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Prospects for Developing Countries

Following the sudden and sharp drop in market valuations of U.S. mortgage-backed securities in mid-2007, global markets have entered a phase of heightened uncertainty. This has been reflected in increased volatility in equity markets, commodity prices, and exchange rates.

Notwithstanding the increased volatility, the impact on developing countries has been relatively minor to date. Risk premiums have escalated, but remain relatively low in a historic context, and capital inflows remain plentiful, although bank lending has dropped off. Aggregate growth in developing countries continues to be strong, reflecting improved fundamentals in many countries, sizable revenues from commodity exports, and continued access to international finance at moderately higher cost. Their strong gross domestic product (GDP) growth is partially offsetting weaker U.S. domestic demand, which is now expected to remain subdued well into 2008.

Despite the resilience demonstrated by the global economy, risks exist and increased volatility has made several developing countries more vulnerable to financial disturbance, especially those with large current account deficits, pegged exchange rates, or domestic banking sectors that have borrowed heavily in international markets.

Growth outlook

On average, developing countries have been affected only modestly by the slowdown in the United States during 2007, which is now anticipated to continue into 2008 before picking up in 2009. GDP growth among low- and middle-income economies eased just 0.1 percentage point in 2007 from the strong 7.5 percent recorded in 2006. Despite weaker U.S. import growth, continued robust spending by oil-exporting countries and vibrant expansions in China and India are projected to keep developing-country growth strong at 7 percent or more in 2008 and 2009.

Over the longer term, the resilience of developing countries' improved fundamentals will be tested. More prudent macroeconomic management and technological progress (see chapters 2 and 3) have contributed to an increase in total factor productivity (TFP) and real income growth over the past 15 years. Over the next 10 years, these same factors are expected to enable developing countries to achieve annual per capita income gains of 3.9 percent, and perhaps as much as 3.4 percent in the following decade. These projections imply per capita income growth that is more than twice as fast as that in high-income countries. Growth of such magnitude would reduce the number of people living on less than a dollar a day from 1.2 billion in 1990 and 970 million in 2004 to 624 million by 2015. Such aggregate outcomes are not guaranteed, however, and performance across individual countries is likely to be diverse.

Inflation has remained remarkably muted worldwide despite four years of strong growth. Many developing countries have contained domestic inflation following a tightening of monetary and fiscal policies. The sharp increases in commodity prices mainly had one-time direct impacts on inflation, with only limited second-round effects. Moreover, the increasing integration of developing countries into global markets and their rising shares in world trade have helped dampen inflation globally through heightened international competition. In some countries, however, inflation may become an increasing challenge. In several oil-exporting countries, spending of vast export revenues is heating up domestic markets. In China, efforts to slow growth may not succeed in quickly reversing a recent acceleration of inflation, and demand pressures remain pronounced in several countries in Europe and Central Asia and Latin America and the Caribbean. In Sub-Saharan Africa, the combination of strong domestic demand and rising international grain prices could push already mounting inflation still higher, particularly in import-dependent coastal states.

Continued high and increasing oil prices have stimulated the use of food crops for biofuels and raised fertilizer costs. Prices of maize and vegetable oils increased by 33 and 50 percent, respectively, during 2007. Wheat production fell short of consumption partly because it has been displaced by maize and partly because of adverse weather conditions. As a result, stocks have reached historic lows, and wheat prices have jumped 30 percent. From a macroeconomic perspective, these price increases have hit low-income countries the hardest, resulting in a terms-of-trade loss equal to 0.5 percent of their GDP, with the poorest urban and nonfarming rural segments of the population bearing the greatest burden. While experience shows that direct and targeted income support, rather than price controls, is the most effective way to help these vulnerable consumers, the institutional requirements for social safety nets can be daunting.

Risks

The financial turbulence that emerged in mid-2007 has demonstrated how sudden and pervasive adjustments in financial markets can be. Because the dynamics of financial behavior are inherently difficult to control, and because new securitized instruments have made identifying the location or magnitude of underlying risk difficult, the possibility of a breakdown in a key financial institution or system cannot be fully discounted. Moreover, the likelihood of financial problems would increase rapidly if home prices in the United States were to fall precipitously, an event that could push the U.S. economy into recession. Such circumstances, and the likely U.S. monetary policy reaction, would reinforce the dollar's slide, with a consequent destabilizing effect on global markets.

To date, strong fundamentals in developing countries have helped mitigate the slowdown in the United States, but in the case of a major disruption, adverse effects in emerging markets are unlikely to be avoided, which at some point would exacerbate the U.S. slowdown. Substantially tighter financial conditions could generate a credit crunch that would have consequences for investment and growth in middle-income countries. Low-income countries would also suffer substantial repercussions resulting from weaker global demand for commodities, price declines, and terms-of-trade losses. Even without further turmoil in international financial markets, several developing countries have become more vulnerable to financial pressure as a result of heightened anxiety and increased volatility in foreign exchange markets.

Another important risk is that the loosening of monetary policy in response to the U.S. subprime mortgage crisis could cause growth to overshoot. Commodity markets could tighten further, inflationary pressures would mount, and financial imbalances would increase rather than recede. Such a scenario could sow the seeds of a much sharper slowdown in the medium term and illustrates the current challenge facing monetary authorities in both high-income and developing countries.

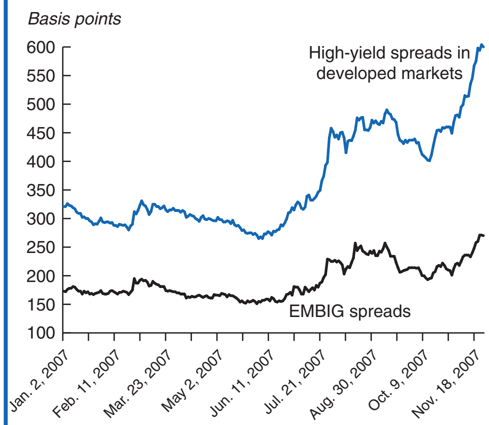
Financial markets: Needed correction or major disruption?

The financial market turmoil of the second half of 2007 resulted from the interaction of several factors. An extended period of abundant liquidity and low interest rates worldwide sparked a search for yield that induced many investors to take on additional risk. This was supported by robust global growth and favorable financial conditions, fueling a four-year expansion in the global credit cycle. Rapid growth in the market for asset-backed securities and structured financial products (collateralized debt obligations in particular) throughout major financial centers facilitated both lending (by making the calibration and offloading of risk easier) and borrowing (by effectively increasing liquidity and the availability of credit). Emerging market bond spreads declined to record lows, and equity prices increased rapidly in many developing countries during the first half of 2007. However, the degree of risk was especially underestimated in the lower credit segments of the U.S. mortgage market (subprime and "alt-A" loans), and hence the value of many asset-backed securities was grossly overestimated.

Corrections to this overvaluation began suddenly in late July, and rising default rates in the U.S. subprime mortgage market spilled over into equity, currency, and bond markets worldwide. Credit conditions for corporate borrowers tightened significantly, while government bond yields declined sharply in what is known as a "flight to quality." Spreads on noninvestment grade U.S. corporate securities widened by 200 basis points in July and the first half of August, indicating that investors' appetite for risk had diminished considerably (figure 1.1). In mid-August, the U.S. Federal Reserve and the European Central Bank provided ample liquidity to the banking system to help stabilize financial conditions.

The sell-off in risky assets served to widen emerging market bond spreads by about 100 basis points by mid-August, raising the cost of capital for corporate borrowers in both mature and emerging markets. As financial conditions tightened once more near the end of the year, U.S. high-yield spreads jumped to 600 basis points by the end of November and emerging market spreads retreated, then increased to 270 basis points, with the overall widening attributable to the current episode moving to 170 points.

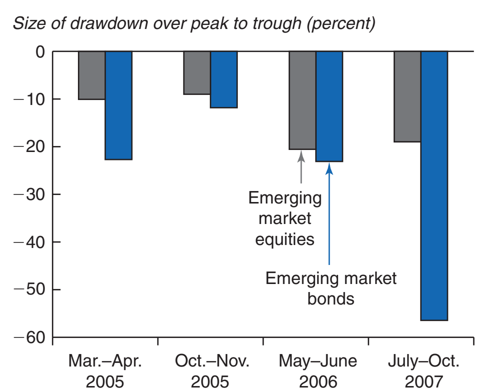
Figure 1.1 The perceived riskiness of high-yield corporate bonds increased more than that of emerging market bonds



Sources: Bloomberg, JPMorgan-Chase, and World Bank.
Note: EMBIG = Emerging Market Bond Index-G.

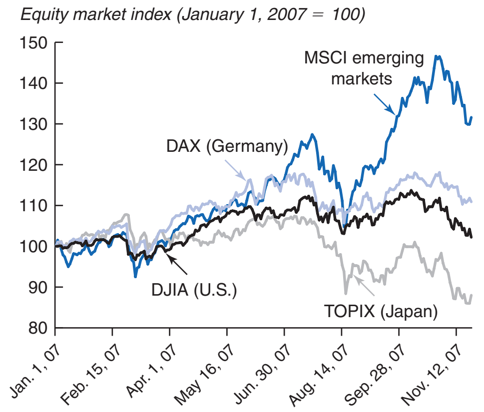
Even though the turmoil has affected emerging markets, so far the financial fallout has been limited, though nevertheless more serious than other, fairly short-lived episodes of market turbulence and volatility that have occurred since 2005 (figure 1.2). Flight to

Figure 1.2 Emerging market asset sell-off more severe than during earlier periods of market turbulence



Sources: Bloomberg and World Bank.

Figure 1.3 Global equity markets fall, then recover led by emerging markets



Source: Thomson/Datastream.

Note: DJIA = Dow Jones Industrial Average; MSCI = Morgan-Stanley Composite Index; TOPIX = Tokyo Stock Price Index; DAX = Deutsche Aktien Exchange.

quality and the need to cover losses in the subprime market provoked a sell-off across the entire spectrum of high-yield assets in mature and emerging markets. Equity price declines in emerging market economies initially exceeded those in mature markets, but emerging markets rebounded sharply, outpacing gains in mature markets (figure 1.3). The Morgan-Stanley composite index of emerging-market stocks picked up close to 50 percent from the beginning of the year, well above the developed markets, before both retreated in tandem by late November. The rebound in emerging market equities was underscored by a resumption of inflows to equity funds, which had experienced outflows of some $5 billion during late July and early August. Until recently, corrections were global in nature, and stock exchanges in East Asia and the Pacific and Latin America and the Caribbean were continuing to drive solid recovery in emerging market equities.

Gross capital flows to developing countries showed strong gains in 2007 before financial uncertainties arose. Bond issuance, bank loan commitments, and equity placements together averaged $53 billion a month from January through July, up from $41 billion during 2006, but a decline in August dropped flows to $42 billion (table 1.1). The surge in flows before August was concentrated in bond issuance and equity placements, and these categories initially experienced the steepest falloff after the turmoil. By October, bond and equity flows had recovered fully or almost fully, but a sharp falloff in bank lending emerged, with commitments dropping $25 billion during the month. Viewed on the basis of only moderate increases in sovereign spreads, the lack of bond issuance in August and September may have reflected decisions by governments in developing countries to postpone new issuance because of limited financing needs rather than an inability to access the market. However, for corporate borrowers in emerging economies, which accounted for 80 percent of bond issuance during 2007, financial conditions have deteriorated. The decline in banking flows is a concern, possibly reflecting a partial near-term withdrawal from

Table 1.1 Gross capital flows to developing countries, 2005–07
(monthly averages, $ billions)

			2007		
	2005	2006	January–July	August	October
Total	30	41	53	42	50
Bond issues	11	11	22	3	15
Bank loan commitments	15	20	18	35	10
Equity placements	5	9	13	4	25

Source: Dealogic Loanware and Bondware.

emerging markets, as banks tighten credit criteria and assume a more risk-averse posture as they replenish reserves after sharp losses in subprime securities.

Global growth

After four years of robust GDP and trade growth, steadily increasing commodity prices, low bond market spreads, gradually changing interest rates, and relatively stable exchange rates, volatility in international markets has increased. Conditions in global financial markets have turned from exceptionally favorable to less stable and less predictable.

More than in recent years, reserves and other buffers will be needed to absorb unexpected shocks. Policy makers must prepare both for the possibility that their economies may slow sharply and for the possibility that growth may continue to exceed potential. Similarly, they must prepare for the possibility of an abrupt depreciation of their currencies as well as the possibility that continued capital inflows could push them up. Commodity prices may spike, or they could give up part of the gains realized this decade.

Despite such a volatile climate, aggregate growth is likely to remain robust for the developing countries, mainly because of strong domestic momentum in most of them. Indeed, economic performance for many developing economies was exceptionally robust during the first half of 2007, much stronger than anticipated in *Global Development Finance* in early 2007 (World Bank 2007a).

