocco, and Tunisia.
g. Algeria, Iran, Syria, and Yemen.
h. Bahrain, Kuwait, Oman, and Saudi Arabia.

Figure A.7 Impact of ATC quota removal

Growth in U.S. ATC imports from Middle East and North African countries



Source: World Bank; U.S. Department of Commerce.

tourism opportunities.[8] Fiscal deficits rose among oil-importing countries, notably Jordan, that subsidize petroleum prices.

Medium-term outlook

Regional GDP is projected to accelerate in 2006, reaching 5.4 percent before easing somewhat in 2007, reflecting a pickup in economic activity among oil importers (from 4.0 to 5.4 percent) and a broadly stable expansion among oil exporters at (5.4 percent).

This very strong regional outlook, which should help address some of the demographic and labor market pressures in labor-abundant countries, is mainly a reflection of continued strong oil revenues. The projected recovery in European growth and import demand also plays a role—especially for oil importers

(Europe is the destination of 70 percent of non-oil exports).

Limited excess capacity and the short-term inelasticity of both energy demand and energy supply are expected to keep oil prices high over the projection period. Nevertheless, the slowing of the global economy should allow prices to ease somewhat to about $56 on average in 2006 and $52 in 2007. Among developing regional oil exporters, the massive In-Salah and In-Amenas gas projects in Algeria are expected to increase deliveries by a wide margin in 2006 and 2007. In other countries in the region, declining yields in Iran are expected to slow growth, with expanded output of natural gas and LNG in Oman providing only a partial offset.

Despite weaker growth in hydrocarbon production, continued high oil prices will maintain government revenues. These are projected to translate into a rapid expansion in fiscal spending (transfers as well as investment), which is expected to sustain growth among oil exporters at close to 5.5 percent in 2006. Current account surpluses for the group are expected to reach $48 billion, or 11 percent of GDP.

Risks and uncertainties

For countries in the region, the most important risks and uncertainties stem from the future price of oil and the strength of the European recovery.

For oil exporters, a much higher-than-projected oil price would benefit revenues and stimulate both investment and consumption over the projection period. Over the longer term, higher prices would likely accelerate supply and demand responses, provoking a faster-than-projected decline in oil prices over the long term. In particular, a substantially higher oil price could stimulate technical innovation, which could in turn lead to a significant and permanent decline in the energy intensity of global production. In the 1970s and 1980s this came about as alternatives to hydrocarbons were found in the generation of electricity; currently the prospect of substantially increasing the fuel efficiency of vehicles through the use of hybrid technologies could have a similar effect.

For oil importers, higher oil prices would likely cut into growth. To date, much of the domestic economic impact of high oil prices has been forestalled because of the subsidization of domestic hydrocarbon prices. While it is unclear how sustainable this policy is at current prices, few oil-importing countries could continue to subsidize at higher oil prices. If the subsidization were to end, private consumption and investment would be affected both because of reduced incomes and because higher inflation would likely result in increased interest rates.

While slower-than-projected growth in Europe would likely have a smaller impact on regional prospects than higher oil prices, it could accentuate the current account and fiscal difficulties of the region's oil-importing economies. The region's external performance will also depend on the extent to which local manufacturers can adapt to lower quotas in the clothing and textile sector. In the baseline, countries' market shares are expected to stabilize, but this will require firms to find niches that they can continue to serve. More generally, industry has to respond flexibly to increased competition from the new member countries of the EU as well as developing Asia.

Longer-term prospects

Notwithstanding the current period of relatively strong growth, the region faces a daunting menu of structural reform issues related to economic policy, as well as governance, gender, and resources (e.g., water), against a background of geopolitical tensions that remain a central concern for policymakers.[9] Long-term projections suggest that real per capita incomes will rise by 2.8 percent a year over the next decade, unless policy succeeds in improving employment prospects and overall productivity growth. To accelerate growth and enhance opportunities, much will need to be done to improve private-sector job creation, lower unemployment, and diversify the sources of growth.

