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Prospects for the Global Economy

The stresses in the financial markets of the United States that first emerged in the summer of 2007 transformed themselves into a full-blown global financial crisis in the fall of 2008: credit markets froze; stock markets crashed; and a sequence of insolvencies threatened the entire international financial system. Massive liquidity injections by central banks and a variety of stopgap measures by governments proved inadequate to contain the crisis at first.

The initially hesitant policy response has become increasingly robust. The United States government introduced a $700 billion rescue package and has taken equity positions in nine major banks and several large regional banks. Various debt and deposit guarantees have also been introduced. At the same time, European governments have announced plans for equity injections and purchases of bank assets worth some $460 billion, along with up to almost $2 trillion in guarantees of bank debt. At the time of this writing, November 20, 2008, markets remain volatile despite the forcefulness of these measures and signs that credit conditions are improving somewhat in high-income countries. Both private-sector and sovereign interest rate spreads for developing countries have spiked even higher, and a growing list of countries have been forced to seek assistance from the International Monetary Fund (IMF).

During the initial phases of this financial crisis in 2007, the effects of the financial turmoil on developing countries were relatively modest. However, as the crisis intensified in 2008 and especially since mid-September, risk aversion (the absence of which had been the hallmark of the preceding boom) has increased, and capital flows to developing countries have seized up. As a result, the currencies of a wide range of developing countries depreciated sharply, and developing-market equity prices have given up almost all of their gains since the beginning of 2008. Initial public equity offerings have disappeared, and risk premiums have increased to more than 700 basis points on sovereign bonds and to more than 1,000 basis points on the debt of developing-country firms. Very recent data on bank lending and foreign direct investment inflows are not available, but indications are that these inflows have also declined, but less dramatically.

Virtually no country, developing or high-income, has escaped the impact of the widening crisis, although those countries with stronger fundamentals going into the crisis have been less affected. The deterioration in financing conditions has been most severe in countries with large current account deficits, and in those that showed signs of overheating and unsustainably rapid credit creation before the financial crisis intensified. Of the 20 developing countries whose economies have reacted most sharply to the deterioration in conditions (as measured by exchange rate depreciation, increase in spreads, and equity market declines), 6 come from Europe and Central Asia, and 8 from Latin America and the Caribbean.

Much tighter credit conditions will see investment and GDP growth slow sharply

In this climate, growth prospects for both high-income and developing countries have deteriorated substantially, and the possibility of a serious global recession cannot be ruled out.

Even if the waves of panic that have inundated credit and equity markets across the world are soon brought under control, the crisis is likely to cause a sharp slowdown in activity stemming from the deleveraging in financial markets that has already occurred and that is expected to continue. In the baseline forecast presented in this chapter, much tighter credit conditions, weaker capital inflows to middle-income countries, and a sharp reduction in global import demand are expected to be the main factors driving the slowdown in developing countries. Import demand is projected to decline by 3.4 percent in high-income countries during 2009, while net private debt and equity flows to developing countries are projected to decline from $1 trillion in 2007 to about $530 billion in 2009, or from 7.7 to 3 percent of developing-country GDP. As a result, investment growth in developing countries is projected to slow dramatically, rising only 3.5 percent in middle-income countries, compared with a 13.2 percent increase in 2007.

A pronounced recession is believed to have begun in mid-2008 in Europe, Japan, and most recently, the United States. This recession is projected to extend into 2009, yielding a decline in high-income country GDP of 0.1 percent that year (table 1.1). In developing countries, growth is projected to slow to 4.5 percent in 2009, down from 7.9 and 6.3 percent in 2007 and 2008. Overall, global GDP is projected to expand only 0.9 percent in 2009 (figure 1.1)—below the rate recorded in 2001 and 1991 and indeed, the weakest since records became available beginning in 1970.

Because low-income countries have less access to international capital markets, the slowdown will affect them mainly through indirect mechanisms, including reduced demand for their exports, lower commodity prices, and reduced remittance inflows. International trade is projected to decelerate sharply, with global export volumes falling by 2.1 percent in 2009—the first time they have declined since 1982 and eclipsing the 1.9 percent falloff that occurred in 1975. Export opportunities for developing countries will fade rapidly because of the recession in high-income countries and because export credits are drying up and export insurance has become more expensive.

Slower growth in high-income countries is estimated to have reduced remittance flows into developing countries from 2 to 1.8 percent of recipient country GDP between 2007 and 2008. At the country level, the extent of further slowdown will depend critically on exchange rate developments, with recent swings in bilateral exchange rates dwarfing the expected changes in remittances denominated in host-country currencies.

The global growth recession is projected to cause both commodity prices and inflation to ease further, with oil prices averaging about $75 a barrel (bbl) in 2009, and food and metal prices projected to decline by about 23 and 26 percent, respectively, compared with their average levels in 2008. Nevertheless, commodity prices will remain well above the very low levels of the 1990s.

Lower commodity prices should reduce the burden on some segments of the poor (notably urban dwellers), whose purchasing power has declined because of high food and fuel prices (see chapter 3). Lower prices should also help dampen headline inflation. Indeed, the rapid rise of food and energy prices over the course of 2007 and the first half of 2008, coupled with tight capacity in many countries (following years of very fast growth fueled by ample liquidity) caused headline and core inflation to pick up throughout the world. Headline inflation increased by 5 percentage points or more in most developing countries, and more than half of developing countries had an inflation rate in excess of 10 percent by the middle of 2008.

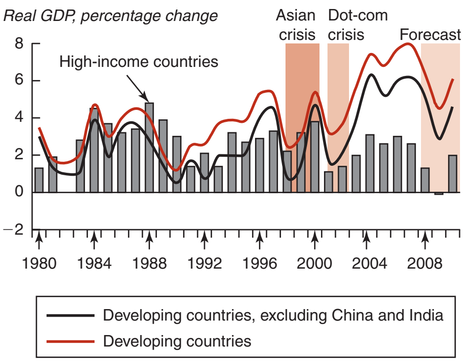
This financial crisis and the expected abrupt slowing of global growth comes at a moment when developing countries considered as a whole are more vulnerable than they have been

Table 1.1 The global outlook in summary
(percentage change from previous year, except for interest rates and oil prices)

Indicator	2006	2007	2008*	2009†	2010†
Global conditions					
World trade volume	9.8	7.5	6.2	−2.1	6.0
Consumer prices					
G-7 countries[a,b]	2.2	1.7	3.3	1.6	1.8
United States	3.3	2.6	4.5	2.5	2.8
Commodity prices (US$)					
Non-oil commodities	29.1	17.0	22.4	−23.2	−4.3
Oil price (US$ per barrel)[c]	64.3	71.1	101.2	74.5	75.8
Oil price (percent change)	20.4	10.6	42.3	−26.4	1.8
Manufactures unit export value[d]	1.6	5.5	9.0	2.1	1.3
Interest rates					
$ LIBOR, 6-month (percent)	5.2	5.3	3.3	1.9	2.5
€ EURIBOR, 6-month (percent)	3.1	4.3	4.9	3.8	4.2
Real GDP growth[e]					
World	**4.0**	**3.7**	**2.5**	**0.9**	**3.0**
Memo item: World (PPP weights)[f]	5.0	4.9	3.6	1.9	3.9
High-income countries	**3.0**	**2.6**	**1.3**	**−0.1**	**2.0**
OECD countries	2.9	2.4	1.2	−0.3	1.9
Euro Area	2.9	2.6	1.1	−0.6	1.6
Japan	2.4	2.1	0.5	−0.1	1.5
United States	2.8	2.0	1.4	−0.5	2.0
Non-OECD countries	5.5	5.6	4.3	3.1	5.3
Developing countries	**7.7**	**7.9**	**6.3**	**4.5**	**6.1**
East Asia and the Pacific	10.1	10.5	8.5	6.7	7.8
China	11.6	11.9	9.4	7.5	8.5
Indonesia	5.5	6.3	6.0	4.4	6.0
Thailand	5.1	4.8	4.6	3.6	5.0
Europe and Central Asia	7.5	7.1	5.3	2.7	5.0
Poland	6.2	6.6	5.4	4.0	4.7
Russian Federation	7.4	8.1	6.0	3.0	5.0
Turkey	6.9	4.6	3.0	1.7	4.9
Latin America and the Caribbean	5.6	5.7	4.4	2.1	4.0
Argentina	8.5	8.7	6.6	1.5	4.0
Brazil	3.8	5.4	5.2	2.8	4.6
Mexico	4.9	3.2	2.0	1.1	3.1
Middle East and North Africa	5.3	5.8	5.8	3.9	5.2
Algeria	1.8	3.1	4.9	3.8	5.4
Egypt, Arab Rep. of	6.8	7.1	7.2	4.5	6.0
Iran, Islamic Rep. of	5.9	7.8	5.6	3.5	4.2
South Asia	9.0	8.4	6.3	5.4	7.2
Bangladesh	6.6	6.4	6.2	5.7	6.2
India	9.7	9.0	6.3	5.8	7.7
Pakistan	6.2	6.0	6.0	3.0	4.5
Sub-Saharan Africa	5.9	6.3	5.4	4.6	5.8
Kenya	6.1	7.1	3.3	3.7	5.9
Nigeria	5.2	6.5	6.3	5.8	6.2
South Africa	5.4	5.1	3.4	2.8	4.4
Memo items					
Developing countries					
excluding transition countries	7.8	7.9	6.3	4.6	6.2
excluding China and India	6.0	6.1	5.0	2.9	4.7

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

Figure 1.1 GDP growth



Source: World Bank.

in the recent past. Higher commodity prices have widened current account deficits of many oil-importing countries to worrisome levels (they exceed 10 percent of GDP in about one-third of developing countries), and after having increased substantially, the international reserves of oil-exporting developing countries are now declining as a share of their imports. Moreover, inflation is high, and fiscal positions have deteriorated both for cyclical reasons and because government spending has increased to alleviate some of the burden of higher commodity prices.

Although the global recession is likely to be protracted, some elements of an eventual recovery can already be discerned. These include early movement toward stabilization in the housing sector in the United States; continued progress on debt workouts and a strengthening of balance sheets among both banks and households; a gradual easing of credit conditions as government rescue packages take hold and investors begin to return to heavily discounted equity markets; increases in real incomes (stemming from lower food and fuel prices) among individuals with relatively high marginal propensities to consume; and increased space for fiscal and monetary policies as inflationary pressures ease and government outlays on food and fuel subsidies decline in tandem.

Prudent and vigilant policies are key as uncertainty continues to cloud the outlook

Although this sober outlook represents a likely outcome, the situation remains unstable, and a wide range of outcomes are possible, including a scenario where the rebound of growth in 2010 is weaker, held back by continuing banking sector restructuring, and negative wealth effects resulting from lower housing and stock market prices.

An even sharper recession is also possible. If the freeze in credit markets does not thaw as anticipated in the baseline, the consequences for developing countries could be catastrophic. Financing conditions would deteriorate rapidly, and apparently sound domestic financial sectors could find themselves unable to borrow or unwilling to lend—in both international and domestic markets. Such a scenario would be characterized by a long and profound recession in high-income countries and substantial disruption and turmoil, including bank failures and currency crises, in a wide range of developing countries. Sharply negative growth in a number of developing countries with all of the attendant repercussions, including increased poverty and unemployment, would be inevitable.