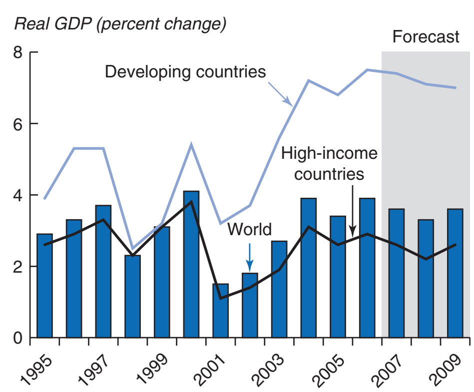
Table 1.2 and figure 1.4 summarize recent developments and the base case outlook. World growth eased from 3.9 percent in 2006 to 3.6 percent in 2007, with the slowdown led by members of the Organisation for Economic Co-operation and Development (OECD). Their GDP dipped by 0.3 percentage points to 2.5 percent in the year. The downturn was more marked in the United States, with growth slowing from 2.9 percent in 2006 to 2.2 percent in 2007. Much of the decline reflected the direct fallout of the weakening housing market, with residential investment falling rapidly, and credit conditions for both firms and consumers tightening.

Among developing countries, growth remained firm at 7.4 percent in 2007, after an equally strong 7.5 percent in 2006, underpinned by continued strength in East and South Asia. If China and India are excluded, activity in low- and middle-income countries slipped by 0.2 percentage points to 5.7 percent in the year.

In 2008, global growth is expected to moderate further, as the effective cost of capital remains elevated for financial institutions, firms, and households. Weak domestic demand is expected to keep U.S. GDP growth below 2 percent in 2008, while growth in Europe and Japan should continue to ease under the additional weight of appreciating currencies. OECD import demand is projected to move from a solid 6.8 percent gain in 2007 to 5.4 percent during 2008, slowing export growth in developing countries by a point to 11 percent and dampening their output growth to 7.1 percent.

The OECD countries are anticipated to recover during the course of 2009, as returning stability in financial markets helps revive consumer and business confidence and residential

Figure 1.4 A step-down in growth in 2008



Source: World Bank.

Table 1.2 The global outlook in summary, 2005–09

(percent change per annum, except where otherwise indicated)

			Estimate	Forecast	
	2005	2006	2007	2008	2009
Global conditions					
World trade volume	7.8	10.1	9.2	7.6	9.2
Consumer prices					
Group of seven countries [a,b]	2.0	2.0	1.7	1.7	1.9
United States	3.4	3.2	1.9	1.5	1.9
Commodity prices (US$ terms)					
Non-oil commodities	13.4	24.5	15.3	−0.7	−4.6
Oil price					
US$ per barrel [c]	53.4	64.3	71.2	84.1	78.4
Percentage change	41.5	20.4	10.8	18.1	−6.8
Manufactures unit export value [d]	0.0	1.6	2.3	0.8	0.8
Interest rates					
$, 6-month (percent)	3.7	5.2	5.3	4.8	5.0
€, 6-month (percent)	2.2	3.2	4.3	4.0	4.3
Real GDP growth [e]					
World	**3.4**	**3.9**	**3.6**	**3.3**	**3.6**
World (PPP weights) [f]	4.8	5.3	5.2	4.9	5.1
High-income countries	**2.6**	**2.9**	**2.6**	**2.2**	**2.6**
OECD countries	2.4	2.8	2.5	2.1	2.4
Euro Area	1.5	2.8	2.7	2.1	2.4
Japan	1.9	2.2	2.0	1.8	2.1
United States	3.1	2.9	2.2	1.9	2.3
Non-OECD countries	5.8	5.6	5.1	4.8	5.0
Developing countries	**6.8**	**7.5**	**7.4**	**7.1**	**7.0**
East Asia and the Pacific	9.1	9.7	10.0	9.7	9.6
China	10.4	11.1	11.3	10.8	10.5
Indonesia	5.7	5.5	6.3	6.3	6.5
Thailand	4.5	5.0	4.3	4.6	5.2
Europe and Central Asia	6.1	6.9	6.7	6.1	5.7
Poland	3.6	6.1	6.5	5.7	5.1
Russian Federation	6.4	6.7	7.5	6.5	6.0
Turkey	7.4	6.1	5.1	5.4	5.7
Latin America and the Caribbean	4.6	5.6	5.1	4.5	4.3
Argentina	9.2	8.5	7.8	5.7	4.7
Brazil	2.9	3.7	4.8	4.5	4.5
Mexico	2.8	4.8	2.9	3.2	3.6
Middle East and North Africa	4.3	5.0	4.9	5.4	5.3
Algeria	5.1	1.8	3.4	4.0	3.8
Egypt, Arab Rep. of	4.4	6.8	7.1	7.0	6.8
Iran, Islamic Rep. of	4.3	4.6	5.0	5.0	4.7
South Asia	8.7	8.8	8.4	7.9	8.1
Bangladesh	6.0	6.6	6.5	5.5	6.5
India	9.2	9.4	9.0	8.4	8.5
Pakistan	7.7	6.9	6.4	6.5	6.7
Sub-Saharan Africa	5.8	5.7	6.1	6.4	5.8
Kenya	5.8	6.1	6.3	5.3	5.1
Nigeria	6.6	5.6	5.9	7.4	6.1
South Africa	5.0	5.4	5.0	5.1	5.3
Memo items					
Developing countries					
Excluding transition countries	6.9	7.5	7.5	7.2	7.1
Excluding China and India	5.2	5.9	5.7	5.3	5.2

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

investment bottoms out. On aggregate, growth in developing countries is expected to be robust in both 2008 and 2009, remaining at or above 7 percent.

The high-income countries

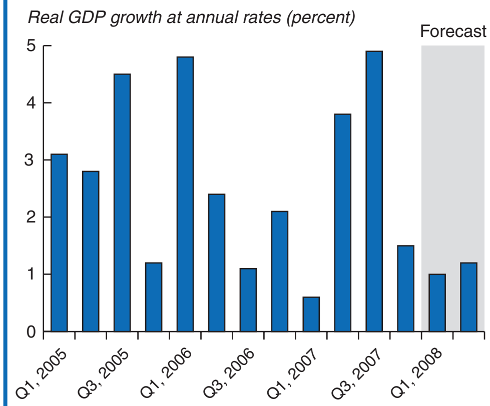
Among OECD countries, the first quarters of 2007 appeared to be a prelude to more volatile growth (figure 1.5). U.S. GDP weakened sharply in the first quarter before rebounding to 3.8 and 4.9 percent in the second and third quarters on the strength of business investment in the second quarter, surprisingly strong consumer demand and stock-building in the third, and strong net exports in both. But high-frequency data point to weaker consumption growth in the fourth quarter, and for the year as a whole, 2.2 percent growth is expected, 0.7 percentage points below 2006 results (figure 1.6).

In contrast, Japan and the Euro Area maintained a favorable pace of growth in the first quarter, with business confidence breaching record highs, but developments in the second quarter were disappointing. In Europe, a retrenchment in business capital outlays more than halved GDP gains of the previous quarter, while in Japan, a slide in fixed investment turned growth into a decline. Third quarter results for Europe provided an upside surprise, with growth returning to a favorable 2.9 percent. GDP gains were broadly based across countries, while business investment, stocks, and consumer spending in France and Germany revived to spur overall growth.

The Japanese economy rebounded modestly in the third quarter as well to register growth of 1.5 percent after a 1.8 percent decline in the previous quarter based on much improved net exports and a moderate boost to household spending. For 2007 as a whole, European growth is expected to register a strong 2.7 percent, eclipsing the United States for the first time in more than a decade, and growth in Japan should register 2 percent.

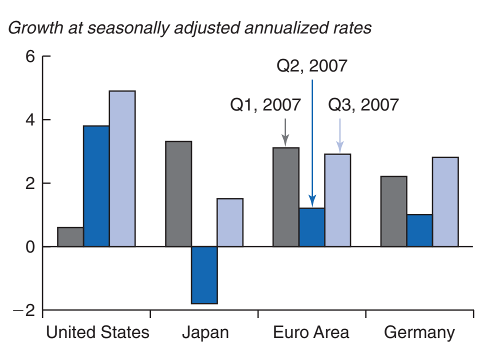
GDP growth in the United States is projected to weaken further in 2008, falling to 1.9 percent. During the year, continuing difficulties in the commercial paper market, the source of working capital for most U.S. business, implies a boost in the effective cost of short-term funds, despite a cumulative reduction of 100 basis points in Federal funds over September through December, which carried the rate to 4.25 percent. Recovery is anticipated for 2009, with growth registering

Figure 1.6 Tighter credit and weak housing yield slower U.S. growth



Source: World Bank.
Note: Q = quarter.

Figure 1.5 Volatile patterns of growth among OECD countries



Source: National agencies and Eurostat.
Note: Q = quarter.

2.3 percent, grounded in a stabilization of financial markets and a revival of business and household spending.

As a result of weaker domestic demand and stronger export performance (in part based on a substantially weaker dollar and continued solid demand from emerging markets), the U.S. current account deficit is expected to decline from its high of 6.6 percent of GDP in 2006 to around 5 percent by 2009. Inflation is anticipated to moderate toward 2.5 percent, in step with slower growth, while household savings could move toward positive ground for the first time in many years. Developments in the United States are expected to influence conditions in Japan, both because of Japan's reliance on trade as a source of growth and because of the sensitivity of business investment to the costs of long-term capital. This is of particular note given Japan's experience with the yen carry trade.[1] Because such trade can potentially unwind rapidly, with local currency proceeds used to redeem yen, substantial appreciation of the currency could hamper exports, production, and incomes. Growth in Japan is expected to slow to 1.8 percent in 2008 before picking up to 2.1 percent by 2009.

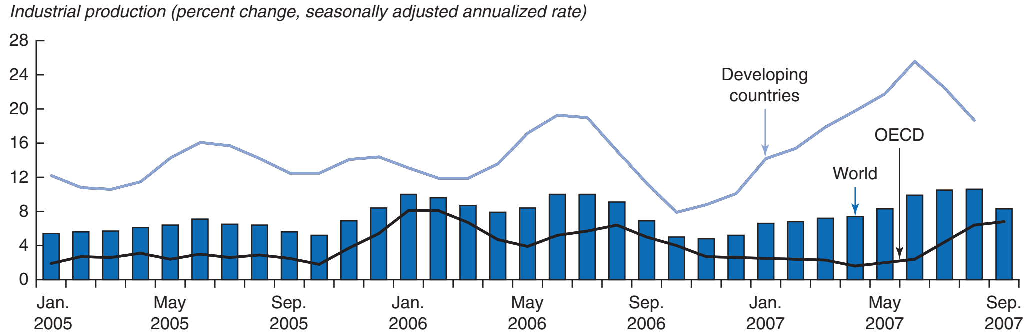
Household spending in the Euro Area has not yet fully recovered from the increase in the German value added tax of January 2007, although unemployment in Europe eased to 7.3 percent in September 2007, the lowest level since figures began to be compiled in 1993. Business investment continues to move in close step with export performance, which deteriorated toward the end of the year, in part because of the appreciation of the euro and slowing U.S. demand. As exports soften and business investment declines, GDP growth is projected to slip to 2.1 percent in 2008 before reviving to 2.4 percent in 2009.

The developing countries

The first half of 2007 was marked by an acceleration in industrial production across developing regions, notably in East Asia (20 percent, year over year) (figure 1.7 and table 1.3).[2] A pickup in China's production, together with momentum gains in Indonesia (7.3 percent) and Thailand (6.0 percent), resulted partly from a bottoming out of the high-tech slump in the second quarter of the year. South Asia's continued buoyant production gains are linked to double-digit growth in India, which is tied in turn to strong domestic demand. Latin America and the Caribbean achieved a 6.4 percent increase in industrial production during the second quarter, at a seasonally adjusted annual rate, up from 2.4 percent during the first. Within the region, strong performance in Brazil (10 percent), Colombia (13 percent), and Mexico (5.5 percent) have offset weakening output

Figure 1.7 Robust growth in developing country industrial production

Industrial production (percent change, seasonally adjusted annualized rate)



Source: World Bank.