Recent reforms have moved in this direction, but more needs to be done because, with the exception of Egypt, relatively little progress has been made since 2004. Earlier positive steps in Morocco and Tunisia included reforms to improve the business and investment climate, and Morocco's Free Trade Agreement with the United States, which came into force in 2005 and offers some promise of increased exports and higher FDI inflows. However, additional reforms are needed to improve the investment climate in the export sector. Algeria's Hydrocarbons Reform Bill will make the sector far more transparent for foreign firms, while prospects for passage of the country's Economic Recovery Program II have improved. Egypt has embarked upon an ambitious and ongoing reform agenda; some of the major elements are tariff reduction, domestic tax reforms, and a resuscitation of the privatization program. Such reform programs need to be sustained, extended to other countries in the region, and accelerated. If this is achieved, a shift from public-sector-led to more rapid private-sector-led growth could take shape over the next several years.

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

South Asian regional prospects

Recent developments

Real GDP growth in South Asia is estimated at 6.9 percent in 2005, slightly higher than in 2004 (table A.6). This aggregate performance reflects stable growth of about 7.0 percent in India (the region's largest economy), an acceleration from 5.8 percent to 6.6 percent in

Table A.6 South Asia forecast summary

Annual percent change (unless otherwise indicated)

					Estimate	Forecast		
	1991–2000[a]	2002	2003	2004	2005	2006	2007	2007–2015[a]
GDP at market prices (1995 US$)[b]	5.5	4.0	7.9	6.8	6.9	6.4	6.3	5.5
GDP per capita (units in US$)	3.6	2.3	6.2	5.1	5.3	4.8	4.7	4.1
PPP GDP[c]	5.6	4.0	8.0	6.8	6.9	6.4	6.3	
Private consumption	4.5	3.3	6.7	11.0	7.9	7.8	7.5	
Public consumption	5.4	0.1	4.6	4.9	5.6	5.6	5.0	
Fixed investment	6.5	4.8	9.9	5.1	8.1	7.3	7.2	
Exports, GNFS[d]	10.4	17.3	14.7	10.1	13.2	12.4	12.3	
Imports, GNFS[d]	10.6	5.8	15.1	22.6	19.3	16.2	15.1	
Net exports, contribution to growth	−0.1	1.8	0.2	−2.0	−1.2	−1.0	−1.0	
Current account balance/GDP (%)	−1.4	1.8	1.4	−0.7	−2.0	−2.5	−2.3	
GDP deflator (median, LCU)	7.5	4.5	4.7	3.1	6.3	5.3	5.9	
Fiscal balance/GDP (%)	−9.8	−9.3	−7.8	−7.7	−7.6	−7.8	−8.0	
Memorandum items: GDP								
South Asia, excluding India	8.5	3.6	5.5	6.2	6.7	6.0	5.7	

Source: World Bank.

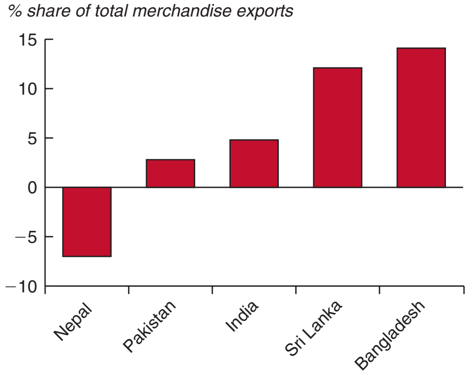
Notes: a. Growth rates over intervals are compound averages; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 1995 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services.

Pakistan, and a deceleration among the region's smaller economies from 5.9 percent to 5.1 percent. The slowdown among the smaller countries reflects higher oil prices, increased political instability (Bangladesh and Nepal), flooding in Bangladesh, and the after-effects of the December 2004 tsunami (Maldives and to a lesser extent Sri Lanka). In Afghanistan, favorable weather has boosted agricultural output and GDP.

Growth in the region's largest economies, India and Pakistan, was broadly based. Consumption, investment, and exports, all expanded rapidly, and industrial production in both countries increased at double-digit rates. Strong investment growth reflects an improved investment climate, following pro-business reforms. Easier relations between the two countries and relatively moderate increases in domestic fuel prices (due to implicit and explicit price-subsidy programs) also supported consumer demand, investment, and regional tourism. Export growth was especially strong, and many countries in the region have increased market share following the removal of quotas under the Agreement on Textiles and Clothing (ATC). While the October 2005 earthquake in Pakistan had catastrophic human consequences, its overall economic effects are expected to be small.