Although it is a receding concern, high inflation in developing countries remains a problem, especially if the impact from the current crisis on developing-country investment demand is less pronounced, and the stimulus provided by various rescue and fiscal packages in high-income and developing countries feeds a rapid expansion in demand. Under such a scenario, global growth would still slow in 2009, which would tend to dampen inflationary pressures initially, but growth could be expected to snap back much more sharply in 2010. Countries that now have large current account deficits and high inflation could suffer from a renewed overheating of their economies. Policies would have to be very prudent in these circumstances, because the currencies of these countries are likely to remain sensitive to changing market perceptions and increased risk aversion.

The challenge for policy makers is not only to prevent an escalation of the crisis and to mitigate the downturn but also to ensure a good starting position once the rebound sets in. For developing countries, this means responding rapidly and forcefully to signs of weakness in domestic banking sectors, including resorting to international assistance where necessary. It also means pursuing a prudent countercyclical policy, relying on automatic stabilizers, social safety nets, and infrastructure investment that addresses bottlenecks that have become binding constraints on long-term sustainable growth in many countries.

In the current circumstances of heightened risk aversion and investor skittishness, policy makers need to be especially wary of taking on excessive levels of debt or creating the conditions for an inflationary bubble by reacting too aggressively to the global slowdown. Although it is important for policy makers to react quickly to emerging problems, it is also essential that steps and conditions attached to assistance be well focused on overcoming some of the fundamental sources of weakness. Otherwise there is a risk that governments lose the support of markets and taxpayers in their efforts to limit the extent of near-term disruptions.

Financial markets

The deterioration in financial conditions accelerated markedly in September 2008

The protracted turmoil that has plagued global financial and credit markets since mid-2007 escalated in September 2008, with the sudden collapse of major financial institutions, first in the United States and subsequently in Europe. The crisis has spread rapidly to emerging markets and has raised fears of systemic risk to the international financial system. Growing concerns about counterparty risk have disrupted credit markets, especially the interbank and commercial paper markets.

Earlier in the year major banks were still able to attract new equity investors in an effort to rebuild their capital bases, which were eroded by significant losses stemming from large write-downs on mortgage-backed securities and other assets. However, investor confidence was shaken by the March collapse of Bear Sterns, the seventh largest securities firm in the world in total assets. In September and October, authorities in the United States and Europe had to respond with extraordinary steps, including large injections of liquidity; coordinated reductions in policy interest rates; the takeover of major financial institutions; enhancements in deposit guarantees; and plans to purchase impaired financial assets (such as the U.S. Troubled Asset Repurchase Program, or TARP), to take equity positions in commercial banks, and to intervene in the commercial paper markets (box 1.1).

The turmoil has had a dramatic impact on emerging market assets

Although financial institutions in developing countries are believed to have limited direct exposure to U.S. subprime assets and related securities, the financial turmoil has affected virtually all emerging-market economies as high-income-country banks and investment funds withdrew from emerging markets and converted a broad range of risky assets into more liquid holdings. The rapid increase in risk aversion has also led to a forceful unwinding of the carry trade. The sell-off in risky assets carried a dramatic impact on equity prices, bond spreads, and currencies in virtually all emerging-market economies and has also contributed to tighter domestic credit conditions in larger countries, including India, the Russian Federation, and Brazil, and smaller countries, including Thailand and the Philippines. These developments were reinforced as local investors also moved out of equity markets, and more generally, out of investments denominated in local currencies.

Countries with large current account deficits, and therefore most dependent on foreign capital, were hit hardest by the substantial

Box 1.1 Chronology of recent developments in the financial crisis

Financial stress escalated in the United States and Europe over the course of 2008, beginning with the takeover of Bear Stearns by JP Morgan in March, and culminating in September when several major institutions came under severe distress.

Week of September 7

The U.S. government seized control of Fannie Mae and Freddie Mac, institutions that own or guarantee about one-half of all mortgage assets in the United States.

Week of September 14

The U.S. investment bank Lehman Brothers filed for bankruptcy and Merrill Lynch was taken over by the Bank of America for $50 billion.

The U.S. government seized control of American International Group Inc., providing an $85 billion emergency loan and taking a 79.9 percent equity stake in the firm.

Britain's largest mortgage lender, HBOS, agreed to be purchased by Lloyds TSB in an $18.9 billion deal.

The Russian government pledged to provide $120 billion to support financial markets and banks (the amount was increased by $50 billion on October 7).

U.S. Treasury Secretary Henry Paulson introduced the Troubled Asset Relief Program, a key element of which enables the government to buy up to $700 billion of mortgage-backed securities. An amended version was signed into law on October 4th.

Week of September 21

Goldman-Sachs and Morgan Stanley became bank holding companies.

The U.K. government nationalized the mortgage bank Bradford and Bingley (a loan portfolio of $90 billion).

Week of September 28

Washington Mutual became the largest bank failure in U.S. history, with assets valued at $328 billion.

The Belgian, Dutch, and Luxembourg governments each took a 49.9 percent equity stake in the operations of the banking and insurance company Fortis within their respective borders, each injecting $16.4 billion in capital. One week later, the Dutch government took full control of the company's operations in the Netherlands. Fortis' operations in the BENELUX countries were later sold to the French commercial bank, BNP Paribas.

The German government, together with commercial banks and federal regulators, provided $50 billion in credit guarantees to Hypo Real Estate.

Citigroup agreed to buy the banking operations of Wachovia.

France, Belgium, and Luxembourg injected $9.2 billion into the French-Belgian bank Dexia.

The Icelandic government took a 75 percent equity stake in Glitnir, the country's third-largest bank.

The Swedish central bank announced that it would lend up to $700 million to the Swedish unit of the Icelandic bank Kaupthing.

Ireland announced unlimited guarantees on retail, commercial, and interbank bank deposits. Similar measures were adopted in Austria, Denmark, Germany, Greece, Iceland, Italy, and Portugal. Sweden, the United Kingdom, and the United States raised limits on deposit guarantees. On October 3, European finance ministers agreed to raise the minimum guarantee on bank deposits to €50,000 across all EU member states.

Week of October 5

The Icelandic government loaned $683 million to Kaupthing, and seized control of Landsbanki, and sought a $5.5 billion loan from Russia.

The Spanish government established a $40 to $68 billion emergency fund to purchase assets held by Spanish banks.

The U.S. Federal Reserve intervened in the commercial paper market for the first time since the Great Depression.

The British government made available $87 billion in emergency loans to the banking system and offered to purchase capital in eight of the largest banks. The package includes guarantees of £250 million for new debt and the same for liquidity provisions.

The central banks of the United States, the Euro Zone, Canada, Sweden, and Switzerland each cut their benchmark rates by half a percentage point in an unprecedented coordinated effort. Separately, China's central bank lowered its key one-year lending rate by 27 basis points, the second reduction in three weeks.

The Icelandic government placed Glitnir into receivership, seized control of Kaupthing Bank, and abandoned its attempt to peg the krona at 131 per euro, established one day earlier, after it touched 340 against the euro.

California, the most populous U.S. state, asked federal authorities for a $7 billion emergency loan as it was unable to obtain financing in the wake of the bankruptcy of Lehman Brothers.

The British government announced a $685 billion plan to restore confidence in financial institutions, which included insuring up to $438 billion in new debt issued by banks, along with providing as much as $88 billion in equity capital.

The National Bank of Ukraine seized control of Prominvestbank, the country's sixth-largest bank.

Week of October 12

European governments announced financing packages totaling over $2.5 trillion. The packages include recapitalizing the banking sectors, credit guarantees on interbank lending, and direct loans.

The British government injected $60 billion in equity capital into the country's three largest banks.

The United States announced that it would commit $250 billion of the $700 billion rescue package to recapitalize the banking sector.

Week of October 19

The IMF agreed with Iceland on an economic recovery program supported by a two-year loan of $2.1 billion.

The Belarusian authorities requested financial assistance from the IMF under a program that could be supported by a Stand-By Arrangement.

The Pakistani authorities requested discussions with the IMF on an economic program supported by financial assistance from the IMF.

Week of October 26

IMF staff agreed with the Hungarian and Ukrainian authorities' economic programs supporting loans of $15.7 and $16.7 billion, respectively.

The European Union stood ready to provide a loan of $8.1 billion to Hungary and the World Bank agreed to provide $1.3 billion.

The IMF announced the Short-Term Liquidity Facility designed to channel funds quickly to emerging markets that have a strong track record, but that need rapid help during the current financial crisis to get them through temporary liquidity problems.

Week of November 9

The Leaders of the Group of Twenty agreed to a plan of action to restore global growth and achieve needed reforms of the world's financial systems.

IMF staff and Pakistani authorities reached agreement on an economic program supported by a $7.6 billion loan. The Executive Board of the IMF was expected to discuss the program shortly under the IMF's Emergency Financing Mechanism procedures.

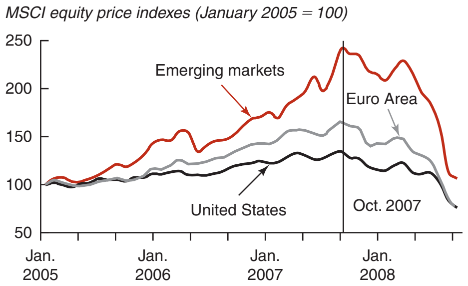
Week of November 16

IMF staff and Serbian authorities agreed on an economic program supported by a $0.5 billion loan.

tightening of credit conditions in international markets. One-third of developing countries are running current account deficits in excess of 10 percent of GDP, many of which may be forced to restrict domestic demand severely as capital inflows dry up. During 2007, for example, several countries were the recipients of vigorous increases in private debt flows that fueled credit growth to the domestic private sector and intensified inflation pressures. A year later private debt flows to the banking sector declined dramatically in a number of cases: by $13.2 billion in Kazakhstan, $6.6 billion in Russia, $3.7 billion in South Africa, $3.1 billion in Turkey, and $2.1 billion in Ukraine (comparing January through September 2008 with the same period in 2007).

All middle-income countries, even with current account surplus positions, have come to be substantially affected by the financial crisis. A Revealed Vulnerability Index indicates the extent to which financial conditions for developing countries have deteriorated since September 15, 2008 (upon the failure of Lehman Brothers). The vulnerability index averages the standardized depreciation of currencies, domestic equity market losses, and increases in risk premiums, as well as the decline

Figure 1.2 Emerging market equities are hit hard as turbulence evolves to crisis



Source: Morgan-Stanley, Standard & Poor's.

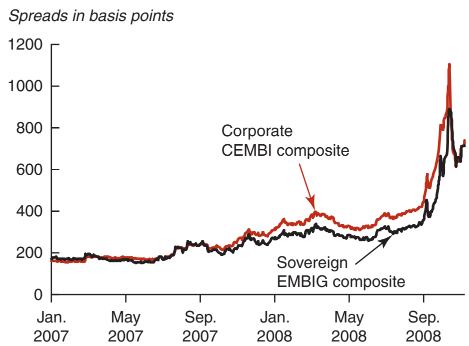
in gross capital flows to a country over the preceding 12 months. The index shows that virtually all middle-income countries are experiencing financial stress.

Emerging-market equity prices—as captured by the Morgan-Stanley Composite Index (MSCI)—tumbled by over 60 percent (in dollar terms) from their peak of October 2007, bringing prices back to levels attained at the beginning of 2005 (figure 1.2).[1] The massive correction in equity prices was widespread across emerging market economies, with the largest declines found in a number of European and Central Asian economies—Ukraine (80 percent), Romania (75 percent), Bulgaria (75 percent), and the Russian Federation (73 percent). Other large emerging market economies, including Brazil, China, and India, experienced corrections of over 60 percent. Despite the declines of the past year, equity prices in emerging markets remain above those in mature markets from a longer-term perspective, albeit characterized by much higher volatility.