Table 1.3 Recent economic indicators, developing regions, 2005–07

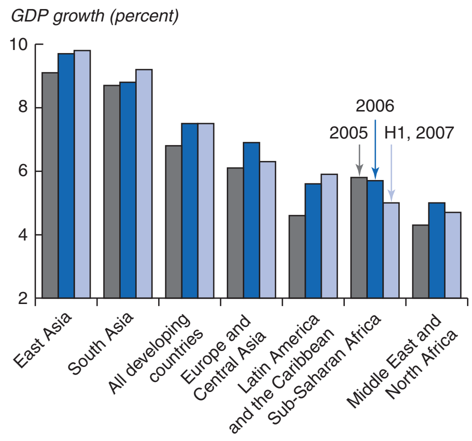
	Growth year-on-year		Seasonally adjusted annualized growth		Growth year-on-year	
Indicator and region	2005	2006	Q1, 2007	Q2, 2007	H1, 07	Latest
GDP growth (percent) [a]						
Developing countries	6.8	7.5	8.5	7.0	7.5	—
East Asia and the Pacific	9.1	9.7	10.3	10.5	9.8	10.2
Europe and Central Asia	6.1	6.9	3.8	4.3	6.3	—
Latin America and the Caribbean	4.6	5.6	7.5	5.0	5.9	5.7
Middle East and North Africa	4.3	5.0	4.8	4.5	4.7	—
South Asia	8.7	8.8	15.6	7.7	9.2	—
Sub-Saharan Africa	5.8	5.7	4.9	4.0	5.0	—
Industrial production growth (percent)						
Developing countries	9.3	10.1	14.6	18.5	14.0	11.4
East Asia and the Pacific	13.8	14.3	19.6	28.9	19.6	16.4
Europe and Central Asia	1.4	4.5	5.6	0.0	3.7	5.0
Latin America and the Caribbean	3.9	4.3	2.4	6.4	3.8	4.6
Middle East and North Africa	4.4	−0.3	−1.9	1.5	−0.5	−1.2
South Asia	9.1	11.0	15.6	11.3	13.0	8.0
Sub-Saharan Africa	5.0	5.3	—	—	—	—
Consumer prices (year over year growth rates in percent)						
Developing countries	6.4	6.2	5.7	6.1	5.9	6.1
East Asia and the Pacific	7.2	4.9	4.3	3.4	3.8	3.1
Europe and Central Asia	4.4	5.6	4.5	4.8	4.7	7.1
Latin America and the Caribbean	5.4	5.6	5.8	5.0	5.4	4.7
Middle East and North Africa	2.8	1.8	4.9	4.2	4.5	5.0
South Asia	7.0	7.6	7.1	6.4	6.7	6.9
Sub-Saharan Africa	3.4	4.6	6.3	7.1	6.7	7.1
Spreads on debt (basis points)						
Developing countries	306	198	176	162	169	243
East Asia and the Pacific	265	180	138	129	134	207
Europe and Central Asia	185	137	147	134	141	192
Latin America and the Caribbean	364	213	183	167	175	259
Middle East and North Africa	324	338	418	434	426	548
South Asia	199	199	166	171	169	482
Sub-Saharan Africa	277	266	283	270	277	321

Source: National statistical agencies through Thomson/Datastream; spreads: JPMorgan.
Note: Q = quarter.
Quarterly 2007 growth for developing regions based on data available for key economies.
EAP: China, Indonesia, Malaysia, Philippines, Thailand. SAR: India. ECA: Hungary, Poland, Russian Federation, Turkey.
LAC: Argentina, Brazil, Chile, Colombia, Mexico. MENA: Arab Rep. of Egypt. SSA: Nigeria, South Africa.
— = not available; H1 = 1st half.
a. Growth rates at annual or annualized rates unless otherwise indicated.

gains in Argentina and the República Boliviarana de Venezuela.

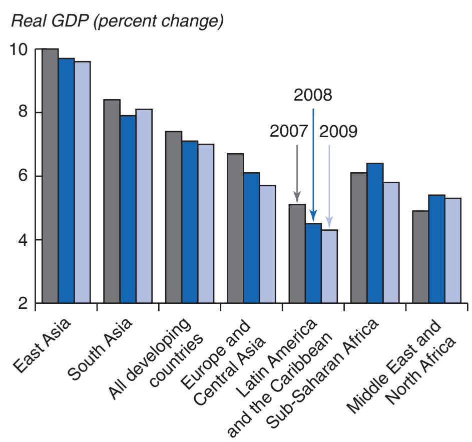
Robust production data are also reflected in GDP results. Led by the large economies, notably China, India, and the Russian Federation, output for the developing countries averaged 7.5 percent (year-on-year) in the first half of 2007, matching the record pace of 2006 (table 1.3 and figure 1.8). Because developing economies have been less affected by the fallout from the subprime crisis than high-income economies, the anticipated slowdown of growth in 2008 should be less pronounced. Gains among developing countries are projected to slow from 7.4 percent in 2007 to 7.1 percent in 2008, with easing across all regions except the Middle East and North Africa and Sub-Saharan Africa, in part because of higher oil revenues. For the remaining countries, slower export market growth, only gradual improvement in financing conditions, and declines in the terms of trade account for most of the slowdown. Though a further easing of growth to 7 percent is anticipated for 2009,

Figure 1.8 Developing growth retains strong momentum during the first half of 2007...



Sources: World Bank and National agencies.
Note: H1 = 1st half.

Figure 1.9 ...with growth moderating through 2009



Source: World Bank.

global conditions should favor a smoother step-down in activity for those countries and regions more dependent on trade, notably East Asia and Latin America (figure 1.9).

Developing region perspectives

GDP in **East Asia and the Pacific** is expected to grow about 10 percent in 2007, the strongest performance since 1994. Growth in China is expected to exceed 11 percent (table 1.2). Elsewhere in the region, strong investment demand boosted growth in Indonesia by almost a percentage point, from 5.5 percent in 2006 to 6.3 percent in 2007. Tighter monetary policy and the economy's absorption of the direct effects of the removal of energy subsidies in 2006 have nearly halved inflation, from 13 percent in 2006 to 7 percent in 2007. Growth is expected to remain in the 6 percent range. Growth in Malaysia and the Philippines appears to have picked up as well, coming in at near 6 percent or better, reflecting a relaxation of monetary policies and improved external demand for electronics. Growth in Thailand has been more subdued during 2007, at a little over 4 percent, tied in part to political unrest, as well as a lagging response to the high-tech revival.

Assuming that China continues its double-digit growth and that the authorities succeed in dampening overheated sectors, GDP growth in East Asia should slow gradually to 9.7 percent in 2008 and to 9.6 percent by 2009. Many countries in the region could, however, experience a stalling of export growth and a loss of business and consumer confidence, leading to a moderate falloff in GDP gains in 2008.

The effects from the turmoil in the world's financial centers may be minimal for most economies in East Asia. Except for China, direct exposures of financial institutions in the region to mortgage-backed securities (or subprime risks) are limited.[3] Economies in East Asia and the Pacific are entering this more turbulent period from a position of relative strength: improved macroeconomic fundamentals, further movement into current account surplus, and rapidly increasing reserves. Yet several of these economies have been the object of international investor interest through carry trades.[3] Should conditions in the mature markets deteriorate so that assets are shifted out of classes perceived as risky to cover other losses, the threat of an unwinding of the yen carry trade, with attendant down-spikes in local equity markets and rapid currency depreciation, is a concern for policy makers.

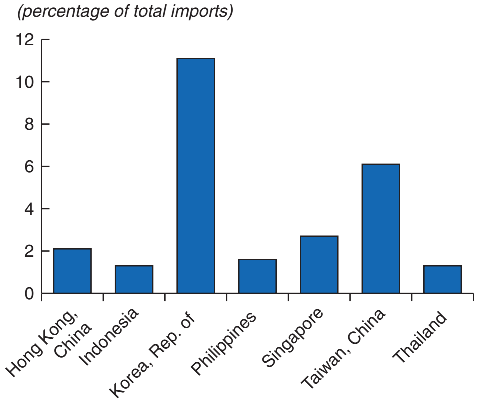
Possible side effects related to financial market turbulence—notably a distinct softening of U.S. and European import demand—could affect all East Asian countries. The Euro Area and the United States together account for 43 percent of China's export market, while Japan accounts for 7.5 percent. With the development of China as a hub for the final assembly and shipment of goods to destination markets, with parts and materials supplied by other East Asian economies (figure 1.10), slower import demand from developed countries could adversely affect the entire region. Some East Asian economies could experience a double hit, sustaining a loss of both direct and indirect import demand.

In the **Europe and Central Asia** region, investment and external demand are both slowing, leading to a moderate easing of growth from 6.9 percent in 2006 to 6.7 percent in 2007. Private consumption, fed by robust credit creation, accounted for 4.6 percentage points of the advance in 2007. Investment, which accounted for 3.4 percentage points of growth in 2007, was driven by policy reforms, improved business confidence tied to European Union (EU) accession by several Central and Eastern European countries, and continuing high oil prices that have fueled a construction boom in several countries of the Commonwealth of Independent States (CIS).

The falloff in external demand took hold in the second half of 2007, slowing growth by 2 percentage points, as net exports continued to deteriorate. Inflation has risen in several countries, tied to sustained strong growth in domestic demand, rising fuel and food prices (the latter aggravated by drought in Bulgaria and Romania), and higher world grain prices. Rapid credit expansion in most of the region has contributed to a worsening of external balances while exerting upward pressure on asset, goods, and labor market prices (figure 1.11). Signs of overheating are evident in Bulgaria and the Baltic states, for example, where external positions have deteriorated from already high levels. Effects on the region stemming from the crisis in the U.S. subprime mortgage market have thus far been limited. Initial downward adjustments to asset prices

Figure 1.10 East Asia now accounts for one-quarter of China's imports

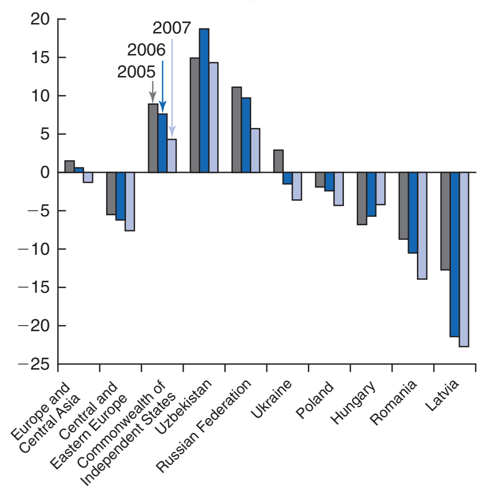
(percentage of total imports)



Source: National sources through Haver Analytics.

Figure 1.11 External positions vary widely across Europe and Central Asia

Current account balance as a percent of GDP



Source: World Bank.

and currencies have since been recouped and bond spreads increased, but to a lesser extent than in other markets.

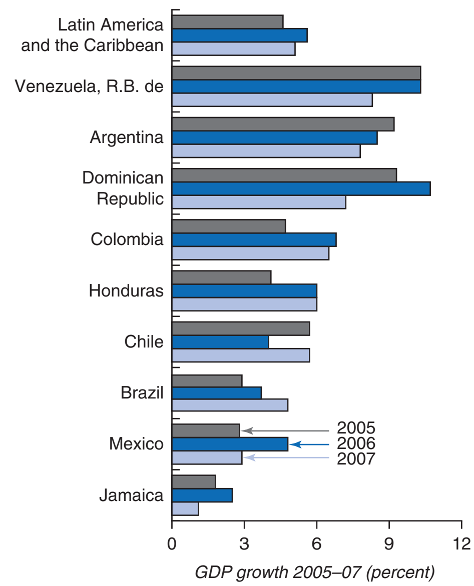
Regional GDP growth is expected to slow to 6.1 percent in 2008 and 5.7 percent in 2009. Given tighter international credit conditions and weakening external demand, the growth falloff in 2008 is likely to affect almost the entire region. Domestic demand is also projected to soften slightly from its recent strong growth, with contributions to GDP of both private consumption and investment dropping by 0.2 percentage points during 2008.

Three exceptions to this growth forecast for 2008 are Albania, Hungary, and Turkey. In Albania, growth is likely to firm on continued strong domestic demand, including an increase in public investment. That investment is crucial to overcome substantial problems in infrastructure, as power shortages now form a significant bottleneck to growth. In Hungary and Turkey, further easing in monetary policy is expected to strengthen domestic demand, leading to a pickup in growth.

External demand is projected to revive by 2009 as GDP growth among the OECD countries picks up. After slowing GDP by 2.2 percentage points in 2008, net exports are projected to boost growth by 1.7 percentage points in 2009. This gain is expected to be offset by further slowing in domestic demand, particularly investment in the CIS countries, yielding GDP growth of 5.7 percent in 2009. The expected falloff in investment in the CIS is driven by the completion of hydrocarbon infrastructure projects that have supported production and export capacity in recent years.

In **Latin America and the Caribbean,** GDP advanced by 5.1 percent in 2007, the fourth consecutive year of sustained growth. The average rate of output gains over 2005–07 was 5.3 percent, twice the 2.7 percent registered during the previous 15 years. Recent growth has also been broadly based, with positive results shared across subregions: South America, Central America, and the Caribbean (figure 1.12). A favorable external environment, together with better macroeconomic management, helped improve fundamentals, reduce the volatility of economic indicators, and sustain growth. GDP in the region picked up to a 5.9 percent pace in the first half of 2007 on the back of continued strong activity in Argentina, Brazil, Chile, and the República Bolivariana de Venezuela. In addition, the mid-2007 credit market turmoil that hit the United States seems to have had limited effects on Latin America and the Caribbean to date. To a degree, the recent upturn in growth will serve as a buffer. Even though any stagnation in the United States will eventually affect regional prospects, countries seem better prepared for exogenous shocks than during prior episodes of financial market disturbance.

Figure 1.12 Growth eases in 2007 for the Latin America and Caribbean region



Sources: World Bank and national agencies.

In contrast with previous expansion phases—and indeed, with previous episodes of crisis—Latin America and the Caribbean is now recording a healthy current account surplus and accumulating large stocks of international reserves. The improvements of recent years might indeed be sufficient to ward off some of the adverse effects of developments in the United States. For example, at the time of the 1998 Russian crisis, the current account deficit for the region was close to $89 billion or 4.4 percent of GDP. In 2003, the deficit reversed to a surplus, and in 2006, the region had a surplus of more than $46 billion, equivalent to 1.6 percent of GDP. Trade liberalization and flexible exchange rates are among the frequently cited policies that facilitated these improvements in external balances.