The lifting of ATC quotas benefited regional trade, at least initially. For Bangladesh and Sri Lanka, increased sales of clothing and textiles during the first half of 2005 are estimated to have represented between 10 and 15 percent of their total merchandise exports in 2004 (figure A.8). Large, but less important, gains were also registered in India and Pakistan. Nepal, however, was hit hard by the increased competition, and declines in its clothing and textile exports were equal to about 5 percent of its total merchandise trade. The region's good performance may reflect the efforts of importers to maintain a diversity of suppliers; however, it also likely reflects efforts by producers to prepare for the new trade regime by improving efficiency and by expanding their offerings of high-end products—a market segment where China's comparative advantage is weaker.

Figure A.8 Estimated change in textile and clothing exports to the European Union and United States during the first half of 2005



Source: World Bank; Eurostat; U.S. Department of Commerce.

Despite oil price subsidies, inflation[10] was up in most of the countries in the region, and the median inflation rate has increased from 3.1 percent in 2004 to 6.3 percent in 2005. Sri Lanka witnessed the sharpest advance, at an estimated 14.2 percent in 2005 versus 7.3 percent the year before, partly because of the impact of the tsunami. In Pakistan, accommodating monetary policy and very fast growth were important factors in the rise of inflation.

Price subsidies may mute the impact of higher oil prices on consumer inflation, but they do not change the overall oil bill. As a result, the region's current account balance deteriorated by 1.3 percent of GDP in 2005. In Bangladesh, the authorities reacted to high energy costs by dipping into its reserves, which by April 2005 covered only 2.6 months of imports, down from 3.2 months on average in 2004. Elsewhere, better export performance limited the overall impacts on these countries' current account deficits, and stocks of reserves were much higher (about 6 months of imports in India, Nepal, and Pakistan).

Meanwhile, the subsidization of energy prices brought fiscal positions under increasing strain—because of lower taxes, reduced profits from state-run oil companies that have been forced to sell at below-market prices, and increased expenditures. As a result, governments were forced either to cut non-oil fiscal outlays or to increase fiscal deficits. Fiscal deficits in both Bangladesh and Pakistan are projected to widen by about 0.4 percent of GDP in 2005.

Medium-term outlook

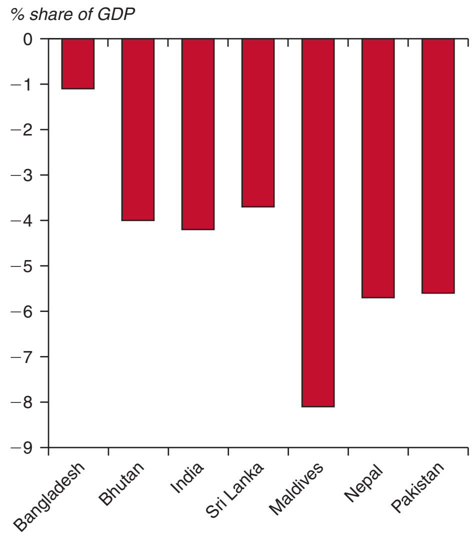
Despite some slowing, regional growth is projected to remain strong through 2007. Regional investment growth is expected to strengthen, supported by reforms to promote private-sector and infrastructure investment[11] and because of the assumed improvements in relations between India and Pakistan, although significant issues are yet to be resolved. At the same time, in Sri Lanka, progress toward ending the civil war and tsunami-related reconstruction efforts are expected to accelerate growth.

While government budgets have absorbed much of the shock of higher oil prices, these are expected to be passed through to consumers in the form of higher prices and taxes. As a result, inflationary pressures are not expected to ease as quickly as they might have otherwise. Moreover, higher average oil prices in 2006 are expected to lead to a further deterioration in the regional current account balance to −2.5 percent of GDP.

Risks and uncertainties

Future energy pricing policies in the region are a source of uncertainty. While the present oil subsidy policies are popular and help cushion the impacts on the very poor, the policies are very expensive and poorly targeted. Moreover, by keeping domestic prices low, they eliminate incentives to conserve and prevent market mechanisms from establishing a new, more energy-efficient equilibrium. As associated

Figure A.9 Impact of high oil prices: estimated loss in terms of trade, given a $30 oil price increase



Source: World Bank.

Note: Scenario assumes full pass-through and no demand response.

fiscal and external debts grow, there is a risk that the creditworthiness of countries will suffer, resulting in increased risk premia, higher interest rates, and slower growth. These risks would intensify if oil prices were to rise further (figure A.9).