The selloff in emerging market assets triggered a marked depreciation of exchange rates in a large number of countries, reversing much of the appreciation of the past two years. For example, the Brazilian real dropped by 40 percent against the dollar (20 percent against the euro) from early August to mid-November 2008, but the currency stands only 8 percent below its January 2007 dollar value. The South African rand depreciated by nearly 60 percent against the dollar (38 percent against the euro) from late October 2007 to mid-November 2008. Similarly, the Turkish lira depreciated by over 40 percent against the dollar (20 percent vis-à-vis the euro) from late October 2007 to mid-November 2008, but the currency has appreciated by 6 percent in real effective terms between January 2007 and October 2008.

The banking crisis that erupted in September 2008 is restricting credit to developing countries, and in particular to the least creditworthy borrowers. Sovereign bond spreads widened to a peak of 1,100 basis points in late October 2008 from 330 points in late August—well above the record 150 basis points registered in June 2007—before recovering to just over 700 basis points by mid-November. At that time, sovereign bond spreads exceeded the "distressed debt" threshold of 1,000 basis points in 14 of 38 emerging market economies currently part of JPMorgan's EMBI Global Index. Corporate bond spreads jumped by still more than sovereign spreads (figure 1.3). Spreads on risky non-investment grade (BB-rated) emerging market corporate bonds widened to 1,750 basis points in mid-November, up more than 1,450 points since mid-2007.

Figure 1.3 Emerging-market bond spreads widen, especially for corporates



Source: JPMorgan-Chase.

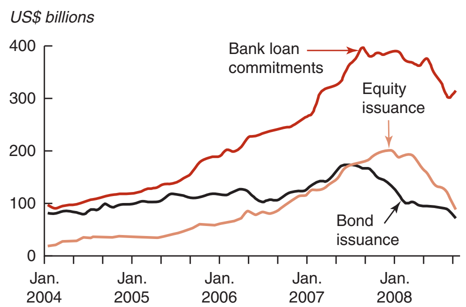
Note: CEMBI = Corporate Emerging Markets Bond Index; EMBIG = Emerging Markets Bond Index Global.

The rise in spreads was only partially offset by a 1.3 percentage point decline in the benchmark yield on 10-year U.S. Treasury notes between June 2007 and November 2008, so the yield on dollar-denominated sovereign bonds issued by emerging markets reached 10.5 percent, the highest in four years.

Private capital flows expected to continue decline

Even before the intensification of the financial crisis, tighter credit conditions were curtailing gross private debt and equity flows to developing countries (figure 1.4). Cross-border syndicated bank loan commitments declined to $315 billion over the 12-months ending October 2008, down from a record $400 billion a year earlier (but still above levels recorded over 2005–06). Bond issuance by developing countries decreased to $72 billion over the year to October, down from a record high of just over $170 billion at mid-2007. Corporate bond issuance declined sharply, with large falloffs in South Africa (by $15.6 billion), India ($12.8 billion), and Russia ($9.4 billion). Indeed, non-investment-grade bonds by corporations located in emerging markets accounted for about 40 percent of total issuance from January to October 2008, compared with 60 percent over 2005–06. And equity issuance plummeted along with falling equity prices to total $90 billion in the period, down from a record high of $200 billion achieved at the start of 2008.

Figure 1.4 Private debt and equity flows decline by a third in 2008



Source: Dealogic Analytics.

Even assuming a restoration of market confidence and a thawing of credit markets and capital movements, overall credit conditions for emerging markets will remain substantially tighter than in the recent past. As a consequence, net private debt and equity flows to developing countries are anticipated to decline from the record-high $1.03 trillion (7.6 percent of developing-country GDP) set in 2007 to about $530 billion (3 percent of GDP) in 2009. Although net foreign direct investment should be moderately more resistant to the downturn (as in past episodes), tighter credit may cause high-income firms to reduce their foreign direct investment by much more than they did during earlier financial crises, which were centered in developing countries.

Tightening of credit sharply reduces domestic growth prospects

Before the financial turmoil developed into a crisis of global proportions, developing countries were affected mainly by slowing demand in high-income countries through the export channel. Many developing countries had shown strong resilience in the face of the gradually deteriorating external environment, because their economies were supported by strong investment growth and shielded by large amounts of international reserves. This situation has changed dramatically since September 2008.

Unlike gradual adjustments in markets for goods and services, adjustments in financial markets come fast and suddenly, and they often tend to “overshoot.” More importantly, the escalation of the crisis directly affects the engine for domestic growth in many developing economies, because obtaining finance for capital spending has become abruptly more difficult. Moreover, the crisis is placing strong pressure on foreign exchange reserves and, at the same time, can reveal dangerous currency mismatches in private sector balance sheets.

During the global boom of the past five years, local banks and private companies whose local currencies were appreciating found it attractive to borrow abroad in dollars. With the sudden turnaround in currency movements, the currency mismatch on private sector balance sheets has likely led to substantial losses across firms and banks and even for households. To the extent that this development results in loan defaults, it may strain domestic banking systems and place pressure on banks to find alternative sources of funding at a time when global financing conditions have deteriorated markedly. Stress induced by currency movements thus carries the potential to further degrade prospects for investment spending in developing countries.

Outlook for high-income OECD countries

The intensification of the financial crisis in the United States, and its widening to major European countries in the autumn of 2008, is expected to exact a significant toll on economic activity across the high-income countries belonging to the Organisation for Economic Co-operation and Development (OECD). Even if confidence in global credit markets is restored quickly, reductions in the finance available for firms and consumers, coupled with a slowdown in developing-country import demand, have set the stage for a recession in the United States, Europe, and Japan beginning in the second half of 2008 and lasting into 2009.

A movement to joint recession across key OECD countries

Through the first quarter of 2008, the slowdown among the OECD countries was fairly moderate (although industrial production stagnated in the quarter): exports benefited from strong import demand from developing countries and from oil exporters, while falling imports served to boost the contribution of net trade to GDP growth. But GDP fell to 0.3 percent growth (at an annual rate) in the second quarter for the key advanced economies, down from 2.4 percent in 2007; and as GDP growth moved to decline across the United States, Europe, and Japan during the third quarter, OECD growth dropped to −0.6 percent.

Industrial production slipped to negative ground across all major OECD economies in both the second and third quarters of the year, as fading overseas demand combined with a lack of domestic orders tied to sluggish conditions in housing and autos in a number of countries (table 1.2, first and second panels). Growth of export volumes dropped from 14.6 percent in 2007 to 2.5 percent during the third quarter (saar), as intra-OECD trade (especially within Europe) softened at the same time as developing-country demand slowed.

During the second quarter, conditions in Europe and Japan deteriorated sharply. Japan's GDP declined at a steep 3.7 percent seasonally adjusted annualized rate (saar), and Euro Area GDP fell 0.7 percent (figure 1.5 and table 1.2, first panel). A falloff in household spending tied to the effects of much higher inflation, a decline in investment, and a dramatic shift in the growth contribution of trade all contributed to the turnaround. In Europe, increased sluggishness in export markets and the long bout of euro appreciation pressured exports and imports into negative territory in the second quarter, with contributions to overall growth slipping to nil from 1.4 points in the final quarter of 2007.

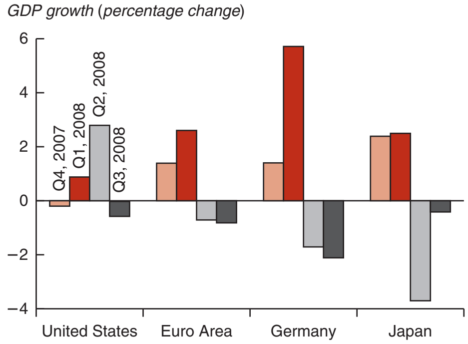
In the United States, conversely, GDP picked up 2.8 percent (saar) in the second quarter, as fiscal stimulus and looser monetary policy boosted consumption spending. Moreover, the pace of decline in residential investment slackened, while contributions from trade—still benefiting from the weak dollar—increased to a large 1.6 percentage points of growth (figure 1.6). U.S. domestic demand has been depressed since the final quarter of 2006, as a rise in domestic savings helped to unwind the global imbalances that were of such concern a couple of years ago. As financial dislocations heightened in the third quarter, including unprecedented declines in equity markets in Europe, Japan, and the United States, consumer spending came under increasing

Table 1.2 High-income OECD countries: growth and related indicators

	Growth year-over-year		Seasonally adjusted annualized growth			Growth year-over-year	
Indicator, country	2006	2007	Q108	Q208	Q308	H108	Q308
GDP growth (percent)							
High-income OECD	**2.9**	**2.4**	**1.5**	**0.3**	**−0.6**	**1.9**	**0.5**
United States	2.8	2.0	0.9	2.8	−0.5	2.3	0.7
Japan	2.4	2.1	2.5	−3.7	−0.4	1.0	0.0
Euro Area	3.0	2.6	2.6	−0.7	−0.8	1.7	0.3
Germany	3.2	2.6	5.7	−1.7	−2.1	2.2	0.8
France	2.4	2.1	1.6	−1.1	0.6	1.6	0.6
United Kingdom	2.8	3.0	1.1	0.0	−2.0	1.9	0.3
Industrial production							
High-income OECD	**2.9**	**2.4**	**0.1**	**−3.2**	**−3.8**	**1.4**	**−2.2**
United States	2.2	1.7	0.4	−3.2	−5.9	1.0	−4.5
Japan	4.1	2.9	−1.7	−3.5	−4.3	1.8	−1.9
Euro Area	3.4	2.8	1.3	−4.5	−2.6	1.2	−1.8
Germany	5.9	6.1	4.9	−3.2	−4.7	4.2	−2.3
France	0.9	1.2	0.1	−6.1	−2.6	0.7	−1.9
United Kingdom	0.7	0.4	−1.7	−2.9	−5.8	−0.2	−3.0
Consumer prices[a]							
High-income OECD	**2.3**	**2.0**	**3.1**	**3.2**	**4.0**	**3.2**	**4.0**
United States	3.2	2.9	4.3	4.0	4.9	4.2	4.9
Japan	0.3	0.1	0.7	1.2	2.1	1.0	2.1
Euro Area	1.9	2.3	3.3	3.5	3.9	3.4	3.9
Germany	1.7	2.3	2.8	3.1	2.9	3.0	2.9
France	1.7	1.5	2.8	3.2	3.0	3.0	3.0
United Kingdom	2.3	2.3	2.2	2.4	5.0	2.3	5.0
Export volumes							
High-income OECD	**13.9**	**14.6**	**9.2**	**2.8**	**2.5**	**6.7**	**4.8**
United States	10.5	6.9	5.3	14.7	21.9	9.8	11.2
Japan	8.1	5.9	4.0	2.1	−12.9	7.1	−1.6
Germany	13.0	6.2	11.0	0.4	−5.9	6.4	3.9
France	9.9	3.7	32.6	−14.6	−0.1	5.1	4.2
United Kingdom	11.7	−10.4	0.7	−1.3	4.2	−0.8	0.2

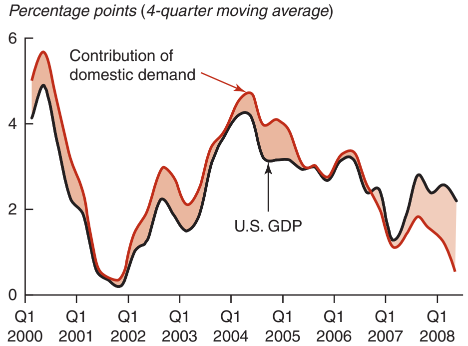
Source: National statistical agencies through Haver Analytics and Thomson/Datastream.
Note: CPI inflation for high-income OECD countries is GDP weighted.
a. Year-over-year growth rates.