On the heels of strong growth in 2007, regional GDP growth is expected to ease to 4.5 percent in 2008 and further to 4.3 percent by 2009. Such measured regional slowdown is underpinned by continued strong growth in Brazil and a rebound from a weak 2007 in Mexico, while growth in other countries—notably Argentina and the República Boliviarana de Venezuela—is likely to slow. Excluding the latter two countries, GDP moderated slightly from 4.7 percent in 2006 to 4.4 percent in 2007 and, following an anticipated dip to 4.2 percent in 2008 because of weak import demand in the United States, is expected to recoup to 4.3 percent by 2009. Should these outturns be realized, they would represent the longest positive growth spell for Latin America and the Caribbean since the 1960s. Despite a gradual worsening of current account positions because of stabilizing commodity prices and slower growth in global demand, strong growth is likely to persist, supported by continued expansion in consumption and investment, buoyed by an environment of low inflation (excluding Argentina and the República Boliviarana de Venezuela), improved fiscal policy (particularly in Mexico), and continued strong capital inflows (especially to Brazil).

High oil prices have continued to support growth for the oil-exporting countries in the **Middle East and North Africa,** coming on the heels of a 5 percent regional GDP advance in 2006, the fastest in a decade for the region's developing countries.[4] Oil prices, which spiked to almost $100 per barrel late in the year and averaged $71 per barrel for 2007, are further buttressing government revenues, some of which are dedicated to infrastructure spending in the developing oil exporters (principally Algeria and the Islamic Republic of Iran). At the same time, a solid pickup in European growth over the course of 2007 has favored economic activity among the diversified exporters in the Maghreb and Mashreq, which have especially close trade and services ties with the Euro Area. GDP in the Middle East and North Africa appears to have fared well over the first half of 2007, though easing from 2006 to a 4.7 percent pace during the period, with the slowing tied in part to a return to drought conditions that have affected several countries in the Maghreb, notably Morocco.

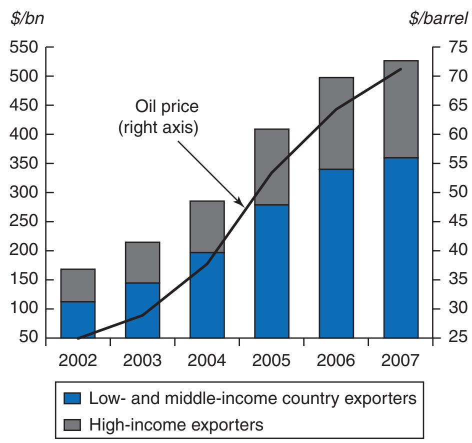
The run-up of surplus funds among oil exporters and the availability of new investment opportunities across the region boosted foreign direct investment (FDI) flows to new highs of more than $24 billion in 2006, or 3.4 percent of regional GDP. At the same time, recovery of local equity markets offers promise that after bouts of overheating during 2004–05 and stabilization following the recent tensions in global financial markets, a less volatile source of funds may play a larger role in the region's growth.

Developing country oil exporters in the Middle East and North Africa registered growth of 4.5 percent in 2007, half a percentage point up from 2006, as GDP in the Islamic Republic of Iran advanced to 5 percent, while output in Algeria almost doubled from the poor 1.8 percent showing of 2006. Hydrocarbon revenues (oil and natural gas) flowing to developing country exporters amounted to $167 billion in the year, representing an increase of 5.7 percent, or $9 billion, over 2006 results. In contrast, export revenues for the high-income country exporters grew by 6 percent to $360 billion, an increment of $20 billion, over 2006 levels (figure 1.13).[5]

For diversified exporters, trade responded well to increased European demand, and to a degree by a depreciation of local currencies in relation to the euro. Exports of goods and

Figure 1.13 Continued oil revenue gains support growth among Middle East and North Africa oil exporters

Crude oil and product revenues ($ billions) oil price, World Bank ($/barrel)



Sources: UN Comtrade database; International Monetary Fund; International Energy Agency; World Bank.

services for Jordan, Morocco, and Tunisia as a group jumped to 10.2 percent growth in the year, in step with a 2.5 percent increment in Euro Area demand, setting the stage for improved output growth. At the same time, a risk facing the region's textiles and clothing exporters, as well as many other low- and middle-income country exporters, is the coming removal of remaining barriers to Chinese exports of specific textiles and clothing products (box 1.1).

A number of factors are likely to shape the growth profile for the Middle East and North Africa region. A softening of OECD demand is anticipated for 2008, although it may be accompanied by additional firming of global oil prices tied to continued robust demand in emerging markets. This should benefit the oil exporters for a time, and should support regional growth of 5.4 percent. As the global environment improves by 2009, the Middle East and North Africa region should be able to maintain the broader pace of growth established in 2008 for several more years. Domestic conditions will vary decidedly across the disparate economies of the region, as will efforts at reform, which in most cases are aimed at spurring private sector or non-oil activity. Tensions related to continuing conflict in Iraq, unsettled conditions in the Levant, and international disputes with the Islamic Republic of Iran will tend to affect global and regional investors' confidence concerning the region, and any projections exercise about the region should take these into account as a risk.

In **South Asia,** regional GDP growth remained vibrant at 8.4 percent in 2007, though easing somewhat from the stellar 8.8 percent gains of 2006. Industrial production and GDP growth are being driven by strong domestic demand, with private consumption and investment each contributing about 4 points to GDP growth in the year. An expansion of credit, rising incomes, and strong worker remittance receipts are underpinning private consumption, while improvements in business sentiment—both foreign and domestic—along with rising corporate profits, are providing a further boost to investment. Despite more restrictive monetary policy and progress toward greater fiscal consolidation in a number of countries, domestic demand growth has picked up, building on the momentum of reforms undertaken in recent years. Moreover, because of tighter policy conditions, inflation pressures moderated during the first half of 2007 in the larger regional economies of India and Pakistan. The risks of revived inflation remain, in part because of the still incomplete pass-through of high energy prices and upward pressures on food prices.

Current account balances deteriorated in a number of countries in 2007, with deficits reaching close to 5 percent of GDP in Pakistan and Sri Lanka and about 2 percent in India. Pakistan's current account deficit is a concern, having deteriorated by the equivalent of more than 5 percentage points of GDP during the last four years. In India, monetary tightening and large capital inflows led to substantial appreciation of the rupee over the year, with the currency reaching a near decade high of Rs 39.30 against the dollar by late November

Box 1.1 Developing country exports in the wake of the removal of barriers to Chinese exports

The system of quantitative restrictions that managed rich countries' imports of textiles and clothing from developing countries for 30 years, especially those produced in China and India (the Multi-Fiber Arrangement), was finally dismantled at the end of 2004, although restrictions for a number of categories of Chinese textile and clothing exports to the EU and the United States remained because of measures that are due to expire in 2008.

China's exports of clothing soared 22 percent in 2005 and 32 percent in 2006, increasing its market share in those two years to 24 percent and 28 percent, respectively, but the impact on competitors has been less drastic than some had feared. The increase in the size of the world market for clothing has allowed exports from many other countries to grow, including the Arab Republic of Egypt, India, Peru, Sri Lanka, and Turkey. In Bangladesh, where 1 million jobs were predicted to be lost, exports to the EU and the United States gained continuously between 2004 and the first four months of 2007.

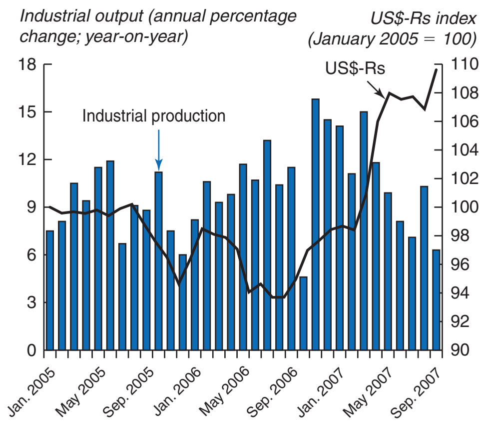
Nevertheless, some countries have seen declines in clothing exports that may entail substantial adjustment. For example, exports to the U.S. and EU markets from Brazil, the Dominican Republic, Swaziland, and Taiwan (China) declined substantially in 2005 and 2006. With the exception of Swaziland, clothing exports from these countries continued to decline into 2007. In addition, for Sub-Saharan Africa as a whole, where the end of the clothing sector had been foreseen, exports to the EU and the United States fell by 7 percent in 2004 and 17 percent in 2005 (on a trade weighted average). In 2006, Sub-Saharan African textile exports to the EU grew 3 percent, whereas exports to the United States declined by 6 percent. In 2007, to the extent that data are available, Sub-Saharan African textile exports to both the EU and the United States grew by 7 and 2 percent, respectively. A number of countries, including Madagascar, Mauritius, and Swaziland, managed to reverse an initial decline in clothing exports and return to growth in 2006 or early 2007.

How vulnerable are other countries when the final restrictions on Chinese textile and clothing exports to the EU and the United States expire? In 2006, 19 percent of Chinese exports to the EU and 20 percent of exports to the United States were subject to quota restrictions, and exports of these products will likely grow significantly after removal of the quotas. In the EU market, Colombia, the Dominican Republic, Mauritius, Peru, and Sri Lanka appear to be most at risk with more than 40 percent of their 2006 exports in product categories for which China is currently still subject to quotas. For other countries, the ratio is between 20 and 40 percent, and for Sub-Saharan Africa as a whole stands at 51 percent, mainly driven by the high exposure of Mauritius (74 percent). In the U.S. market, exposure is generally lower: only the Dominican Republic, India, and Sri Lanka export more than 20 percent of their textiles and clothing in categories where Chinese exports are currently subject to quotas. For most other countries, the ratio is between 5 and 20 percent. However, looking at the impact of the elimination of Multi-Fiber Arrangement quotas in 2004, many competitors managed to defend their market shares in recent years, and they might be able to do so in 2008 as well.

The clothing sector still provides an opportunity for export diversification and the expansion of manufactured exports for low-wage countries, even in the face of unfettered competition from China. The countries best able to expand their exports of clothing will be those that have a supportive business environment, low trade costs (efficient customs, ports, and transport infrastructure), and competitive firms that are flexible enough to meet the changing demands of the global buyers that now dominate the industry.

At the same time, significant adjustment pressures may arise as more efficient firms expand, while those unable to compete in the global market decline. In the absence of other employment opportunities, especially for women, workers made redundant from the textile and clothing sector may fall back into poverty. Minimizing the costs incurred by released workers and their families and facilitating their adjustment into alternative employment will be a major challenge for a number of developing countries.

Figure 1.14 South Asia growth is slowing as the Indian rupee appreciates



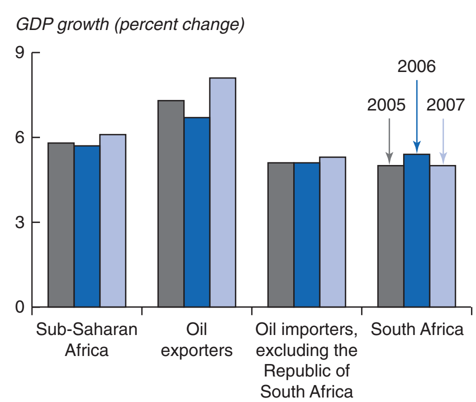
Source: World Bank.

(figure 1.14). The initial effects of increased volatility in international credit markets during the latter part of mid-2007 led to a falloff in equity prices for both India and Pakistan, though both countries have recouped losses in the interim and returns remain well in the positive territory for the year. In local currency, equity markets are up 36 percent in India (50 percent in dollar terms) and 20 percent in Pakistan (19 percent in dollar terms) as of the end of November 2007.

Tighter credit conditions, greater market volatility, increased risk of recession in the United States, and easing growth in the EU will place downward pressures on regional exports before improvement sets in by 2009. At the same time, increased competition from China will be a factor in shaping the path of export growth over the next few years, and an additional 18 percent increase in crude oil prices in 2008 will contribute to a marked deterioration in external balances. On balance, these factors should lead to an easing of regional growth from 8.4 percent in 2007 to 7.9 percent in 2008. Growth is projected to pick up to 8.1 percent in 2009 as external demand revives and given easing pressures on the import bill as oil price gains diminish. Domestic demand is anticipated to revive into 2009, assuming inflation conditions permit some easing of monetary policy in the second half of 2008.

Growth in **Sub-Saharan Africa** looks poised to remain buoyant by historic standards, maintaining a growth pace near 6 percent from 2007 through 2009, notwithstanding slowing demand in the United States and the Euro Area. GDP continued to grow strongly in 2007, with output expanding 5 percent in the first half of the year, and is expected to amount to 6.1 percent for 2007 as a whole. This follows a solid 5.7 percent advance in 2006, grounded in sharp gains for regional oil exporters and South Africa (figure 1.15). Global commodity demand and prices were pushed higher in recent years, notably by continued brisk economic expansion in China. Sub-Saharan Africa is one of few regions that has witnessed a strong supply response to higher oil prices, with crude oil production up 14.3 percent in 2004, an additional 7.6 percent in 2005, and 8.1 percent in 2006 (when Nigeria, which suffered from a number of shutdowns of facilities, is excluded).

Figure 1.15 Oil exporters drive 2007 growth results for Sub-Saharan Africa



Sources: World Bank and national agencies.