The possibility that world interest rates may rise more rapidly than in the base case represents a second risk. Strong investment inflows in the baseline are contingent upon further domestic policy reforms that strengthen the investment climate and access to international capital. Should global liquidity dry up and interest rates rise, then investment is likely to increase much less quickly, slowing the potential growth rate of economies in the region.

Longer-term prospects

Long-term growth in South Asia is forecast to average about 5.5 percent during 2007–15, reflecting a rising contribution to growth from the private sector. Trade reforms, banking-sector liberalization and re-regulation, privatization, and infrastructure development are all expected to contribute to improving the investment climate, productivity growth, and ultimately incomes. Private–sector investment (both domestic and foreign) is expected to contribute to improving the growth rate of potential output, buoyed by rising private savings as dependency ratios decline.

In this context, the incidence of extreme poverty in the region, which had fallen to 31 percent of the population in 2002, is expected to decline to less than 13 percent by 2015. Despite declining infant mortality rates, falling birth rates mean that regional population growth is projected to decelerate, and dependency ratios are expected to decline. As a result, per capita incomes will accelerate significantly (as compared with the 1990s), coming in at a projected 4.1 percent per year for the period 2007–15.

Nevertheless, poverty reduction challenges are daunting. More than four hundred million people in the region are currently living on less than $1 a day, and despite substantial progress on the extreme poverty measure, more than half of the population is projected to be living on less than $2 a day by 2015. To improve on this record, policies should raise education levels (at 44 percent, the region has the highest illiteracy rate in the world) and reduce infant mortality rates, which should also boost productivity and growth.

Substantial segments of the region's population remain vulnerable to weather patterns and natural disasters. Building capacity to mitigate their impacts without distorting economic incentives should be a priority. Recent peace agreements have eased regional tensions and are contributing to enhanced stability, improved business confidence, and greater intraregional trade. However, some international and domestic tensions remain. These tensions and the political climate continue to represent downside risks to growth outcomes, which could have serious consequences for poverty reduction.

Sub-Saharan Africa regional prospects

Recent developments

GDP growth in Sub-Saharan Africa picked up somewhat in 2005, reaching 4.6 percent, up from 4.5 percent in 2004 (table A.7). This is the sixth consecutive year of growth in excess of 3 percent for the region, representing a sustained period during which per capita GDP has been rising by an average of 1.8 percent. This strong performance occurred in a (generally) supportive international environment, but it was achieved despite a number of negative factors. In the past, these factors (for instance, rapidly rising oil prices, slow growth in Europe, a severe locust infestation in the Sahel region, drought in southern Africa, and low international cotton prices) might have been associated with much weaker performance.

This aggregate performance in 2005 represents the combination of a significant slowing among oil-exporting countries in the region from 6.1 percent to 5.5 percent and an acceleration among oil importers from 4.0 percent growth in 2004 to an estimated 4.3 percent this year. Excluding South Africa (the region's largest economy), oil importers growth decelerated somewhat, from 4.6 to 4.3 percent.

Oil-producing economies (including Nigeria, the region's second largest economy) have continued expanding at a robust pace. However, growth slowed in most of these economies, reflecting capacity constraints in the oil sectors and production disruption in Nigeria due to localized unrest in the Rivers State. The expansion accelerated in a few oil producers as a result of rapidly rising levels of investment and the coming on stream of new fields. Economic activity in the non-oil sectors continued to be robust, boosted by oil revenues, an expansionary fiscal stance, and strong investment spending.

Given the relative weakness of non-oil commodity prices since the beginning of 2004, the relative strength of oil-importing economies is particularly encouraging. In part, this strength reflects a recovery in South

Table A.7 Sub-Saharan Africa forecast summary

Annual percent change (unless otherwise indicated)