Figure 1.5 Change in GDP in the United States, Europe, and Japan



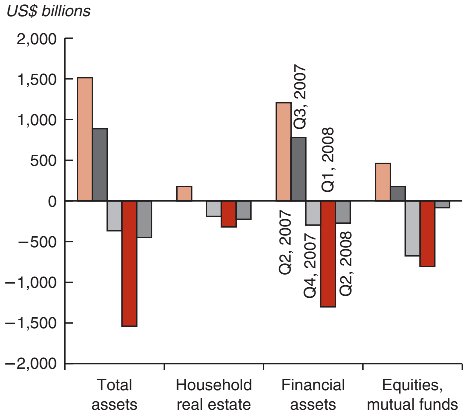
Source: World Bank, national statistical agencies.

Figure 1.6 The contribution of U.S. domestic demand to GDP growth



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

Figure 1.7 U.S. household wealth falls sharply in the last quarters



Source: Federal Reserve.

pressure (figure 1.7).[2] And with export performance for OECD economies fading on the back of sputtering global demand, the Euro Area and Japan fell into technical recession in the quarter, while growth in the United States reverted to decline.

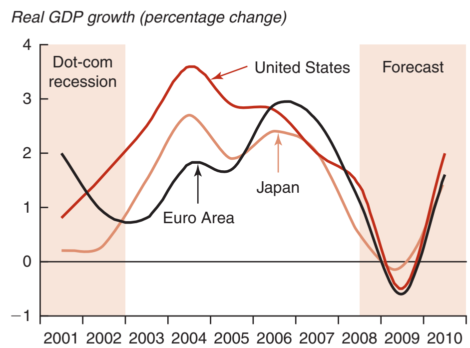
Financial crisis places outlook under exceptional uncertainty

Given the dramatic developments over September to November 2008, the depth of the coming recession is difficult to gauge. Should credit markets remain frozen and asset prices continue to fall, then the decline in output over the next year could be extreme. However, the extraordinary measures now being taken by fiscal and monetary authorities are expected to eventually restore confidence so that banks will no longer hoard cash, and businesses can obtain the finance essential for normal operations. Nevertheless, the outlook for OECD countries remains grim. A common element is a falloff in domestic demand—increasingly deep in business capital spending—no longer offset by support from net trade because of a coincident marked slowdown in growth among the developing countries.

With U.S. private consumption dropping an unprecedented 3.1 percent in the quarter, the decline in GDP would have been much more severe save for the contribution of net trade. Notwithstanding that GDP is projected to decline more sharply in the fourth quarter of 2008, growth for the year is expected to register 1.4 percent, because of the strong contributions of trade in the first half of the year. An abrupt decline in investment and a 1 percent falloff in consumer spending are expected to cause GDP to fall in both the first and second quarters of 2009, with a shallow recovery beginning in the second half of the year. GDP is projected to decline by 0.5 percent for all of 2009 but to recover to a still below-par 2.0 percent in 2010 (figure 1.8).

Financial conditions in the Euro Area are now also perilous. After having fallen 0.7 percent in the second quarter (saar), GDP dropped 0.8 percent during the third quarter and is expected to register modest declines in coming quarters before picking up steam toward the end of 2009. Growth is expected to register a weak 1.1 percent increase for 2008 as a whole and a 0.6 percent decline in 2009, before strengthening in 2010 to a still below-trend advance of 1.6 percent. The depth of recession in Europe should be comparable to that in the United States, in part because corporate finance in Europe is more reliant on the banking sector but also because lower commodity prices will dampen import demand in

Figure 1.8 GDP to decline across the OECD



Source: National statistical agencies, World Bank.

the Middle East and North Africa, a region that has been an important origin of export demand for Europe. The rapid decline in output, plus the drop in commodity prices should alleviate inflationary pressures in Europe. But the recent depreciation of the euro measured against the dollar may continue, as investors' continue to perceive U.S. government securities as safe-haven assets.

Aside from sharp equity market declines, Japan's financial markets have been less affected (through mid-November 2008) by fallout from the global financial and banking crisis. Nevertheless, the macroeconomic landscape is surprisingly similar to that in the United States and Europe. Household spending has retrenched, higher inflation has compressed purchasing power, and consumer sentiment has plummeted to 17-year lows. The Tankan survey of business investment intentions has been marked down steeply, in line with a downward shift in expectations for Japan's export prospects. Slumping import demand in emerging Asia has been amplified by a tightening of policy interest rates in countries such as India, Indonesia, the Philippines, and Thailand to stem inflation pressures. During the third quarter, Japan's GDP dropped by 0.4 percent (saar) and for the remainder of 2008, creeping spillover from the credit crunch and falling exports will cause Japan's GDP to recede further, coming to register 0.5 percent growth for the year. Recession in Japan is expected to be less pronounced than elsewhere, with output declining by 0.1 percent in 2009 before picking up to 1.6 percent in 2010 as global investment demand revives and stimulates Japanese exports.

Outlook for the developing countries

(A deeper discussion of developments in each of the six developing regions may be found in the Regional Appendix in this book.)

Even before international credit channels froze, there were increasing signs of slowing economic activity in developing countries. Slowing growth in the high-income economies, falling equity markets, and reduced international capital flows cut into investment in developing countries, while a sharp acceleration in inflation linked to the surge in commodity prices constrained consumer spending.

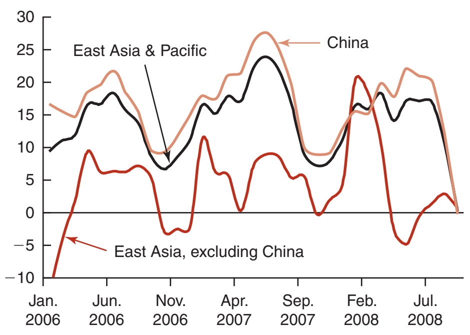
Industrial production (outside of China) had been robust but began to slow in mid-2008. In the rest of East Asia, the downward shift in production growth has been sharp, dropping from 20 percent in January (saar) to a decline of 5 percent by May 2008, before recovery to nil by September (figure 1.9).

More dramatic has been the steep recent falloff in China's industrial production growth, from 20 percent in July to a decline of 0.2 percent in September (saar). Softening export growth, together with tightening micromanagement of inventories—given uncertain sales prospects—have underpinned this development. This, in turn, has carried aggregate production growth in East Asia to zero as of the third quarter.

Output growth also faded in India and elsewhere in South Asia, while production in Hungary, Poland, Turkey, and the Baltic states began to decline more recently. Output dynamics have also faltered in Latin America, as production in Chile, Colombia, and Mexico have dropped to negative ground, while that in Brazil has slowed

Figure 1.9 East Asian countries show steep falloff in output growth

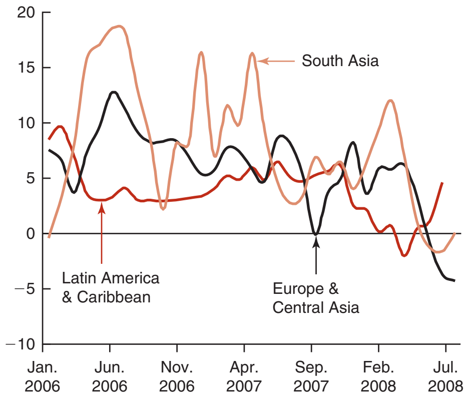
Industrial production (percentage change, saar)



Source: World Bank data.

Figure 1.10 Output growth in Latin America, South Asia, and Europe and Central Asia is fading

Industrial production (percentage change, saar)



Source: World Bank data.

sharply (figure 1.10 and table 1.3, second panel). Imports across developing regions are also showing signs of easing, reflecting a softening of domestic demand. And export volumes from emerging markets displayed fading momentum over the first three quarters of 2008, notably in Latin America, as import demand in the OECD countries declined sharply. Overall GDP growth for the developing countries slowed from the 7.9 percent advance recorded in 2007 to 5.3 percent (annualized) during the second quarter of 2008 (see table 1.3 and associated notes).

Financial turmoil likely to curb investment

Fixed investment has been a powerful driving force for growth across developing countries over the last decade, particularly in East Asia and the Pacific and in Europe and Central Asia, increasing its contribution to overall growth to almost 4 percentage points in recent years, and well outstripping contributions from trade (figure 1.11). But the intensification of the credit crisis in the United States has severely constrained finance to developing countries, with ominous implications for growth prospects. The effects of the global financial crisis on developing countries will differ by region and by the ability of individual countries to offset adverse effects on domestic banking sectors and the broader financial market.

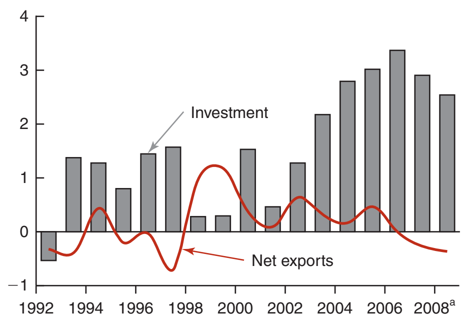
Emerging-market corporate borrowers already are seeing a sizable widening of spreads and are increasingly being shut out of international bond markets (see discussion above). A pullback in syndicated bank lending is emerging (as commercial banks and other financial institutions in the high-income countries shore up balance sheets by limiting new lending or by calling in existing lines of credit), and initial public equity offerings from key emerging markets have dried up. Even before the freezing of credit flows that has accompanied the banking crisis, overall capital inflows to developing economies were down 35 percent over the first nine months of 2008 from the same period a year earlier.

The slowdown is likely to be more pronounced in 2009

Looking forward, recent adverse trends are anticipated to intensify, driven by an especially sharp decline in investment growth in developing countries, weaker exports as import demand from high-income economies declines, and lingering and in some cases still-escalating

Figure 1.11 Investment was the driving force for growth in developing countries

Contribution to real GDP growth (percentage points)



Source: World Bank data.

a. Projected.