Improved macroeconomic stability is also playing an important role in sustaining growth, as is a pickup in both domestic and foreign investment. Debt relief in recent years has freed budgetary resources for spending on infrastructure and social programs. A common trait across economies is a notable pickup in capital spending focused on the transport, telecommunications, and construction sectors. In addition, recovery from drought in many areas of the region is translating into improved performance in agriculture, adding impetus to growth, while the income effects stemming from several years of high non-oil commodity prices are stimulating private consumption.

Recent turbulence in international financial markets resulted in a moderate depreciation of the South African rand against the dollar, but this followed a period of appreciation of the rand because of anticipated capital inflows related to merger and acquisition activity. Due to weakness in the U.S. dollar, the nominal effective exchange rate of the rand has returned to levels prevailing in July, declining 11.2 percent during the first 10 months of the year. There are as yet no signs of a sharp sell-off of South African assets, and there appears to be little evidence of marked adverse effects on the domestic growth outlook.

Much of the impetus for regional growth over 2008–09 will come from strong domestic demand, notwithstanding softer private demand in South Africa, the region's powerhouse, where higher interest rates and an erosion of real incomes are curbing real outlays. A sharp decline in farmers' income in countries affected by recent floods will constitute a near-term drag on growth, and on private consumption in particular, although government and donor transfers and assistance may mitigate some of the effects. Investment is expected to remain strong, notwithstanding the tightening of international credit conditions and lower commodity prices, in part because of large strategic investments by rapidly growing developing economies such as China and India. A notable activity is the Moatize coal project in Mozambique, investment in which amounted to $1.44 billion in the first half of 2007. Madagascar is also experiencing huge investments in its economy. Against this background, Sub-Saharan African GDP is anticipated to be sustained at a pace above 6 percent through 2008, before slipping to 5.8 percent growth in 2009 as oil exporters respond to international conditions and restrain output moderately.

World trade

The globalization of markets for goods and services is continuing at an unabated pace. Over the past seven years, world trade volumes have increased at an average rate of 6.7 percent, virtually the same as during the 1990s (table 1.4). Trade volumes are expanding more than twice as fast as industrial production (global GDP has grown 3 percent a year since 2000, up from 2.8 percent a year during the 1990s). In current dollar terms, world trade doubled during the 1990s and has doubled again since 2000.

While world trade has grown steadily for the last 15 years, developing country trade has accelerated in recent years. During the 1990s, developing country export volumes increased at an annual pace of 6.8 percent, roughly the same as the 6.9 percent export gains of the high-income countries. Since 2000, however, developing countries' exports have been growing twice as fast as exports from high-income countries: 10.8 percent a year versus 5.1 percent a year.

On the import side, the acceleration is even more impressive. During the 1990s, developing countries' import growth of 5.7 percent a year lagged behind that in high-income countries (7.0 percent), but over the last seven years, those positions have reversed. In 2006, import growth in developing countries registered 14.3 percent, compared with 7.9 percent in the high-income countries. Imports across developing regions were growing at double-digit rates during 2006, as export revenues, which had been boosted by high-volume growth and sharp increases in commodity prices, were

Table 1.4 Developments and prospects for world trade and payments

Growth in percent	1991–2000	2000–05	2006	Estimate 2007	Forecast 2008	Forecast 2009
World trade volume[a] (growth in percent)	6.8	5.7	9.8	8.7	7.4	9.3
World exports (growth in percent)	**6.9**	**5.7**	**10.1**	**9.2**	**7.6**	**9.2**
High-income countries	6.9	4.3	9.2	8.2	6.3	7.6
OECD high-income	6.8	3.6	8.8	8.7	6.5	7.7
United States	7.1	1.9	8.4	7.8	8.5	9.0
Japan	4.4	5.9	9.6	6.5	4.0	4.3
Euro Area	6.9	3.6	9.0	11.9	7.2	8.6
Developing countries	**6.8**	**10.4**	**12.7**	**12.0**	**11.0**	**13.1**
East Asia and the Pacific	11.7	15.4	17.7	17.8	15.2	18.5
Europe and Central Asia	0.9	9.1	10.3	9.2	8.5	8.7
Latin America and the Caribbean	8.1	5.3	7.8	4.8	5.5	5.8
Middle East and North Africa	4.4	6.1	9.5	4.3	3.8	5.2
South Asia	9.0	11.2	9.0	8.5	8.4	10.5
Sub-Saharan Africa	4.7	5.4	4.4	5.7	7.3	6.6
World imports (growth in percent)	**6.7**	**5.8**	**9.5**	**8.3**	**7.2**	**9.5**
High-income countries	**7.0**	**4.5**	**7.9**	**6.8**	**5.4**	**7.9**
OECD high-income	6.8	4.1	7.4	6.8	5.0	7.8
United States	9.3	4.3	5.9	2.0	1.3	6.8
Japan	3.6	3.9	4.6	3.6	3.0	5.2
Euro Area	6.3	3.4	7.5	10.1	7.4	9.4
Developing countries	**5.7**	**10.1**	**14.3**	**12.5**	**11.9**	**13.3**
East Asia and the Pacific	11.3	13.7	14.8	14.9	14.3	19.2
Europe and Central Asia	−0.9	10.5	14.2	12.8	11.6	10.4
Latin America and the Caribbean	10.7	4.2	13.3	9.2	9.3	8.1
Middle East and North Africa	1.6	9.7	19.1	12.0	10.0	7.4
South Asia	7.9	12.9	12.1	12.1	10.5	11.9
Sub-Saharan Africa	4.4	8.5	12.4	8.2	8.7	8.8
Current account (percent of GDP)						
High-income countries	**−0.1**	**−0.8**	**−1.1**	**−0.7**	**−0.6**	**−0.5**
OECD high-income	−0.2	−1.1	−1.9	−1.5	−1.4	−1.2
United States	−1.8	−4.9	−6.6	−6.0	−5.4	−5.1
Japan	2.4	3.1	3.9	4.1	3.7	3.8
Euro Area	0.0	0.2	−0.2	0.4	−0.1	0.1
Developing countries	**−1.5**	**1.4**	**3.6**	**3.1**	**2.5**	**1.8**
East Asia and the Pacific	0.1	3.3	8.4	10.1	8.6	7.6
Europe and Central Asia	−1.0	1.4	0.6	−1.3	−1.9	−2.6
Latin America and the Caribbean	−2.6	−0.6	1.6	0.5	0.1	−0.2
Middle East and North Africa	−0.3	5.5	9.6	8.2	9.5	6.2
South Asia	−1.6	0.3	−1.3	−2.4	−3.0	−2.7
Sub-Saharan Africa	−1.9	−0.3	0.9	0.4	0.9	−0.2

Source: World Bank.
Note: a. Exports and imports of goods and non-factor services in 2000 US$.

being expended. The pickup of trade in developing countries also shows in their shares of world markets: in current dollars, developing countries' market share increased gradually in the 1990s from 20 to 25 percent, but since 2000, their share has jumped to 35 percent, supported in part by higher commodity prices.

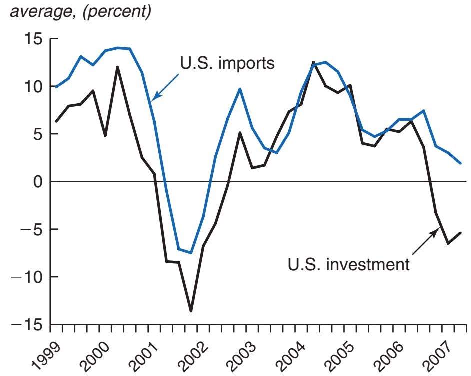
The rapid growth of trade and production in developing countries, seemingly independent of growth in the high-income countries, is sometimes referred to as "delinking." At the same time, the rapid integration of developing countries into global markets, a key factor underlying high growth rates, could also be considered as an intensification of the linkage of developing countries to high-income countries, as they have become an integral part of the global business cycle. The combination of delinking in terms of growth rates and increased linkage in terms of cyclical changes in growth gives developing countries a prominent role in the current economic environment: they have become a driving force for global trade, and their strong trade links can help mitigate the slowdown in high-income countries. In 2007 and the years following, developing countries are expected to be the source of more than half of growth in global imports.

The shift of import demand away from the United States (and high-income countries generally) and toward developing countries is clearly visible in recent high-frequency data. The slowing of high-income countries' imports and of developing countries' exports reflects much weaker investment and consumption growth in the United States in line with the fallout in the housing market (figure 1.16).

At the global level, the slowing of U.S. imports has been offset in part by a strengthening of import demand across developing countries driven, among other factors, by robust domestic demand, especially in the large emerging market economies (figure 1.17). Looking forward, vibrant growth in developing countries should offer a cushion from recessionary conditions in the key OECD economies over the critical 2008 period.

Figure 1.16 Weak U.S. growth reduces demand for developing country exports

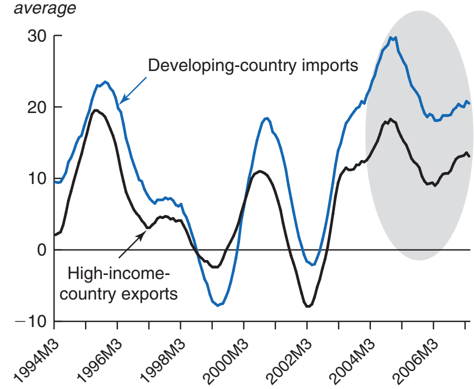
Growth of investment and imports, four quarter moving average, (percent)



Source: World Bank.

Figure 1.17 Export opportunities for high-income countries

(Percent) nominal growth in US$, 12-month moving average



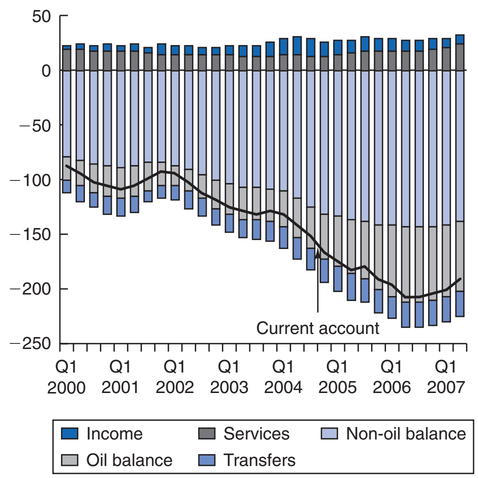
Source: World Bank.
Note: M3 = March.

Indeed, among recent regional developments, dollar-based import growth has been strong: Sub-Saharan African imports increased 23 percent over the year to May 2007; South Asian imports jumped 32 percent through August, driven by strong investment and import demand in India; and Latin America and East Asia were importing at rates of 15 and 14 percent, respectively, through September. However, the key contribution to the pickup in imports stems from Europe and Central Asia (an increase of 28 percent through September, up from 20 percent a year earlier), where in Central and Eastern Europe, EU accession countries are increasing their import potential in dollars with currencies effectively pegged to an appreciating euro, while in the CIS, exporters of oil and other hydrocarbons continue to spend portions of their accumulated revenues.

Such rotation of trade growth is contributing to an unwinding of global imbalances that

Figure 1.18 U.S. current account narrows over 2007 and is likely to continue doing so

U.S. current account components ($ billions, three quarter moving average)



Source: U.S. Department of Commerce.

started in 2006. The U.S. current account deficit declined from a peak of 6.8 percent of GDP in the fourth quarter of 2005 to 5.5 percent by the second quarter of 2007. The shrinking deficit reflected weaker U.S. imports, caused in part by the housing slump, and stronger exports, supported by demand in developing countries and the falling dollar (figure 1.18). The mirror image of the narrowing U.S. current account may be found in developing countries, as well as selected OECD countries, where surpluses are broadly in decline. Based on the strong correlations shown in figure 1.16, export revenues in developing countries are likely beginning to slow in line with the softening of import demand in the high-income countries. At the same time, spending in developing countries remains strong. Such gradual unwinding of global imbalances is expected to continue, at least through 2009, as oil price levels decline, driven by the same elements that emerged in 2007.

Inflation and commodity markets

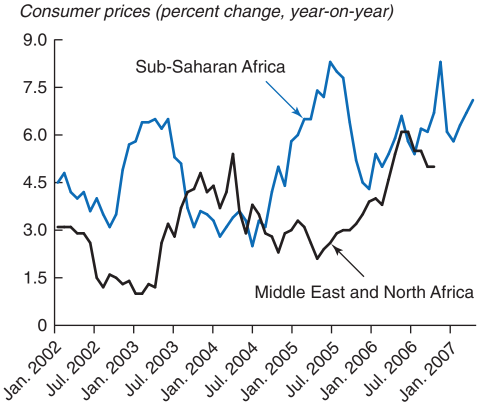
In high-income countries, inflationary pressures were sufficiently under control during 2007 to allow central banks to end a period of monetary tightening. In the United States, the Federal Reserve had become more concerned about a possible recession than about accelerating inflation and lowered Federal funds by 50 basis points to 4.75 percent on September 18—the first reduction in four years. A further 25 basis point cut was enacted on October 31 and a like reduction on December 11, carrying Federal funds to 4.25 percent. In Japan, inflation is not yet permanently in positive territory, making it unlikely that the Bank of Japan will follow its initial tightening steps with further increases in interest rates. In Europe, inflation is fluctuating around the European Central Bank's upper target, recently with more upward than downward momentum. Given expectations for softening growth in 2007, as well as an appreciating currency, the European Central Bank will probably hold its policy rate at 4 percent.