					Estimate	Forecast		
	1991–2000[a]	2002	2003	2004	2005	2006	2007	2007–2015[a]
GDP at market prices (1995 US$)[b]	2.1	3.2	3.6	4.5	4.6	4.7	4.5	3.5
GDP per capita (units in US$)	1.1	1.1	1.5	2.5	2.6	2.8	2.5	1.7
PPP GDP[c]	2.0	3.5	4.1	5.2	4.9	5.2	4.8	
Private consumption	1.4	8.0	0.4	5.5	5.7	4.1	4.5	
Public consumption	3.3	2.8	5.2	4.7	6.4	4.5	3.8	
Fixed investment	3.6	12.9	7.0	11.7	11.8	9.9	8.6	
Exports, GNFS[d]	4.1	0.9	1.9	4.6	4.8	8.1	6.7	
Imports, GNFS[d]	4.4	4.8	7.1	10.5	12.0	10.0	8.7	
Net exports, contribution to growth	−0.3	−1.5	−2.1	−2.7	−3.4	−1.9	−1.9	
Current account balance/GDP (%)	−1.9	−1.5	−2.5	−1.9	−0.9	0.2	−0.5	
GDP deflator (median, LCU)	9.4	5.2	5.8	5.9	7.5	4.4	3.8	
Fiscal balance/GDP (%)	−4.3	−2.4	−2.4	−1.0	0.1	0.6	−0.1	
Memorandum items: GDP								
SSA, excluding South Africa	5.0	2.9	4.3	5.3	4.9	5.6	5.1	
Oil exporters	4.1	3.2	6.0	6.1	5.5	6.5	5.7	
CFA countries	6.0	2.3	3.5	4.3	4.2	3.7	3.5	

Source: World Bank.

Notes: a. Growth rates over intervals are compound averages; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 1995 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services.

Africa. GDP there was estimated to have increased 4.2 percent this year, supported by high metal prices, strong business and consumer confidence, low nominal interest rates, and the rand's recent depreciation against the U.S. dollar. Manufactured output was up some 7.3 percent, while the service and agricultural sectors increased an annualized 4.8 percent in the second quarter.

Among smaller oil-importing countries, strong non-oil commodity prices, an increase in land under cultivation, and more vigorous use of insecticides helped lift regional growth somewhat in West Africa, although higher revenues from export crops only partially offset the negative impact of higher oil prices. It is encouraging that post-conflict countries like Burundi and Democratic Republic of Congo continue to enjoy strong growth. The removal of quotas under the ATC brought textile exports under pressure in some countries, however, and it has slowed the expansion in countries with important textile sectors such as Kenya, Lesotho, Madagascar, Mauritius, and Swaziland. Moreover, last year's drought slowed growth in many smaller southern African nations, despite the acceleration in the Republic of South Africa.

High oil prices took a toll on growth in many oil-importing countries, with the average net increase in the oil bill estimated at 3.0 percent of GDP in 2005. For many, limited access to international financial markets forced domestic demand to adjust and contained the deterioration of their current account balances (down 0.9 percent of GDP on average).

Inflation increased rapidly during the course of 2005 in Sub-Saharan Africa. Sharp increases in food prices, as a result of significant declines in subsistence crops, pushed consumer price inflation to double-digit rates in Chad and Niger, and well above government targets in Benin, Burkina Faso, Mali, and Togo. Some resource-rich economies (Angola, Equatorial Guinea, Nigeria, and South Africa) saw strong domestic demand push inflation rates higher. Overall, the inflationary impact of high oil prices was muted because many governments had yet to pass these price increases through to the public. Inflationary pressures remained contained in most Sub-Saharan African countries. Average inflation was expected to remain in the high single digits for the second consecutive year, following more than two decades of double-digit inflation. More prudent monetary policy and more stable currencies helped limit the buildup in inflationary pressures.

Medium-term outlook

Prospects for the next two years are good. Growth in the region is expected to pick up further in 2006 before moderating to a nevertheless very robust 4.5 percent rate in 2007.

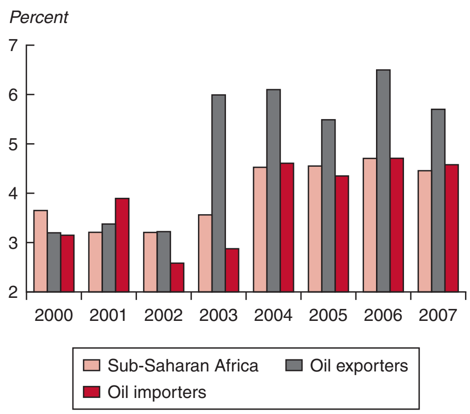
Overall GDP among oil producers is projected to accelerate to about 6.5 percent in 2006 before easing to about 5.7 percent in 2007 (figure A.10). This pattern reflects a generalized slowing in the very rapid pace of oil output on the one hand, and the expected coming on stream of new capacity in Angola, Nigeria, and Mauritania in 2006 on the other hand. Despite slower growth in the oil sector, very strong investment inflows and elevated oil revenues are expected to keep economic activity expanding at a rapid rate.