Table 1.3 Developing regions: growth and related indicators

	Growth year-over-year		Seasonally adjusted annualized growth			Growth year-over-year	
Indicator	2006	2007	Q108	Q208	Q308	H108	Latest
GDP growth (percent)							
Developing countries	**7.7**	**7.9**	**7.5**	**5.3**	—	**6.9**	—
East Asia and the Pacific	10.1	10.5	9.4	9.2	—	9.0	—
South Asia	9.0	8.4	11.3	2.9	—	8.3	—
Europe and Central Asia	7.5	7.1	8.8	−1.2	—	5.9	—
Latin America and the Caribbean	5.6	5.7	4.4	5.4	—	5.3	—
Middle East and North Africa	5.3	5.8	4.0	3.8	—	4.0	—
Sub-Saharan Africa	5.9	6.3	4.9	5.2	—	4.5	—
Industrial production							
Developing countries	**8.8**	**9.7**	**10.6**	**9.6**	**−2.4**	**9.2**	**5.0**
East Asia and the Pacific	13.0	15.0	18.3	17.1	0.2	14.7	10.2
South Asia	10.6	9.1	9.5	1.1	−4.1	6.1	1.0
Europe and Central Asia	7.6	6.9	5.9	3.3	−9.8	5.1	0.3
Latin America and the Caribbean	4.3	4.3	0.2	0.4	3.6	3.4	2.2
Middle East and North Africa	−0.8	−0.5	8.6	3.5	−0.2	3.6	3.5
Sub-Saharan Africa	3.9	5.8	−2.1	15.6	−9.3	6.5	4.7
Consumer prices[a]							
Developing countries	**6.2**	**6.1**	**8.6**	**10.4**	**9.9**	**9.5**	**9.9**
East Asia and the Pacific	5.1	5.3	7.7	9.5	8.2	8.6	8.2
South Asia	7.6	7.6	10.1	11.0	22.0	10.6	22.0
Europe and Central Asia	5.6	8.0	11.0	11.3	11.0	11.2	11.0
Latin America and the Caribbean	5.6	6.5	8.8	9.7	7.5	9.3	7.5
Middle East and North Africa	5.1	7.2	11.2	10.8	12.7	11.0	12.7
Sub-Saharan Africa	6.2	6.0	8.2	10.4	11.3	9.3	11.3
Export volumes[a]							
Developing countries	**13.9**	**14.6**	**14.0**	**13.8**	—	**14.0**	—
East Asia and the Pacific	19.2	18.7	16.2	17.0	17.1	16.2	19.2
South Asia	4.8	9.0	13.8	9.4	12.8	13.8	10.5
Europe & Central Asia	11.8	11.8	14.3	10.3	—	14.3	—
Latin America and the Caribbean	6.9	4.5	0.7	−2.5	−11.4	−0.7	−5.4

Source: National Statistical Agencies through Haver Analytics.

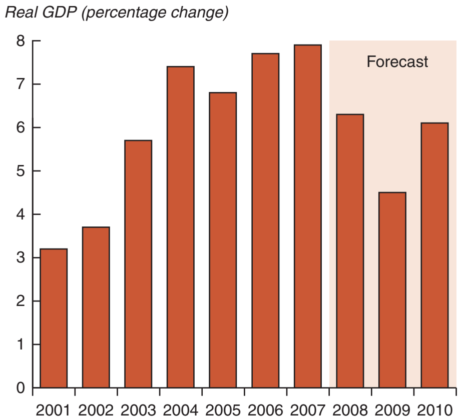
Note: Growth rates at annual or annualized rates, unless otherwise indicated. Consumer prices for regions are medians. Quarterly 2008 growth for developing regions is based on data available for key economies. No data on export volumes for South Asia and Sub-Saharan Africa are available. East Asia and Pacific: China, Indonesia, Malaysia, the Philippines, and Thailand. South Asia: India. Europe and Central Asia: Czech Republic, Hungary, Poland, Russian Federation, and Turkey. Latin America and the Caribbean: Argentina, Brazil, Chile, Colombia, and Mexico. Middle East and North Africa: Arab Republic of Egypt. Sub-Saharan Africa: Nigeria, and South Africa.

a. Quarterly data, year-over-year growth.

inflation. Developing-country GDP growth is projected to decline to 4.5 percent in 2009, more than 3 percentage points below the average of the past five years (figure 1.12). No region or country is likely to escape this growth recession. Recovery in 2010 to a 6.1 percent advance is predicated upon a relatively quick improvement in financial and growth conditions among the high-income countries, a prospect currently subject to a high degree of uncertainty.

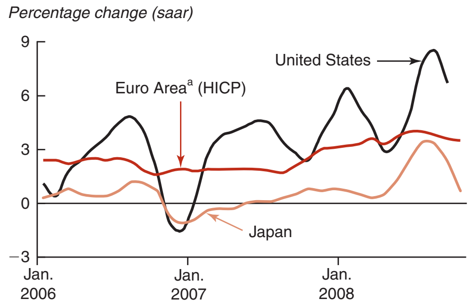
Growth outcomes for 2009 are anticipated to vary significantly across developing countries and regions, depending on their reliance on external flows and bank lending to finance investment, trade links to deeply affected high-income countries, direct and indirect exposures to the subprime mortgage crisis, and the degree of participation of foreign banks in the domestic financial sector. Moreover, policy responses to the crisis will play a large role in shaping the near-term economic outlook.

Figure 1.12 Developing-country GDP growth is expected to fall below 5 percent in 2009



Source: World Bank.

Figure 1.13 Headline inflation is easing across industrial countries



Source: World Bank data.

a. Year-over-year.

Note: HICP = Harmonized index of consumer prices.

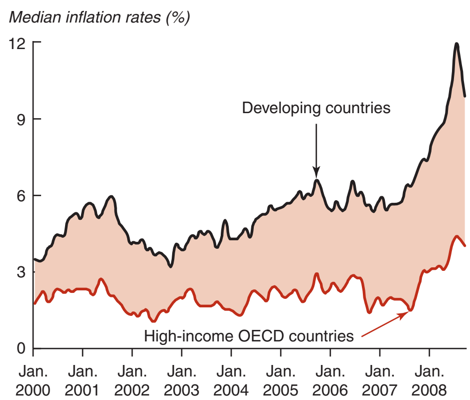
Inflation has been rising but is now set to decline

The projected global growth recession and much lower commodity prices should help ease the surge in inflation observed over 2007 and 2008. Headline consumer price inflation among the OECD countries increased from a modest 2 percent in 2007 to a 4 percent year-over-year pace in the third quarter of 2008, led by increases in the United States (4.9 percent), the Euro Area (3.9 percent), and the United Kingdom (5 percent). Although the peak in commodity prices appears to have passed, the momentum of headline inflation during August picked up to 8.5 percent in the United States before easing in September, while falling to 2.3 percent in Japan and to 3.6 percent in Europe (figure 1.13).

Consumer price inflation accelerated much more quickly in developing countries than in the advanced economies (figure 1.14, and table 1.3, third panel). In the majority of developing economies, most of the increase in headline inflation was attributable to the direct effects of higher commodity prices; increases in core inflation (which excludes food and energy) were limited. Indeed, inflation in developing countries has remained relatively low over the past five years of rapid growth, despite substantial increases in oil and metals prices since 2003 (box 1.2). However, the sharp rise in food and fuel prices in the first half of 2008 pushed median inflation in the developing world to 12 percent by July 2008, and more than 30 countries were facing double-digit inflation rates.

In a welcome development, median inflation has since retreated to below 10 percent in September, as falling commodity prices have improved CPI developments across a wide range of developing countries.

Figure 1.14 Inflation in emerging markets surged on higher food and energy prices



Source: World Bank data.

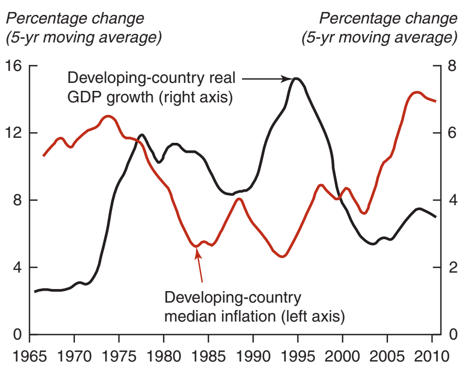
Box 1.2 Commodity prices and inflation in developing countries

Strong growth in developing countries during the 1960s coincided with a low-inflation environment, while high inflation during the subsequent two decades coincided with low average growth (box figure 1.2a). The recent sharp pickup in GDP growth occurred in an environment of low and stable inflation. Although the causality is always difficult to untangle, the potential adverse impact of high inflation on the ability to interpret price signals, on disciplined fiscal management, and on savings and investment are well understood.

These negative effects underscore the importance of preventing an acceleration of inflation beyond the direct impact of increased commodity prices.

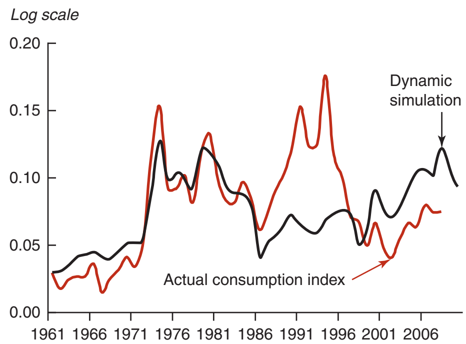
The relatively low inflation of the recent past can be clearly illustrated at an aggregate level with a model that explains median inflation in the developing world as stemming from commodity price increases in local currencies (measured as a median) and persistence (inflation tends to depend on past inflation as a result of indexation and as inflationary expectations are adjusted). In the model, CPI_t denotes consumer price inflation in developing countries, P_t denotes annual commodity prices, both in (median) local currencies for the 1962–2008 period. Numbers in parentheses denote t-ratios, and Δ denotes the first-difference operator:

Box figure 1.2a Inverse long-term correlation between inflation and growth



Source: World Bank.

Box figure 1.2b How do international commodity prices explain inflation in developing countries?



Source: World Bank.

$$\Delta\log(CPI_t) = 0.01 + \underset{(1.39)}{0.09}\,\underset{(5.09)}{\Delta\log(CPI_{t-1})} + \underset{(11.60)}{0.79}\,\Delta\log(P_t),$$

adjusted $R^2 = 0.78$.

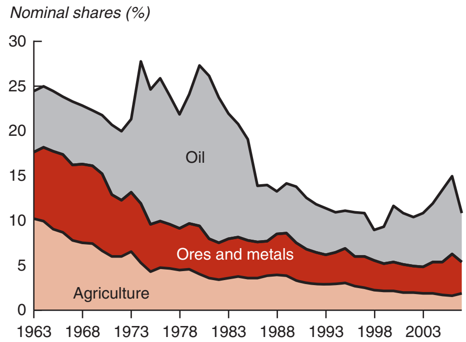
Box figure 1.2b shows a dynamic simulation of the equation since the 1960s.

Inflationary pressures during the 1970s are well explained by a combination of commodity price increases and persistence. During the 1990s, however, many developing countries experienced high inflation unrelated to commodity prices and therefore not explained by the estimated equation. These increases in inflation were caused more by loose policy reactions to debt crises, especially in Latin America, and the transition toward market economies in Europe. In the recent period, inflation has actually remained lower than the model would predict, largely as a result of institutional reforms, which made monetary policy more independent in many countries and inflation targeting more prevalent.

The literature provides a range of explanations for the relatively low inflation of recent years. Dominant in the debate is the role of inflation expectations, which have been brought down sharply by institutional reforms. Increased competition in global markets, making it more difficult to pass through increases in the higher costs of production, is another explanation. Moreover, the additional low-cost supply from developing countries, notably China, in global markets carried deflationary effects. And the share of commodities in world production and trade has declined over time, as a result of which the impact of commodity price increases is now substantially less than during the 1970s (box figure 1.2c).

On the other hand, many of the factors that have kept inflation low over the last five years may have lost a degree of efficacy. Indeed, with the recent rise in commodity prices, the share of commodities in the global economy, and with that, their effects on the general price level, is increasing rapidly. Many fast-growing developing countries have reached capacity constraints in infrastructure, energy, and other inputs to production, and the increase of low-cost goods in global markets is waning. With broader inflation rates rising, it becomes easier to pass through cost increases, and, importantly, low inflation expectations might be revised upward quite quickly. These are serious challenges to be faced to prevent a reemergence of a high-inflation environment. In the baseline forecast, we assume that as a result of the sharp global growth slowdown and the recent declines in commodity prices, headline inflation will ease gradually, even if core inflation moves up moderately. But the probability of higher inflation is certainly not negligible.