The inflation picture is more diverse across developing countries. In several rapidly growing economies, where inflation had picked up over the last two years, policy interest rates have been increased gradually. This occurred across South Asia (India, Pakistan, and Sri Lanka), where signs of overheating became evident, and also in several Latin American and Caribbean countries (Argentina, Chile, Colombia, and the República Bolivariana de Venezuela). China and the Czech Republic are examples of economies where monetary tightening continues. But in some countries (Belarus, Brazil, the Lao People's Democratic Republic, and the Philippines) inflation eased and monetary policy, which was tight, is now loosening moderately. In several countries monetary policy has reversed. In Hungary and Turkey, for example, policy rates were cut in 2007 after being on a long uptrend. This turnabout was a reaction to the recent slowdown in growth after a long period of strong gains in domestic demand that led to large current account deficits and inflation pressures.

Inflation has remained remarkably muted after four years of global growth that has been stronger than that experienced in the last 30 years. Average consumer price inflation in high-income countries registered 1.8 percent in 2007, slightly below that experienced during the downturn of 2001. Median inflation in developing countries registered a moderate (in a historic context) 5.9 percent, only 0.6 percentage points higher than at the beginning of the decade. Hyperinflation, once a trademark of several developing countries, has been eliminated, with Zimbabwe now being the notable exception. The number of developing countries with double-digit inflation has halved since the beginning of the decade.[6] Inflation was lower in the first half of 2007 than it was in the previous year in more than 60 percent of all countries, and among the 56 developing countries for which inflation data are available for the first half of 2007, more countries experienced an easing than a pickup of pressures. Moreover, average inflation is still on the rise in just two of six developing regions (figures 1.19 and 1.20). In Sub-Saharan Africa, inflation is volatile, but is trending higher, reflecting rising food prices, and the Middle East and North Africa region shows a clear uptick in inflation, likely triggered by the expenditure of burgeoning oil revenues in the region, notably in the Islamic Republic of Iran. In other regions, inflation is volatile, but broadly trending flat or slightly downward.

Figure 1.19 Inflationary pressures are rising in the Middle East and North Africa and Sub-Saharan Africa

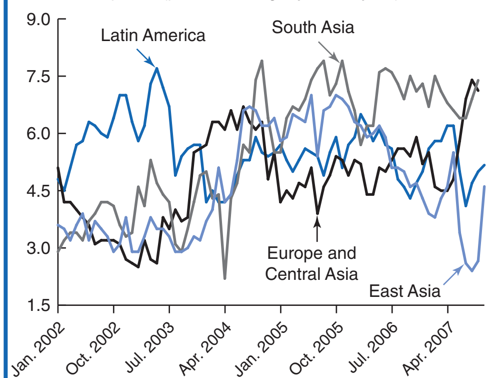
Consumer prices (percent change, year-on-year)



Source: World Bank.

Figure 1.20 Inflation is broadly stable elsewhere, though at high levels

Consumer prices (percent change, year-on-year)

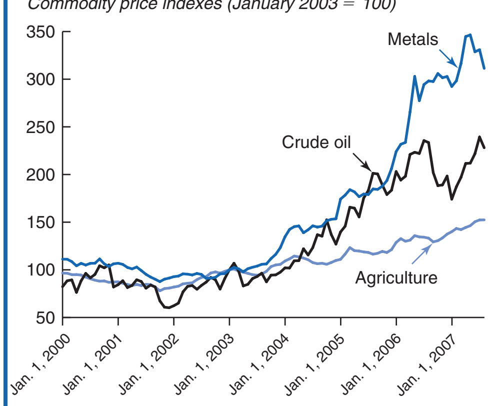


Source: World Bank.

Developing countries have played an important part in restraining inflation worldwide. Improved macroeconomic policies have tended to reduce domestic pressures on inflation across a wide range of countries. Independent monetary policy, more cautious fiscal stances, strong currencies, and rapid TFP growth have increasingly kept domestic inflation under control. In addition, greater engagement in international trade and competition has helped spread price restraint across trading partners. In many countries, passing cost pressures through to output and to consumer prices has become progressively more difficult.

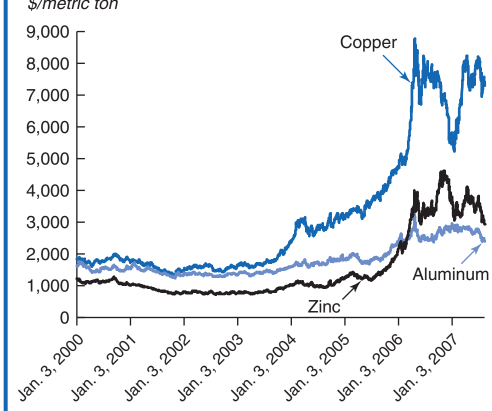
The lack of pass-through, in particular, has enabled monetary policy in the high-income countries to remain fairly passive in the face of rising non-core prices. Partly as a consequence, global growth has been maintained at

Figure 1.21 Commodity prices continued gains through 2007 led by metals



Source: World Bank.

Figure 1.22 Copper, zinc, and aluminum prices sharply affected by China



Sources: London Mercantile Exchange and World Bank.

a higher rate much longer than in the past, generating increasing capacity constraints in commodity markets. As a result, commodity prices continued to increase and remained elevated into the fourth quarter of 2007. Commodities have become more volatile, however, and the increase in several commodity prices is now moderating (figure 1.21).

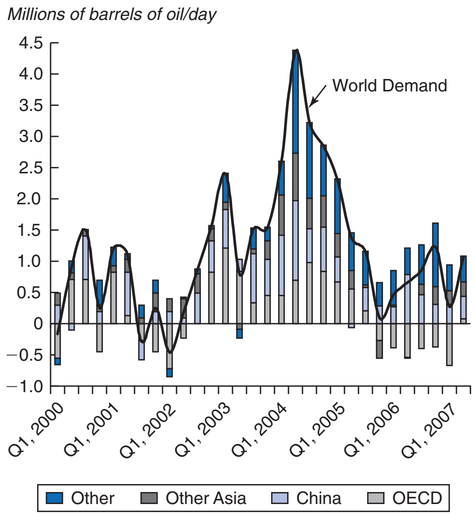
The increased use of food crops for production of biofuels is an important factor that led to large increases in the prices of vegetable oils and grains in 2007, which in turn contributed to an overall 15 percent increase in the index of agricultural prices and a 20 percent rise in food prices. The latter is of special concern for poor consumers in developing countries.

The prices of metals have increased more than other commodity prices over the last four years, largely because of especially strong demand in China. Underinvestment during earlier periods of low prices and numerous supply problems and delays in bringing on new capacity have also played a part. Shortages of equipment and skilled workers have significantly increased development costs, and ore grades are deteriorating. The price of metals for which China is a net importer, especially copper, have experienced sharp gains, while those for which China is a net exporter—mainly aluminum and to some extent zinc—have increased much less (figure 1.22). Following the global credit squeeze in August and September, the prices of metals dropped more than 10 percent (metals tend to be particularly sensitive to slowing economic activity and may have been exposed to speculative pressures when investors closed their positions to finance other losses in their portfolios). The prices of metals are generally expected to peak in 2007, to decline by 5 percent in 2008, and to continue lower into 2009 as rising capacity tips markets into surplus.

Nominal oil prices, measured in dollars, broke historic records in November, reaching nearly $100 a barrel. Measured in euros, oil prices stood 4.5 percent above their 2006 peak, while in real terms (corrected for overall inflation) oil prices remain 4.2 percent below the peaks reached in November 1979.

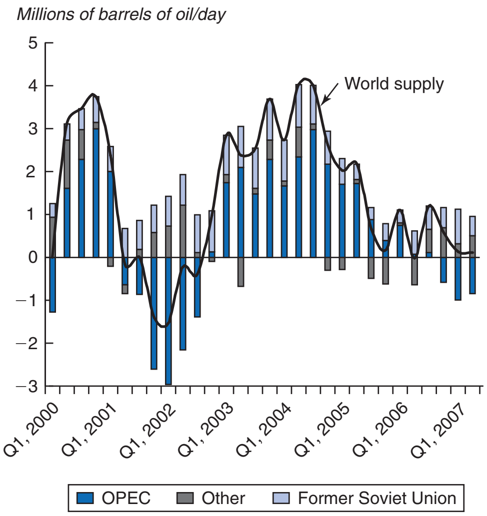
Higher oil prices have reduced growth in global oil demand, particularly in high-income countries. Oil demand in the OECD declined for six consecutive quarters beginning in the fourth quarter of 2005, with an average drop of more than 0.4 million barrels a day (figure 1.23).

Figure 1.23 Growth in the world's demand for oil slows



Sources: International Energy Agency and World Bank.

Figure 1.24 OPEC reduces output to support prices



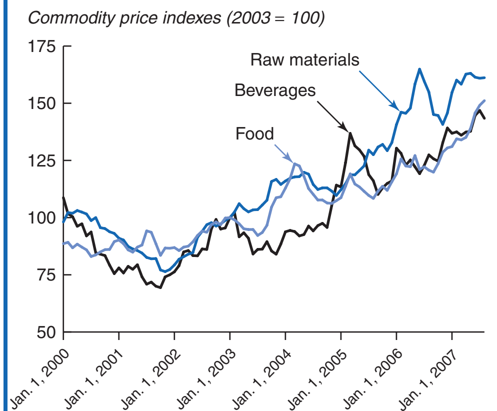
Sources: International Energy Agency and World Bank.

In non-OECD economies, the demand for oil has grown by just over 1 million barrels of oil a day since 2005, down sharply from the surge of 2004. Supply in several producers that are not members of the Organization of Petroleum Exporting Countries (OPEC), especially Russia and countries in western Africa, has increased in recent months, and among OECD countries, Canadian production continues to grow, predominantly from oil sands, while significant new output in the deep water U.S. part of the Gulf of Mexico is starting up. These increases have been partially offset by moderately falling production in the North Sea. As demand eased and non-OPEC supply increased, OPEC countries reduced their output to prevent further increases in stocks and a fall in prices (figure 1.24).

Because OPEC has limited spare capacity and is holding down production, oil prices will likely remain quite elevated and volatile; however, high prices and increasing environmental concerns should continue to moderate growth in demand. At the same time, rising upstream investment in oil-producing countries (both in OPEC and in non-OPEC countries) should result in new capacity that exceeds the growth in oil demand. Nevertheless, oil markets are expected to remain finely balanced over 2007–09, in part because of production discipline by exporters, and prices are expected to remain above $75 a barrel for the coming two years. In the longer term, the oil market balance is expected to loosen and prices are projected to fall toward $50 per barrel.

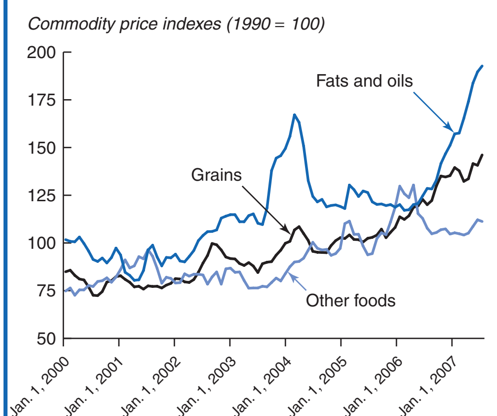
The rise in agricultural prices during 2007 was underpinned by strong demand for food imports, especially by oil-exporting countries, which contributed to a 20 percent increase in global food prices for the year. Higher cocoa and robusta coffee prices raised beverage prices by 13 percent, while raw materials prices were moderately higher (figure 1.25). The increase in food prices was led by fats and oils, up 50 percent for the year, and grains, up 22 percent (figure 1.26).[7] Among other commodities, sugar prices declined 32 percent, as

Figure 1.25 Agricultural prices surge over 2006–07



Source: World Bank.

Figure 1.26 A rise in food prices, led by a ramp-up of the prices of fats, oils, and grains



Source: World Bank.

growing conditions in India, Pakistan, and Thailand improved, and new plantings and favorable weather boosted Brazilian production.

Food prices have risen nearly 75 percent since their lows of 2000. The increases stem partly from the stepped-up use of food crops for biofuels and partly from other more fundamental factors, such as rapid income growth in developing countries, high fertilizer prices, low stocks, and droughts. Biofuels are playing an increasingly important role in agricultural commodity markets as their share of global production and trade increases. In 2006, biofuels accounted for 5–10 percent of the global production of the primary biofuel feedstocks and up to 77 percent of the volume of trade. Among the largest biofuel producers, the United States used 20 percent of its maize production for biofuels; Brazil used 50 percent of its sugarcane for biofuels; and the EU used 68 percent of its vegetable oil production, primarily rapeseed, and also imported additional vegetable oils. Such large usage reduces supplies of these crops for food and feed and has contributed to substantial price gains (box 1.2).