For oil-importing economies, the combination of high oil prices and easing non-oil commodity prices is projected to contribute to a deceleration in growth to about 4.1 percent by 2007. Declining agricultural commodity prices over the short term, due to a combination of improved supply and subdued demand will moderate income growth, while high oil prices will continue to cut into non-oil expenditures. Overall, for oil-importing countries (excluding South Africa) the negative terms-of-trade impact observed since the beginning of 2004 represents some 3.1 percent of GDP. Notwithstanding an expected deterioration in terms of trade for oil-importing economies over the medium term, limited access to international financial markets and a significant increase in donor support is expected to increase these countries' current account deficit to more than 4 percent of GDP in 2006 (see figure A.11). The slowdown in domestic demand and import volume growth is projected to be more significant.

Risks and uncertainties

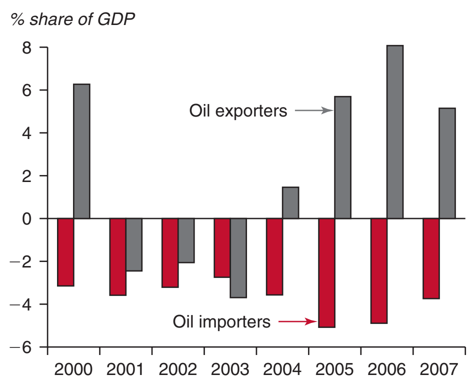
The principal risk for Sub-Saharan economies stems from weather, other natural calamities, and commodity prices. The most recent increases in oil prices, unlike previous episodes,

Figure A.10 Growth performance in Sub-Saharan Africa



Source: World Bank.

Figure A.11 Current account balance in Sub-Saharan Africa



Source: World Bank.

occurred in the context of slowing world growth and easing of non-oil commodity prices to the substantial detriment of the terms of trade of oil-importing African countries. Should oil prices rise further or other commodity prices ease more quickly than projected, the impacts on domestic demand and poverty could be much more serious.

So far the inflationary impact of higher oil prices has been muted, in part because of prudent monetary policy. However, if further price shocks arise, inflationary pressures could mount quickly—particularly among those countries that have yet to pass through the full cost of higher world energy prices. In those countries the fiscal cost of maintaining subsidies will eventually become too high, yielding higher domestic price pressures.

Pressures on current account balances are expected to mount substantially in most oil-importing economies, especially if non-oil commodities collapse. Higher aid flows (donors have pledged to double official development assistance to Africa by 2010) will help to reduce the foreign currency constraints faced by many countries. As more African countries reach the completion point under the HIPC Initiative, official grants as share of GDP are expected to exceed 3 percent of regional GDP (excluding South Africa and Nigeria), with some countries receiving grants in excess of 5 percent of GDP. For these funds to have the maximum development benefit, it is critical that they be used to enhance infrastructure and human capital, not just to pay high oil bills.

Longer-term prospects

Sub-Saharan Africa is projected to continue lagging all other regions in terms of per capita real GDP growth in the long run. This arises despite per capita income growth of 1.7 percent, which represents a marked improvement over the 1990s and 1980s (when incomes were falling). While this stronger growth will yield a projected 12 percentage point decline in the share of the population living in extreme poverty, rapid population growth means that the absolute number of very poor will actually increase. And, notwithstanding improved performance, all other regions will grow faster, implying that unless steps are taken to further improve prospects, Africa will continue to fall behind.

In this regard, policymakers need to take careful aim at macroeconomic mismanagement and political and social instability, factors that undermine long-term growth prospects in many countries in the region. Significant progress in this regard has been made, but the quality of institutions remains poor in many countries, undermining investors' confidence and keeping the cost of doing business at prohibitively high levels.

Microeconomic reform is also critical. Much of the improved performance over the past 10 years reflects the impact of first generation reforms undertaken in a number of countries. These countries have created a more stable macroeconomic climate that has allowed several economies in the region to diversify and enjoy sustained strong economic performance. Such reforms should be extended and implemented in other countries in the region. The World Bank's Action Plan for Africa (2005) emphasizes reforms that improve governments and institutions, promote a vibrant private sector, expand exports, raise the quality of both national and international infrastructure (social, educational, and economic), and increase agricultural productivity. A comprehensive effort along all of these dimensions should help reduce poverty by facilitating the access of the poor to economic opportunity.