Box figure 1.2c Commodities are a declining share in global merchandise trade



Source: World Bank.

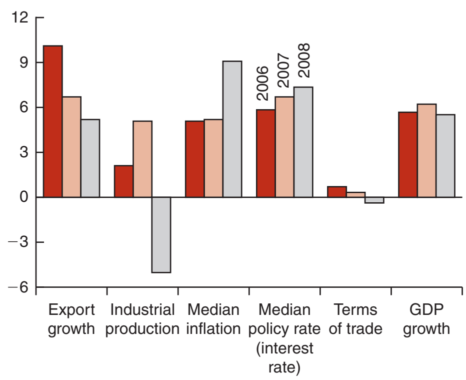
Many countries that experienced the sharpest run-up in inflation have been subjected to a dangerous combination of escalating food and energy prices and generally tight conditions in domestic markets, caused by a rapid increase in credit creation. Of the 24 countries where inflation picked up by more than 5 percentage points within the past year, 10 are in Europe and Central Asia, where inflation was spurred by very strong capital inflows or booming commodity revenues. Other countries subject to strong domestic inflationary pressures include Bolivia, Chile, the Philippines, República Bolivariana de Venezuela, and Vietnam. Some of the biggest jumps in headline inflation were seen in Sub-Saharan African countries, but that is largely because food represents more than 50 percent of consumption in many African countries.

The ramp-up of commodity prices over 2006–08 and the associated acceleration of inflation have posed difficult policy challenges. The continued practice of official subsidization of fuels and basic foodstuffs across many countries in the Middle East and North Africa, and East and South Asia is contributing to wider fiscal deficits, narrowing the room policy makers have for maneuver in other areas, including targeted income support, investment in the Millennium Development Goals, and countercyclical fiscal policy. Many monetary authorities have faced a trade-off between supporting growth and dampening inflation and inflation expectations. Brazil, Indonesia, Mexico, the Philippines, South Africa, and Thailand have raised policy rates by 25 basis points or more. The recent fall in commodity prices and the global slowdown are likely to ease this difficulty over time, and indeed, a shift toward monetary accommodation is now under way to mitigate a portion of the growth-dampening effects of the financial crisis.

Regional outlooks

GDP in **East Asia and the Pacific** increased by 8.5 percent in 2008, down from 10.5 percent in

Figure 1.15 Key developments in 2008 for East Asia and the Pacific (excluding China)



Source: World Bank.

2007. (Excluding China, growth in the region fell to 5.3 percent, from 6.2 percent in 2007.) Of importance to the slowing pace of growth, China's GDP growth in the third quarter eased to 9 percent, from 10.6 percent in the first quarter, on a slump in investment and exports. Rising oil and food prices boosted median inflation in the region to 9 percent in 2008, compared with 5 percent over the preceding 2 years. The deterioration in the outlook for Japan and the United States reduced export growth, which for East Asian countries outside of China fell from 10.5 percent in 2006 to 4 percent in 2008 (figure 1.15). In turn, manufacturing output fell from 5 percent growth in 2007 to a decline of the same magnitude in 2008. And gross capital flows fell by a third, to $64 billion over the year to September 2008.

Prospects for 2009 and 2010 have dimmed with the deterioration in the external environment. The global banking crisis has had little direct effect on the region, but several countries are more vulnerable to spillovers in the form of higher corporate spreads, reduced capital flows, and plummeting domestic equity markets. Private sector investment in particular stands at risk. Although China is well cushioned against coming shocks, several countries remain exposed to a steep downturn in world trade and more difficult financing conditions. While the decline in oil and food prices will support external positions and provide some relief on the inflation front, reduced investment spending is expected to contribute to a substantial slowdown in regional growth to 6.7 percent in 2009. A gradual recovery in key foreign markets will offer fresh impetus for exports and production and will help return growth in the region to a 7.8 percent pace by 2010.

In **Europe and Central Asia,** output is likely to increase by 5.3 percent in 2008, down from 7.1 percent in 2007, though growth held up remarkably well during the first half of the year. First-half GDP growth in Russia (7.8 percent), Poland (6 percent), Turkey (5.8 percent), and Romania (8.8 percent) were grounded in strong domestic demand, along with higher oil prices and fiscal revenues for the region's hydrocarbon exporters. But in 2009 deteriorating external positions and new risks from the global banking crisis are likely to depress prospects for vulnerable countries, and the downside risks are substantial. Sovereign spreads jumped in October 2008, notably for the Russian Federation and Turkey, and especially for Ukraine and Kazakhstan (figure 1.16).

Figure 1.16 Sovereign bond spreads widen across Europe and Central Asia

Source: JPMorgan-Chase.

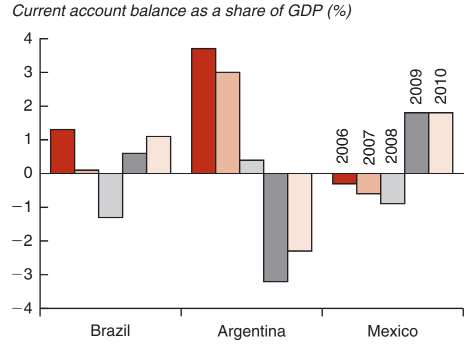
While most countries have maintained forward momentum, a divergence in growth performance has emerged: Latvia is in recession, the Romanian economy is overheating, and the Kyrgyz Republic, Tajikistan, and Moldova, which are receiving World Bank support, are facing the impact of rising food prices. The situation in Russia shifted dramatically from concerns about domestic overheating to fears of financial crisis, as equity prices gyrated with the turmoil in global markets, and oil prices fell.

Most countries have experienced strong growth in domestic demand, but net trade has remained a drag on growth. At the same time, rapid credit expansion and wage escalation has made the region more vulnerable to deterioration in external financing conditions. The medium-term outlook points to a sharp decline in regional growth to 2.7 percent in 2009, driven by a falloff in investment tied to difficult financing conditions and a marked weakening in export market demand. Growth is projected to firm to 5.0 percent by 2010, as credit markets stabilize, inflation pressures ease, and growth in external markets resumes, paving the way for a revival in spending and exports.

Latin America and the Caribbean countries have enjoyed four years of robust growth, while current account surpluses, accumulation of reserves, and improved policies have served to restrain core inflation rates, improve the quality of banking systems, and build up substantial buffers against financial contagion. However, in 2008 headline inflation jumped in response to higher oil and food prices, and policy makers in countries such as Brazil and Chile raised interest rates. Gross capital inflows to the region compressed by 45 percent between January and September 2008, compared with the same period in 2007. The deterioration in external demand and in international financial markets, combined with the recent falloff in commodity prices, reduced GDP growth to 4.4 percent in 2008 from 5.7 percent in 2007.

The global slowdown and a shortfall in capital flows present substantial risks to sustained growth, pressuring private sector investment in particular. As commodity prices continue to weaken, some major exporters, Argentina of note, will likely see current account surplus positions shift to deficit. For other countries, including Brazil and Mexico, the depth of recession in the United States and Europe will turn exports to negative growth, while contraction in imports should lead to a return of surplus position (figure 1.17).

Figure 1.17 In Latin America and the Caribbean, current accounts of largest economies diverge



Source: World Bank.

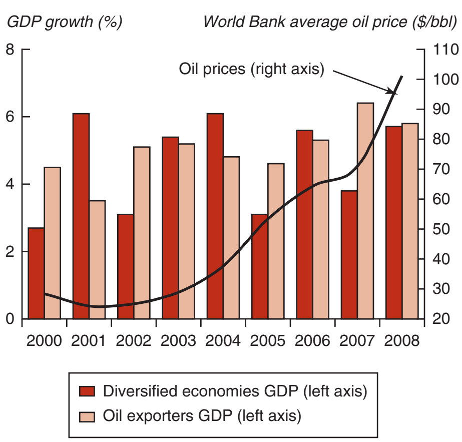
GDP growth in the region is expected to drop to 2.1 percent in 2009 before recouping to 4 percent by 2010. Country-specific events could also pose a challenge: conditions in several Andean countries have tended toward less stability; República Bolivariana de Venezuela has seen another wave of nationalizations, and its growth is expected to fall from 8.4 percent in 2007 to 3.2 percent by 2010; and Argentina's GDP is expected to slow from 8.7 percent in 2007 to 4 percent by 2010, with a 1.5 percent growth trough in 2009.

The developing countries of the **Middle East and North Africa** region offer a good example of the diversity of effects stemming from the ramp-up in global fuel and food prices—at both extremes of the spectrum. In oil-exporting economies, a rise in oil and natural gas revenues to $200 billion supported 5.8 percent growth in 2008, down from 6.4 percent in 2007. Slower domestic demand growth in the Islamic Republic of Iran (where GDP growth declined from 7.8 percent to 5.6 percent) was a key factor in this development. Outside Iran, growth among oil exporters stepped up to 5.9 percent.

In the more-diversified economies that are highly dependent on oil and food imports, exports slowed in 2008 as growth turned sluggish among key trading partners in Europe and the United States. But strong recovery in Morocco following drought in 2007 and continued solid performance in Tunisia and Jordan boosted growth to 5.7 percent from 3.8 percent. For the region as a whole, these developments yielded a flat profile of activity at 5.8 in 2008 (figure 1.18).

The region's oil exporters will face the challenge of diminished revenues in 2009. The global oil price is anticipated to fall from its July 2008 peak ($145/bbl) to below $80 in 2009. Growth in oil-exporting countries is projected to slow to 3.9 percent in 2009. Although their economies are unlikely to be severely affected by developments in financial markets, several countries stand more exposed to spillover effects from these developments, including Lebanon, Jordan, and the Arab Republic of Egypt. Moreover, oil-exporting members of the Gulf Cooperation Council are vulnerable to losses on international investment positions, potentially prompting a hiatus in the recent buildup of foreign direct investment within the region. For the region's oil-importing economies, lower energy prices will reduce the import bill and provide some breathing space on the inflation front following the surge in prices in the first half of 2008. Growth for the region should recover to a 5.2 percent pace by 2010 as external demand recovers, and declines in hydrocarbon prices give way to a period of greater stability.

Figure 1.18 Oil revenues, recovery from drought underpin growth in the Middle East and North Africa in 2008



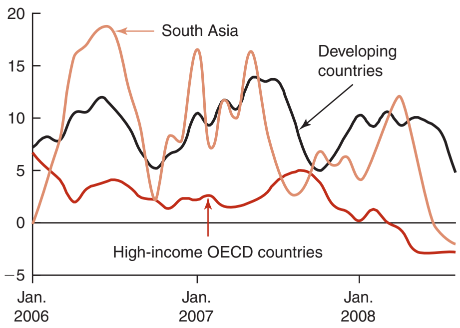
Source: World Bank data.

GDP growth in **South Asia** eased to an estimated 6.3 percent in 2008, from 8.4 percent in 2007 and from a 25-year high of 9 percent during 2006. High food and fuel prices, tighter international credit conditions, and weaker foreign demand have led to worsening external accounts and contributed to a slowdown in investment growth. Deterioration in trade balances, however, has been offset in large part by large remittance inflows, particularly for Bangladesh, Nepal, and Sri Lanka, where remittances represent 8 percent of GDP or more. Policy makers responded to high commodity prices and rising inflation pressures by partially adjusting domestic fuel prices, cutting development spending, and (initially) tightening monetary policy.