The anticipated spike in grains prices, identified as a concern in the World Bank's *Global Development Finance* report published in May 2007 (World Bank 2007a), has largely materialized. Monthly wheat prices have increased 90 percent since mid-2007. Wheat stocks are expected to fall to record lows relative to consumption, and prices may increase further in 2008 before production recoups enough to rebuild stocks. In the meantime, a large number of food-importing countries may suffer substantial terms-of-trade losses over the course of 2007 and into 2008 (box 1.3). Price increases for vegetable oils and grains primarily affect low-income countries, with the rise in prices since the end of 2004 leading to a terms-of-trade loss equivalent to 0.5 percent of GDP. This represents 1 percent of GDP in 29 countries, and nearly 5 percent of GDP for the most affected country, Eritrea. The impact on middle- and high-income countries is considerably less because imports of these commodities represent a smaller share of trade, and higher prices on other commodity exports tends to offset terms-of-trade losses resulting from higher food prices. Agricultural prices are expected to remain nearly flat at high levels in 2008, as biofuels production continues to ramp up in response to consumption mandates and production subsidies, drawing resources from other crops.

Box 1.2 Biofuels

Biofuels are not new: the first Ford automobile was originally intended to run on ethanol. However, the interest in biofuels has increased in recent years along with increases in energy prices and heightened concern about the environment. Countries want not only to achieve greater energy security, but also to reduce the use of fossil fuels to lower greenhouse gas emissions and improve air quality. The demand for biofuels also got a boost when methyl tertiary-butyl ether was banned as a fuel additive to meet clean air regulations in many U.S. states and localities and for fear it was contaminating groundwater. The political gain attached to supporting new demand for agricultural products, and thus enhanced crop prices, has added to interest on the part of politicians and encouraged generous support policies in many countries, including EU countries and the United States.

Biofuels can be produced from a variety of feedstocks. Current technology, often called first-generation technology, relies primarily on food crops such as sugarcane and maize to produce ethanol and on vegetable oils from rapeseed, soybeans, palms, and other crops to produce biodiesel fuel. So-called second-generation technology may be able to produce biofuels from an even wider range of feedstocks, such as switch grass, timber waste, and municipal garbage, but such technology is not yet commercially viable and many experts do not expect it to become so for at least a decade.

Global production of biofuels totaled about 45 billion liters in 2006, representing slightly more than 1 percent of global road transport fuels on an energy equivalent basis. Biofuels can be used to replace their fossil fuel counterparts or can be blended with fossil fuels to achieve certain benefits, such as reduced tailpipe emissions and increased octane levels to improve engine performance. One of their greatest advantages is that they can be used in conventional gasoline and diesel engines without modification of the engines and can be dispensed through existing distribution channels.

Nevertheless, their use has some limitations. Ethanol can be used in conventional gasoline engines only up to about a 10 percent blend with gasoline without engine or fuel system modifications. It also requires special handling in transport to prevent contamination. Specially designed flex-fuel engines can use a wider range of blends of ethanol and gasoline and are available in Brazil and the United States. Biodiesel fuel can be used in any blend with fossil fuel diesel in standard diesel engines, but its use is limited in colder climates. The energy content of ethanol is lower than that of gasoline, providing about 20–30 percent fewer miles per gallon than gasoline, while biodiesel provides 5–10 percent lower mileage than diesel.

While biofuels have thus far had little impact on crude oil prices, they have already had large effects on prices of commodities used as feedstocks for biofuels, as well as for competing crops. For example, maize prices rose by about 60 percent from mid-2005 to mid-2006, largely because of the increased use of maize for ethanol production in the United States. This prompted a huge shift of land from wheat into maize in the following season, which contributed to a sharp increase in wheat prices. Vegetable oil prices have also increased because of their stepped-up use for biodiesel production in Europe and the United States, with palm oil prices up 48 percent in the last year and soybean oil prices up 25 percent. These price shifts have set off a food versus fuel debate that is causing some to question the contribution of biofuels.

Risks and uncertainties: Danger of a banking crisis and a U.S. recession

The baseline projections assume, on the real side of the economy, that the U.S. housing recession does not spill over in a large-scale way to the rest of domestic demand, as the downward spiral in housing is mitigated by strong export growth. On the financial side of the economy, the projections assume that losses on holdings of asset-backed securities are widely distributed and that interventions by the Federal Reserve, the European Central Bank, and other institutions restore calm to financial markets. However, the effective cost

Box 1.3 Policy responses to rising food prices

Higher prices of imported staples, strong growth of domestic and regional demand that pushes up prices of domestically produced goods, and increased prices of production inputs such as fertilizers and energy are causing rapid rises in food prices in many countries. The price increases will hurt the poor, who spend a large share of their income on food, but will also help the rural poor who produce a marketable surplus. Governments are under pressure to take action to blunt the impact of higher food prices, but many countries have liberalized or partially liberalized their domestic food markets and imports (Bangladesh, Brazil, Egypt, India, Mali, Morocco, Russia, Ukraine, and the Republic of Yemen, to name a few) and no longer have policy instruments to control food prices. Those countries that have targeted safety net programs can rely on those channels to provide assistance to the poorest people, but countries without safety net programs will feel pressure to impose price controls or to reintroduce government controls. This would undo successful policy reforms and send a negative message to the private sector.

Bangladesh offers an example of the success of open market food policies. It has transformed its agricultural sector into one of the most productive in South Asia. The country is largely self-sufficient in rice, a basic staple, and is an emerging exporter of high-value agricultural products. One of the keys to this success was the government's decision to liberalize food imports in the early 1990s. Private traders imported food grains during times of domestic shortfall, providing needed supplies and price stabilization, as well as removing a financial burden from the government. By 2000, the private sector was importing 100 percent of imported food, and the government reoriented its large public food distribution system away from mass distribution in favor of a targeted safety net program for the poor. Such a response would be effective in the current situation of high food prices, but a complicating factor is that part of the current price increases might be more persistent than in the past.

Past periods of food price increases were temporary and lasted only two or three years, such as the increases during the 1970s or the more recent increases in 1995–96; however, the current increases have a structural component that may persist because it is closely tied to the rise in global energy prices. If energy prices remain high, food crop prices are unlikely to decline significantly. Over the longer term, supplies of food are expected to increase and prices to fall, but the current price increases are expected to continue for several years, and thus most countries will not be able to shelter their consumers from them. Current food price increases also have a temporary component caused by low stocks and production shortfalls stemming from drought. These can be expected to dissipate as supplies respond to high prices. Countries should aim to protect consumers from temporary price increases caused by shortages, but few countries can afford to protect consumers against structural changes in food prices.

Consumers in food-exporting countries are also seeing their food prices increase as supplies are exported at high international prices, and several countries have imposed export bans to contain domestic food price inflation. Such bans unfairly penalize the producers of these crops and may encourage smuggling and corruption. A more appropriate policy response is to provide a targeted safety net program for the poor while allowing exports to continue unfettered.

of capital is likely to increase further, reflected in tightened credit criteria for firms as well as households in the United States. Elsewhere, however, tightening is expected to be more moderate. Under such conditions, weakness in U.S. housing would continue, but the contraction in residential investment will have bottomed out by mid-2008.

Should unexpected and large-scale new losses occur in financial markets—concentrated among commercial and investment banks or among major investors—credit conditions globally could tighten much more. Such a scenario would tend to increase losses on asset-backed securities, potentially carrying financial markets and the real economy into a downward spiral and requiring an aggressive loosening of monetary policy.

Under such circumstances, contraction in quarterly GDP in the United States would become more likely, pushing growth in 2008 to 1 percent, or almost half of baseline growth. Equity markets in high-income countries would likely decline substantially, and the effective cost of capital could increase by some 200 basis points in 2008, compared with the baseline. Such a pronounced credit crunch would be reflected in a sharp decline in U.S. business investment, declining employment, weaker consumer outlays, and a prolonged period of depressed consumer prices.

Adverse developments in the United States would spill over to the rest of the world through weaker U.S. imports and a substantial further decline in the dollar, spurred by an aggressive loosening of monetary policy. The spillover could be exacerbated by a reversal of the yen carry trade and a reduced appetite for U.S. assets among international investors as growth slows and assets of financial institutions become more risky. Largely because of reduced exports and investment growth, GDP growth in Europe and Japan could fall to 1.5 and 1.3 percent, respectively, about half a percentage point below the baseline.

For a number of middle-income countries, the most important transmission channel of effects stemming from the OECD countries would be a tightening in international credit conditions, which would cut into investment and reduce growth. Middle-income economies with large current account deficits and countries whose currencies are pegged to the euro would likely feel the greatest effects. Growth in middle-income countries would fall a percentage point below the baseline; however, the impact would be quite diversified, in part depending on how economies are linked financially to the U.S. dollar. Central European economies that accumulated euro-denominated debt will be more vulnerable than countries that hold dollar debt.

The repercussions for low-income countries could also be sizable, as weaker global demand for commodities (metals, agricultural products, and fuels) could worsen their terms of trade by 2 percent of GDP, and the pace of expansion could decline by 0.6 points in 2008. Overall, given such a scenario, global growth might decline by three-quarters of a percentage point in 2008 compared with the baseline.

The loosening of monetary policy in response to the subprime crisis might also cause growth to overshoot. As a result, commodity markets could tighten further; inflationary pressures would mount, especially in developing countries; and financial imbalances would increase rather than recede. Such a scenario could sow the seeds of a much sharper growth slowdown in the medium term and illustrates the challenge facing monetary authorities in both high-income and developing countries.

Long-term prospects and poverty forecasts

A potential for catching up

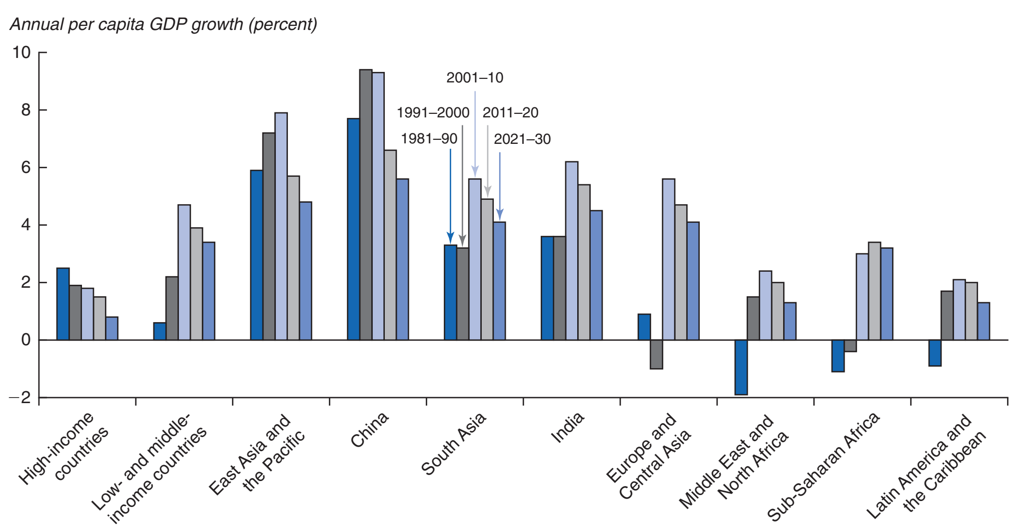
Beginning in the mid-1990s, per capita income growth in developing countries has accelerated, with growth being particularly vibrant since 2000. Several factors suggest that this high growth will be sustained over the longer term. First, economic policies are on a more solid footing than in earlier periods, with both inflation and fiscal deficits broadly under control, and structural policies more conducive to taking advantage of more open global markets, and a business climate more favorable for investment. Second, many countries have entered, or are entering, a period of demographic transition that combines rapid labor force growth with declining dependency ratios. This shift provides a window of opportunity for rapid economic gains. Third, the income disparity between developing and developed countries is still large, but with broader access to information and technology-laden capital and imports, developing countries have the ability—and the incentive—to narrow this gap.

The long-term forecast for 2010–30 projects sustained growth across developing countries, albeit with a moderating trend (figure 1.27). For developing countries as a whole, per capita growth is expected to ease from an average of 3.9 percent in the first decade of the 2000s to 4.5 and 3.4 percent in the second and third decades, mainly reflecting slowing growth in the East Asia and the Pacific region. Sub-Saharan Africa could see a slight acceleration, with average per capita income growth of 3.0 percent in the current decade, increasing to a more sustainable 3.2 to 3.4 percent in subsequent decades. This is a substantial improvement over the 1980s and 1990s, when per capita incomes in Sub-Saharan Africa declined.

Years of sustained increases in per capita incomes should see average real incomes (stated in 2001 prices) more than double by 2020, rising from $1,300 in 2001 to $2,800 by 2020. By 2030, they are projected to reach nearly $4,000. However, significant variation will occur around these numbers, and despite a relatively optimistic growth scenario, the gap between rich and poor countries will remain extremely wide. The average citizen in a developing country is projected to earn only 7.8 percent as much as a citizen of a high-income country, a ratio that should rise to about 10.0 percent by 2030.