While the region's export-to-GDP ratio is relatively high, trade remains heavily dependent on commodities. Here success in the Doha round of trade liberalization could bring to the agricultural sector many of the benefits that earlier rounds have extended to manufacturing. The primary sector continues to account for a large share of GDP in Sub-Saharan Africa, and increasing incomes in this sector could improve the lives of the poor members of society. Infrastructure investments (including improved irrigation and roads) could also play a fundamental role by reducing vulnerability to the vagaries of weather and reducing transportation costs.

Malaria and HIV/AIDS along with low-levels of educational attainment present additional major challenges to improving Sub-Saharan African economic performance. Both diseases are cutting into the most productive layers of the society, while low levels of educational attainment reduce both employment opportunities and productivity growth.

Notes

1. Global demand for high-tech goods has recently been on the upswing; exports of these products accelerated from Korea, Taiwan (China), Singapore, and Thailand in the third quarter.

2. Turkey's investment to GDP ratio increased from 16.5 percent in 2004 to an estimated 21.3 percent in 2005.

3. Estimates of the total terms of trade impact as a percent of GDP from commodity price hikes observed since 1999, plus a an additional $30 hike in oil prices exceed 7 percent in Armenia, Bosnia and Herzegovina, Belarus, Czech Republic, Estonia, Georgia, Croatia, Kyrgyz Republic, Latvia, Moldova, FYR Macedonia, Turkey, and Ukraine.

4. Shipments of oil, copper, and coffee represent 65 percent of the exports of commodities in the region; raw materials in turn account for 31 percent of total regional exports, or 45 percent if Mexico, a strong manufactures exporter, is excluded.

5. Inflation is up in Argentina, Chile, Ecuador, Panama, and Paraguay, but has declined in Brazil, Costa Rica, the Dominican Republic, Mexico Peru, Uruguay, and Republica Bolivariana de Venezuela.

6. In the case of oil importers, the increased cost manifests itself as higher expenditures—or lower revenues if subsidization is achieved through tax policy or by forcing a state-owned enterprise to sell at below market rates; for oil exporters, it materializes as foregone revenues.

7. Saudi Arabia is now classified as a high-income economy, and its revenues (as well as those of Bahrain, Kuwait, Qatar, and the United Arab Emirates) are not included in these figures. If these five countries were included—and their collective spending has a notable effect on economic activity among developing countries in the region—the revenue total for the geographic region would rise to $390 billion, a 38 percent increase.

8. Tourism revenues jumped 15 percent during 2004 for Egypt, Jordan, and Tunisia, and these strong trends continued in 2005. The share of visitors from the Gulf states in total tourism arrivals in Egypt increased from 22.7 percent in 2001 to 26.1 percent in 2004.

9. See MENA region reports on trade and investment, governance, gender, and employment, produced in 2003–4, that highlight fundamental challenges for the region at the start of the 21st century. http://publications.worldbank.org/ecommerce/catalog/product?item_id=2430578.

10. Some pass-through of higher cost has occurred, for example, a 7 percent increase in India in September 2005.

11. In India, the government is seeking to attract $150 billion in foreign investment in infrastructure in the coming decade. A number of sectors are being targeted, and greater emphasis is being placed on private sector participation; for example, the expansion of the power generation capacity, which allows for private operators, and the development of the national highway system, which would use more build-operate-transfer contracts. Pakistan aims to bolster private-sector investment via tax incentives in order to sustain its recent strong growth performance. However, unlike in India, in Pakistan foreign investment is expected to remain somewhat tepid due to the domestic political uncertainty.

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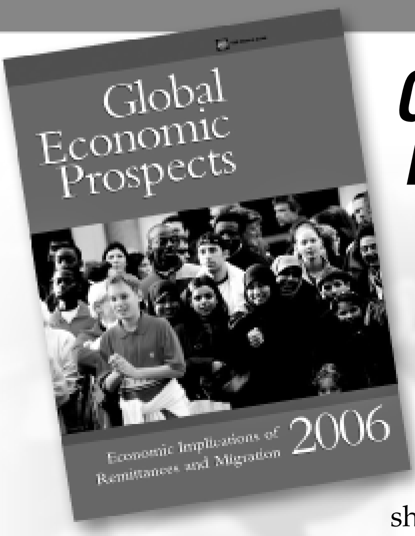

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