The global financial crisis is placing further downward pressure on growth. Lower capital inflows (down 40 percent, over January-September 2008 compared with the same period in 2007) and harder credit terms will reduce private investment, while reduced remittance inflows will add to pressures on growth. Food and fuel price subsidies have pushed fiscal outlays higher, reversing recent progress in fiscal consolidation. And increasing deficits are narrowing the scope to provide support for other urgent public programs, including the region's overburdened infrastructure. The slowdown in growth is most apparent in India and Pakistan, where industrial production fell sharply, and the momentum of production for South Asia has recently declined from a peak

Figure 1.19 South Asian production slips in the last months

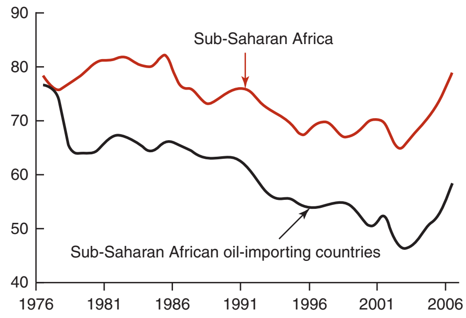
Industrial production (percentage change, saar)



Source: World Bank.

Figure 1.20 In Sub-Saharan Africa, primary commodity exports increased as prices surged

Primary commodities as a share of total exports (%)



Source: UN Conference on Trade and Development, Comtrade.

of 12 percent in April 2008 to a decline of 2 percent in August (saar) (figure 1.19).

South Asia's GDP is expected to drop to 5.4 percent in 2009 but to recoup to 7.2 percent by 2010. Firming growth will be supported by improving external demand and lower commodity prices.

Growth in **Sub-Saharan Africa**, outside of South Africa, increased to a remarkable 7 percent in 2007, the highest in some 35 years, as outcomes for both oil-importing and oil-exporting countries were robust. Growth among oil exporters increased to 8.2 percent in 2007, exceeding 5.5 percent gains for a fifth year running; growth in oil-importing economies breached a 25-year record, gaining 5.4 percent. GDP advances have become more broad-based and less volatile in recent years, especially among oil importers. And a notable and encouraging feature of Africa's recent performance is the sustained contribution of investment to overall GDP growth.

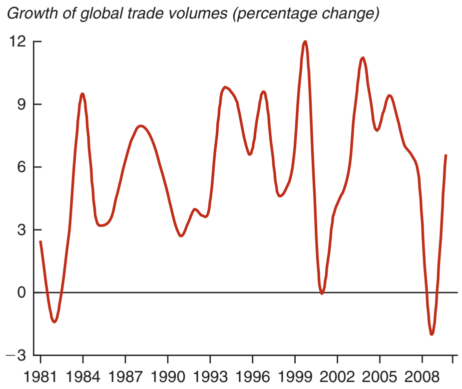
In 2008, activity outside of South Africa remained strong at 6.6 percent as GDP gains among oil-producing countries eased moderately to 7.8 percent, joining the larger group of oil-importing countries where GDP gains slowed to 4.2 percent in the year. Investment continues to provide an underpinning for GDP growth, while net exports are contributing to growth despite a sharp slowdown in global trade (figure 1.20).

The region's growth is expected to decline to 4.6 percent in 2009, before firming to 5.8 percent by 2010 as a result of recovery in external demand. Excluding South Africa, growth is anticipated to ease to 5.7 percent in 2009 and to accelerate to 6.6 percent in 2010. But this scenario is subject to significant downside risks. Should the global slowdown prove much deeper than anticipated, fostering a sharp fall in world trade growth, the contribution of net exports to African GDP growth will diminish. And many countries in the region have become more vulnerable to terms of trade shocks, as high fuel and food prices have led to a deterioration in external positions over the past years. Higher food and fuel prices have also widened the poverty gap, raising the risk of possible social unrest.

World trade

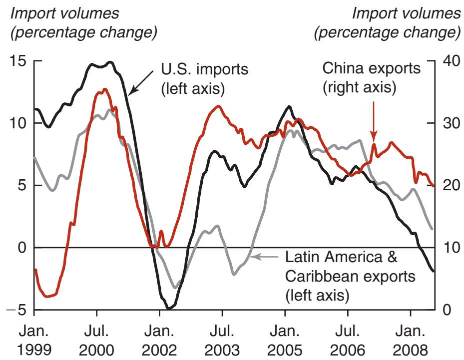
World trade volumes are expected to contract in 2009 for the first time since 1982 (figure 1.21). This decline is driven first and foremost by a sharp drop in demand, as the global financial crisis imposes a rare simultaneous recession in high-income countries and a sharp slowdown across the developing

Figure 1.21 World trade is expected to decline in 2009 for the first time since 1982



Source: World Bank data.

Figure 1.22 Decline in high-income import growth affects developing-country exports



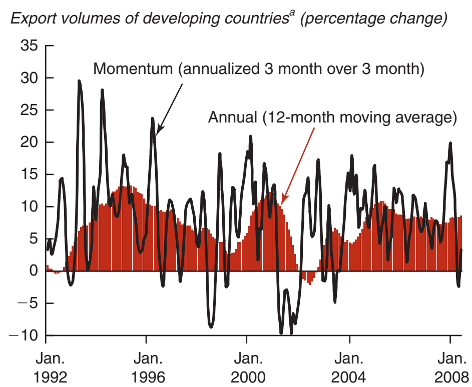
Source: World Bank data.

world. The global credit crunch is likely to affect private investment especially, which is the most cyclical and most internationally traded component of GDP. At the same time, the credit crunch is restricting export finance. Already there is anecdotal evidence that commercial bank trade credits are drying up and that export receipts are becoming more difficult to insure. Similarly, exporting firms may cut back on shipments if their access to credit lines is limited. Finally, the crisis has been associated with sharp, unpredictable swings in exchange rates, which also will hamper trade.

Signs of an economic slowdown have been visible for some time (growth in U.S. import demand was already falling in 2005), but they have been building at a much more gradual pace than occurred, for example, during the sharp correction in 2001, when import growth dropped from plus 15 percent to minus 5 percent within a year (figure 1.22). The current gradual decline in demand growth means that some exporting countries have had time to shift to higher growth markets in developing countries. For example, while the share of the United States in India's exports fell from 17.1 percent in 2004 to 15.3 percent in 2007, China's share in India's imports rose from 5.5 percent to 8.4 percent.

In addition, several countries (many in Latin America) that experienced a slowing of exports because of low U.S. demand growth benefited from higher commodity prices. Moreover, the impact on the volume of world trade was mitigated by the strong intra-regional growth of trade in East Asia, largely driven by China's continuing integration into global markets. China's import and export growth continued to exceed 20 percent over the past two years; while outside of China, export growth remained robust (figure 1.23).

Figure 1.23 Developing-country exports have been strong, even outside China



Source: World Bank data.

a. Excluding China.

These mitigating and compensating factors are unlikely to be active in 2009. The slowdown in high-income import demand has accelerated, few growth centers are left to which exports can be redirected, and commodity prices are falling. Thus developing countries are set to experience a sharp, but likely temporary, fall in their export revenues. Those countries with insufficient reserves to sustain import growth will need to rely on some combination of exchange rate depreciation and slower growth to restrain imports.

Remittance flows to developing countries, which reached an estimated $283 billion in 2008 (Ratha, Mohapatra, and Xu 2008), began easing in the second half of the year and are projected to slow sharply in 2009. Migrant earnings in host-country currency terms are anticipated to be compressed by the recession in the industrial economies, lower revenues in high-income oil-exporting countries, and slower growth in many developing countries that are destinations for migrants.

While the baseline projection is for remittance flows to developing countries to decline as a share of recipient-country GDP from 1.8 to 1.6 percent in 2009, the extent of the decline at the country level will depend critically on exchange rate developments. Recent swings in bilateral exchange rates have outweighed the expected change in remittances denominated in host-country currencies. Future exchange rate movements will also play an important role.

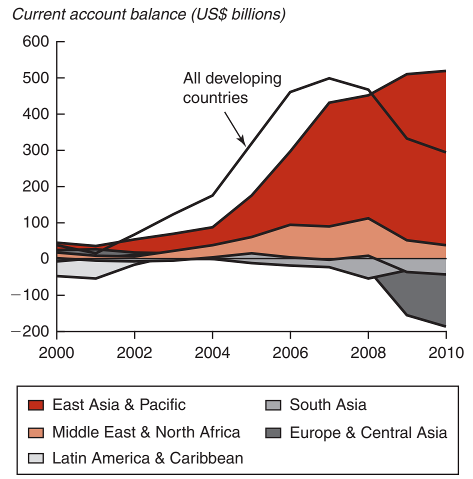
Global current account balances are expected to show substantial shifts

The global recession and attendant decline in world trade and in commodity prices will have a dramatic impact on current account balances. Surplus positions in Japan and the Euro Area should increase to $240 billion and $180 billion, respectively, during 2009 as commodity prices fall and trade volumes compress. Despite the improvement in the U.S. terms of trade, its current account shortfall is expected to deteriorate from $770 billion in 2008 (5.4 percent of GDP) to $830 billion or 5.8 percent of GDP in 2009. The sharp downturn in world trade hits the United States especially hard: export volumes are expected to drop 2.6 percent in 2009, while imports contract 1.1 percent. Overall, the high-income OECD countries' current account deficit is projected to narrow by $185 billion to $375 billion in the year.

The lower industrial-country deficit has its counterpart in lower surpluses in high-income oil exporters and in developing countries. The current account surplus in developing countries is expected to fall from a peak $500 billion, or 3.7 percent of GDP, in 2007 to $333 billion, or 2 percent of GDP in 2009 (figure 1.24). While China's (and thus East Asia's) surplus is anticipated to increase, in other regions, surpluses are expected to narrow, or deficits to widen.

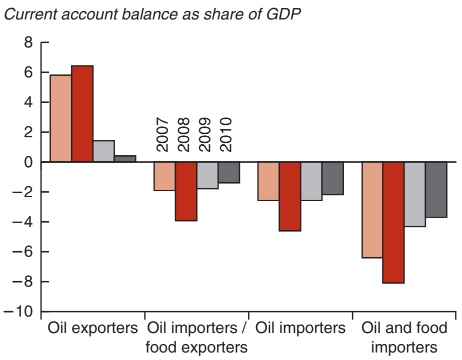
Some appreciation of the impact of the global recession on current account balances can be gained by looking at countries grouped by their primary commodity trade (here we exclude China, because the country's massive current surplus—nearly $400 billion in 2008—masks underlying developments across smaller countries). The expected 26 percent fall in the price of oil and 23 percent fall in non-oil commodity prices (see the Commodity

Figure 1.24 Developing-country current account surpluses to wane after 2008



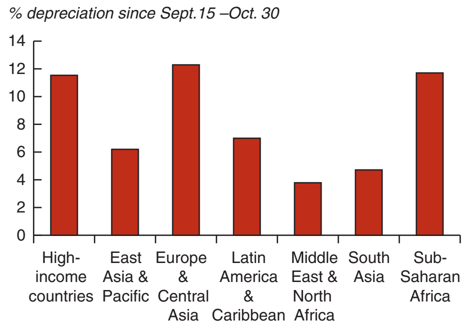
Source: World Bank data.

Figure 1.25 Current account balances for commodity-exporting and -importing developing-country groups (excluding China)



Source: World Bank data.

Figure 1.26 Almost all currencies have depreciated against the dollar



Source: World Bank.