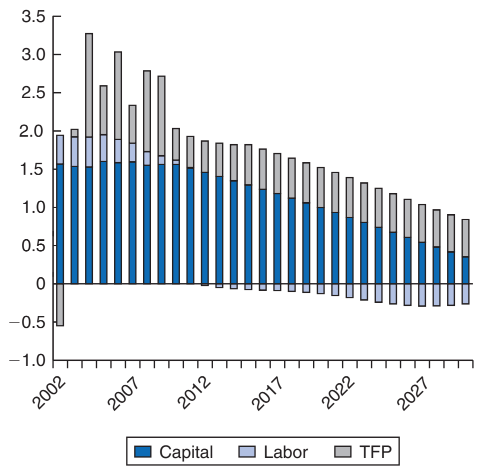
This year's long-term scenario represents a significant upward revision from last year's long-term forecast. The revision reflects a confluence of factors, including the simple recognition that developing country growth has accelerated over the last decade and has been broadly based and sustained. Among the factors that likely contributed to sustaining this high level of growth is the relatively rapid convergence in technological achievement between high-income countries and developing countries (see chapter 2). This progress is projected to continue over the next 20 years, and the returns to knowledge and capital will remain more or less constant. These sustained returns combined with rising incomes will translate into increased investment in education and research and development, helping to

Figure 1.27 Long-term growth, 1980–2030



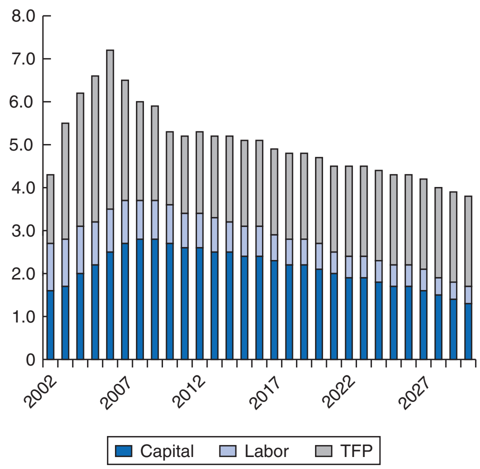
Source: World Bank data and simulations with the Linkage model.

Figure 1.28 Declining capital-led growth for developed countries, 2002–30



Source: Simulation results from the Linkage model.
Note: TFP = total factor productivity.

Figure 1.29 Sustained high productivity growth for developing countries



Source: Simulation results from the Linkage model.
Note: TFP = total factor productivity.

establish a virtuous cycle of further technological progress and increased incomes. Those countries where technological progress has stagnated are expected to benefit from a supportive global environment characterized by accelerating exports and continued strong income gains from commodities, partly explained by the growing importance of developing countries in global growth.

Part of the strong projected performance for developing countries derives from stronger labor force growth, but much can be attributed to technological progress, measured in figures 1.28 and 1.29 by TFP growth. The strong TFP growth in developing countries of the last several years is consistent with the findings in chapter 2 of this report, which suggest that (based on a different measure of technology) the technology gap between middle- and high-income countries has narrowed over the last 10 years. Over the forecast horizon, the relative strength of TFP growth in developing countries is expected to persist, which is also consistent with the finding in chapter 3 that the drivers of technological diffusion and absorption in developing countries have strengthened. However, as stressed there, the realization of this potential during the coming decades will depend on the extent to which countries, especially low-income countries, can strengthen their technological absorptive capacity and remain open to new technology flows.

Poverty declines significantly in the baseline, though not uniformly

The upward revisions to the long-term forecast generate a more positive poverty forecast for 2015, albeit a modest improvement compared to the forecast presented in the *Global Monitoring Report* for 2007 (World Bank 2007b). The percentage of the population in developing countries living on less than $1 a day in 2015 under the current long-term forecast is 10.2 percent, down from 11.8 percent in the *Global Monitoring Report* (table 1.5). The rapid improvements in reducing poverty in Asia since 1990 imply that the target of halving the percentage of the poor living on

Table 1.5 Poverty in developing countries by region, selected years

Region or country	1990	2004	2015
Number of people living on less than $1/day (millions)			
East Asia and the Pacific	476	169	40
China	374	128	29
Rest of East Asia and the Pacific	102	41	11
South Asia	479	446	256
India	376	371	217
Rest of South Asia	103	76	39
Europe and Central Asia	2	4	2
Middle East and North Africa	5	4	2
Sub-Saharan Africa	240	298	290
Latin America and the Caribbean	45	47	34
Total	1,247	970	624
Excluding China	873	841	595
Number of people living on less than $2/day (millions)			
East Asia and the Pacific	1,113	684	296
China	819	452	186
Rest of East Asia and the Pacific	294	232	110
South Asia	954	1,116	997
India	734	868	772
Rest of South Asia	220	248	226
Europe and Central Asia	20	46	16
Middle East and North Africa	49	59	38
Sub-Saharan Africa	396	522	567
Latin America and the Caribbean	115	121	102
Total	2,647	2,548	2,017
Excluding China	1,828	2,096	1,831
Percentage of the population living on less than $1/day			
East Asia and the Pacific	29.8	9.1	2.0
China	33.0	9.9	2.1
Rest of East Asia and the Pacific	22.1	7.1	1.6
South Asia	43.0	30.8	15.1
India	44.3	34.3	17.6
Rest of South Asia	38.9	20.6	8.5
Europe and Central Asia	0.5	0.9	0.3
Middle East and North Africa	2.3	1.5	0.7
Sub-Saharan Africa	46.7	41.1	31.4
Latin America and the Caribbean	10.2	8.6	5.5
Total	28.7	18.1	10.2
Excluding China	27.1	20.7	12.6
Percentage of the population living on less than $2/day			
East Asia and the Pacific	69.7	36.6	14.5
China	72.2	34.9	13.4
Rest of East Asia and the Pacific	63.7	40.4	16.9
South Asia	85.7	77.1	59.0
India	86.4	80.4	62.7
Rest of South Asia	83.4	67.6	49.2
Europe and Central Asia	4.3	9.8	3.4
Middle East and North Africa	21.7	19.7	10.3
Sub-Saharan Africa	77.1	72.0	61.5
Latin America and the Caribbean	26.3	22.2	16.3
Total	60.8	47.6	32.9
Excluding China	56.8	51.6	38.7

Source: World Bank.

$1 a day or less between 1990 and 2015 will be achieved at the global level, though not necessarily at the country or regional level. The new forecast leads to some improvement in the outlook for Sub-Saharan Africa, but the region is still significantly off target.[8,9]

Agricultural productivity has important poverty implications for low-income countries

Agricultural technology is a particularly important determinant of overall technology and poverty reduction in low-income countries (World Bank 2007c), mainly because in most economies the majority of workers remain in agriculture, and the poor are concentrated in rural areas. Moreover, productivity growth in agriculture is one of the main drivers of rising incomes in agricultural economies. Increased agricultural productivity frees up workers to take on more lucrative manufacturing jobs and reduces food costs relative to wages. Moreover, by increasing yields, high agricultural productivity generates a marketable surplus that can be used to purchase higher-quality inputs for production and consumer goods, which in turns leads to a virtuous cycle between the agricultural and nonagricultural sectors of the economy. The marketable surplus can also be used to increase exports or to reduce food imports.

In the baseline scenario, agricultural productivity is projected to increase by a uniform 2.5 percent a year (Martin and Mitra 1999). Historically, however, not all countries have achieved this average increase. For example, the green revolution that lifted agricultural productivity in South Asia over the last 40 years largely bypassed Sub-Saharan Africa, where yields have largely stagnated. Looking ahead, agriculture in Sub-Saharan Africa is faced with some of the same challenges as in the past, for example, lack of access to credit and poorly integrated markets. Both South Asia and Sub-Saharan Africa could be facing additional challenges that will threaten future gains in agricultural productivity, for instance, environmental degradation caused by global climate change or insufficient investment in new and locale-specific varieties of crops.

To illustrate the sensitivity of future outcomes to the possibility of weaker agricultural productivity performance, an alternative scenario looks at the impact on global growth, incomes, and poverty from assuming zero agricultural productivity growth over the period 2008–15 in the two largely low-income regions of South Asia and Sub-Saharan Africa.[10] One key result would be higher prices for agricultural produce compared with the baseline. Agricultural producer prices in Sub-Saharan Africa would increase around 6 percent, with a more modest increase of 2 percent for processed food. The increase in prices is more acute in South Asia: around 11 percent for primary agriculture, with a 4 percent increase in processed foods. These increases lead to a loss of competitiveness in both domestic and export markets.

In the case of Sub-Saharan Africa, imports of crops and livestock products rise by some 40 percent in 2015 relative to the baseline and exports drop by 30 percent. Overall output declines by some 12 percent. Agricultural labor demand barely changes, as the decline in output is offset by a decline in productivity, leaving overall labor demand more or less unchanged, albeit with depressed wages. In South Asia, labor demand actually increases. The output impact is a more modest drop of 9 percent, and the loss of productivity is reflected in an overall increase in labor demand of 1 percent, and thus less rural-to-urban migration occurs. The difference between the two regional impacts is linked to the degree of autonomy of their respective agricultural and food markets. A greater share of Sub-Saharan Africa's agricultural output is exported and a greater share of its demand is imported. The increase in domestic producer prices will therefore be dampened by external markets in Sub-Saharan Africa, compared with the more self-sufficient markets in South Asia.[11] South Asia therefore witnesses more price adjustment and less volume adjustment relative to Sub-Saharan Africa.

Lower agricultural productivity, higher prices, and lower wages for unskilled workers increase poverty in both South Asia and Sub-Saharan Africa. In Sub-Saharan Africa, overall consumer prices rise by 1.4 percent and food prices by 4 percent. In South Asia, the increases are even more marked: 10 and 3 percent, respectively. Combined with a significant fall in wages for the unskilled, which creates a sharp drop in food wages (the quantity of food that can be purchased with the average wage) that affects the poorest the most, the poverty headcount index in Sub-Saharan Africa would increase by some 5 percentage points in 2015 relative to the baseline, even though the average income loss would be a more moderate 3 percent, suggesting that the loss in agricultural productivity harms the poor, on average, more than others.[12]

Notes

1. Carry trade is an approach undertaken to leverage investments in higher-yielding securities intermediated through a low-interest cost center. For example, a purchase of emerging market equities or fixed income securities through borrowing in yen at low Japanese interest rates and converting yen to local currencies to complete the transaction would be classified as a carry trade. Even though estimates of funds intermediated through the yen carry trade are highly uncertain, an indicator of their potential size can be discerned from the substantial weakness of the yen-dollar exchange rate during 2006–7, when it fell some 5.8 percent.

2. A full analysis of recent developments and the outlook for each region is available on the World Bank's Web site at http://www.worldbank.org/prospects.

3. China is the largest overseas holder of U.S. mortgage-backed securities, around $260 billion, largely through China's official reserve holdings and holdings of Chinese commercial banks. However, almost all of these instruments enjoy the backing of U.S. government-sponsored enterprises Fannie Mae and Freddie Mac, and the risks associated with these holdings appear to be minimal.

4. Developing countries of the Middle East and North Africa region, which account for regional aggregate figures in this chapter, are Algeria, the Arab Republic of Egypt, the Islamic Republic of Iran, Jordan, Lebanon, Morocco, Oman, the Syrian Arab Republic, Tunisia, and the Republic of Yemen. Low- and middle-income economies with insufficient data for coverage are Iraq, Libya, and the West Bank and Gaza. High-income countries of the region, which are excluded from aggregates in the chapter, are Bahrain, Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates.

5. Changes in the volume of oil and gas production have been modest in recent years, ranging from 0.5 to 1.0 percent annual gains in Algeria to a decline in the Islamic Republic of Iran and the Republic of Yemen. Hence the buildup in export revenues is largely due to the large-scale increases in global oil prices during 2005 through 2007.

6. Inflation now exceeds 10 percent in Angola, Argentina, Botswana, Costa Rica, Ghana, Haiti, Indonesia, the Islamic Republic of Iran, Kenya, Madagascar, Malawi, Mozambique, Sri Lanka, República Boliviarana de Venezuela, and Zimbabwe.

7. Among individual vegetable oils, palm oil was up 48 percent, coconut oil was up 41 percent, and soybean oil was up 25 percent. Among individual grains, maize prices rose 33 percent and wheat prices increased 30 percent.

8. Even though the revisions to the long-term forecast imply roughly a doubling of per capita growth for Sub-Saharan Africa, that growth will have more impact after 2015 than before, as recent poverty forecasts have already incorporated the strong upward trend in per capita growth rates since the end of the 1990s.

9. The poverty numbers presented here do not yet take into account the results of the recent International Comparison Project, which will provide an updated set of price levels across countries. New purchasing power parity exchange rates could—although not necessarily will—lead to a new set of poverty estimates.

10. These projections involved six modeled countries or regions—Bangladesh, India, Pakistan, the rest of South Asia, Nigeria, and the rest of Sub-Saharan Africa excluding South Africa.

11. One plausible explanation for South Asia's greater self-sufficiency has been its higher agricultural productivity over time because of the green revolution.

12. The poverty impact is generated by the World Bank's Development Economics Prospects Group's global income distribution dynamics poverty tool, and was performed only for Sub-Saharan Africa because of its high projected level of poverty in 2015. The global income distribution dynamics tool probably underestimates the true poverty impact, because information on consumption in most surveys is insufficient to factor in

price changes fully. To the extent that the poor spend a larger share of their meager budget on food, one would anticipate an even greater negative impact for the poor.

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