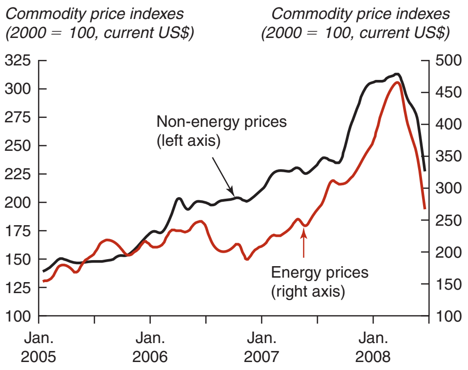
Markets section below) will shift the terms of trade in favor of oil- and food-importing countries, following a string of at least five years of substantial losses. For developing-country oil exporters, the fall in global demand will reduce both oil prices and export volumes (which are expected to shift from 5.1 percent growth in 2008 to 0.3 percent in 2009), and their current account surplus will fall from a peak of 6.4 percent of GDP in 2008 to 1.4 percent in 2009 (figure 1.25). By contrast, the current account deficit of developing-country importers of both oil and food almost halves, from a peak of 8.1 percent of GDP in 2008 to 4.3 percent by 2009, because of lower commodity prices and a sharp slowdown of imports from 8.1 percent growth in 2008 to 1.5 percent in 2009. The impact of these global developments should begin to dissipate in 2010 as oil prices stabilize, the prices of nonenergy commodities decline by only 4.3 percent, and world trade begins to recover.

The financial crisis has induced major fluctuations in exchange rates during the autumn of 2008. Almost every currency in the world has depreciated against the dollar and the yen, reflecting a "flight to quality" into U.S. Treasury securities, the unwinding of yen-based carry trades, and the deleveraging of banks, firms, and investors. No developing-country currency has appreciated against the dollar by more than 0.5 percent during this period. On average, currencies of developing countries have fallen by 15 percent against the dollar, but high-income-country currencies (save Japan's), have also depreciated (figure 1.26). In general the competitiveness of the United States, Japan, China (whose currency has held steady versus the dollar), and those countries whose currencies have been pegged to the dollar will have been reduced; competitiveness for countries whose currencies have depreciated will be improved in these markets. As a result, the strong impetus that net exports have provided for U.S. growth is likely to be attenuated; at the same time, net exports are likely to support the growth recovery of many developing countries.

Commodity markets

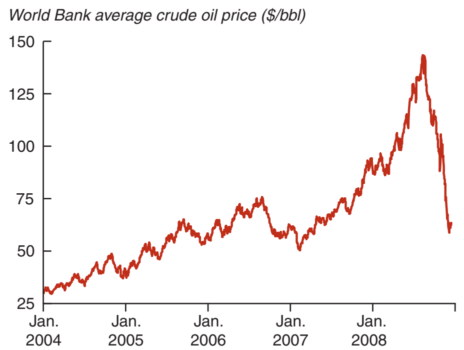
Commodity prices—which have been trending higher since 2003—continued the robust rise that began in 2007 into the first half of 2008. As of mid-November, prices have since fallen sharply, giving up most of their gains of the first half of the year. The abrupt decline reflects a classic response of commodities to slowing global growth at the end of a boom (for more on this subject, see chapter 2), a decline that has been amplified and accelerated by the financial crisis. In the summer of

Figure 1.27 Commodity prices surged before retreating in the second half of 2008



Source: World Bank data.

Figure 1.28 Crude oil prices correct sharply after unprecedented run-up



Source: Datastream and World Bank.

2008, energy prices were 80 percent higher in dollar terms than a year earlier, while nonenergy prices were 35 percent higher (figure 1.27 and table 1.4).

Almost all the advance in nonenergy commodity prices during 2008 came from grains (up 60 percent), fats and oils (up 34 percent), and fertilizers (up 140 percent). Metals prices, which increased rapidly between 2003 and 2008, picked up just 8 percent over the first six months of 2008. Almost all commodity prices peaked in early or mid-2008, and most have declined sharply since then. Crude oil prices dropped from $143/bbl in early July to less than $50/bbl in mid-November. The price drop stemmed from weaker realized demand across

Table 1.4 Forecast of commodity prices

Percent change	2000–05	2006	2007	2008	2009^{f}	2010^{f}
Energy	**13.5**	**17.3**	**10.8**	**45.1**	**−25.0**	**0.9**
Oil	13.6	20.4	10.6	42.3	−26.4	1.8
Natural gas	10.4	33.9	1.0	57.2	−10.8	−4.2
Coal	12.7	3.1	33.9	97.8	−23.1	−10.0
Nonenergy	**8.3**	**29.1**	**17.0**	**22.4**	**−23.2**	**−4.3**
Agriculture	6.0	12.7	20.0	28.4	−20.9	−1.3
Foods	6.0	10.0	25.6	35.2	−23.4	−0.3
Grains	4.8	18.4	26.1	50.9	−27.7	2.6
Raw materials	5.0	22.7	9.0	13.0	−14.9	−2.7
Metals and minerals	12.3	56.9	12.0	5.0	−25.5	−5.5
Copper	15.2	82.7	5.9	−0.6	−32.2	−4.2

Source: World Bank data.
f. Forecast.

OECD member countries, appreciation of the dollar, and concerns about demand prospects in the wake of financial turmoil (figure 1.28). The sharp decline in crude oil prices has also been a significant contributor to declines in other commodities, because these markets are increasingly linked through production costs and through the development of biofuels (see chapter 2).

Falloff in demand in high-income countries drives decline in oil prices

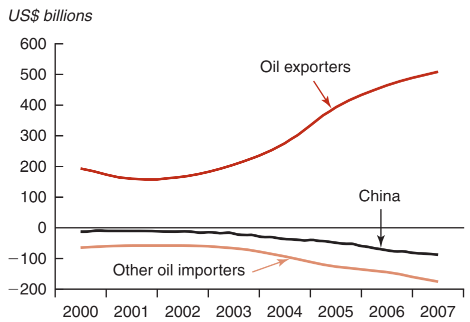
Oil demand in the OECD countries has been declining for three years, with most of the reduction in the United States, which was affected by slowing economic activity and the consumption-dampening effects of higher oil and gasoline prices. U.S. oil demand fell 5.6 percent over the first 10 months of 2008 (year-over-year). Gasoline consumption dropped 3 percent as consumers reduced the number of miles driven and began switching to more energy-efficient vehicles. Oil demand also slowed in Europe. Overall, OECD demand is expected to fall by more than 2.2 percent during 2008 and by less than 2 percent in 2009. Demand in developing countries and emerging markets has continued to grow by about 4 percent, with demand strongest in Asia and the Middle East, the latter fueled until recently by strong economic growth and in some countries fuel subsidies and thus low consumer prices (box 1.3).

Box 1.3 Impact of commodity prices on external balances and capital flows

Deterioration in external balances has become a significant problem for many developing countries. Overall, in 2007, current account deficits exceeded 10 percent of GDP in about one-third of developing countries, up from about one-quarter in 2006. Twelve countries ran deficits in excess of 20 percent of GDP in 2007. In part, these deficits reflect the impact of higher oil prices on oil-importing countries: oil balances account for more than half of the current account deficit in one of every two developing countries. Excluding the massive rise in China's surplus, the current account deficit of oil-importing countries has increased significantly during the rise in prices, from close to zero in 2002–03 to about $130 billion in 2007, an amount equal to 2.2 percent of GDP (box figure 1.3a). In contrast, the current account surplus of oil-exporting countries improved from 2 percent of GDP to more than 7 percent in 2005–06, though it declined to below 5 percent in 2007.

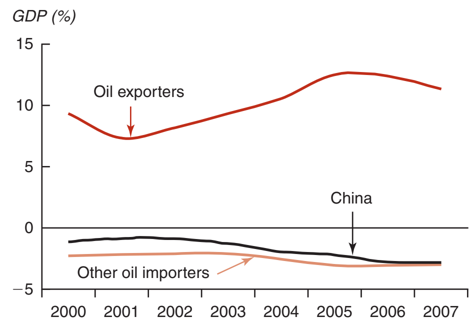
The rise in oil prices has contributed to, but does not fully explain, this disparity in current account balances. The rise in oil-importing countries' deficits has been less than the increase in their net oil balance, while the increase in oil-exporting countries' surplus has been well below the improvement in their oil balance (box figure 1.3b). As should be expected, many countries have made compensating adjustments in trade and domestic absorption to accommodate the rise in oil prices. And there is little correlation between the size of countries' net oil balance and the size of current account balances. Several oil-importing countries continue to run sizable current account surpluses (exceeding 10 percent of GDP in four countries), whereas several oil-exporting countries are running sizable current account deficits (notably Kazakhstan and Sudan). Some countries (Botswana, Nepal, Paraguay, Swaziland, and Thailand) managed to run current account surpluses even though their deficits on the oil component of the trade balance exceeded 5 percent of GDP.

Box figure 1.3a Oil balances in developing countries, 2000–07



Source: World Bank.

Box figure 1.3b Oil balances as a share of GDP in developing countries, 2000–07



Source: World Bank.

How have countries been able to finance their large external imbalances?

The financing of increased current account deficits has not come principally from higher portfolio flows or reserve drawdowns, but from foreign direct investment and aid. Much of the surge in private debt and equity flows to developing countries over the past few years has gone to countries with sizable current account surpluses. For example, private debt flows to the 11 countries with current account surpluses in 2005–07 accounted for half of the total to all developing countries (in 2007, Russia ran a current account surplus equal to 6 percent of its GDP and yet received $125 billion in private debt

Developing countries with large external imbalances, 2007
(percent)

Country	Current account	Oil balance	Non-oil commodity balance	Commodity balance	FDI inflows	Net ODA disbursements
Burundi	−37.6	−11.6	−0.4	−12.0	0.0	46.0
Seychelles	−32.7	−36.5	0.7	−35.8	18.8	1.8
Togo	−21.9	−8.5	4.6	−4.0	3.5	3.6
Nicaragua	−21.5	−13.1	6.5	−6.6	0.1	13.8
Latvia	−20.8	−3.2	1.2	−2.0	7.3	0.0
Georgia	−20.0	−5.5	−1.8	−7.3	16.9	4.7
Fiji	−18.8	−11.7	2.9	−8.8	11.9	1.8
Malawi	−18.6	−4.3	11.6	7.3	—	21.3

Source: World Bank.
Note: — = not available. For Burundi, Fiji, Malawi, Seychelles, and Togo, data are for 2006.

flows). And to date few countries have had to draw down their ample foreign reserve holdings. Instead, of the 13 countries with the largest current account deficits (and where data are available), in 8 countries foreign direct investment covered over half of the current account deficit, and in 4 countries net official development assistance (ODA) disbursements exceeded 10 percent of GDP (box table).

OPEC producers—reluctant to raise output significantly during the run-up in prices during the first half of 2008—increased production at midyear, mainly through Saudi Arabia, which unilaterally agreed in June to lift output by 0.5 million barrels a day (mb/d). Iraq's output breeched 2.5 mb/d for the first time since 2001 as attacks on infrastructure subsided somewhat. But increases elsewhere in the Gulf were partly offset by declines in Nigeria, where civil strife continued to cause large supply disruptions.

As discussed in chapter 2, the non-OPEC supply response has been disappointing. Production has been plagued by several factors during the current decade, notably rising costs and taxes, and the ongoing depletion of aging fields. Despite these constraints, non-OPEC supplies are beginning to increase in a number of regions and are projected to rise in the second half of 2008 and over 2009–10.

As a result of weakening demand and expected supply increases, oil prices are anticipated to average $75/bbl in nominal terms during 2008–10, implying a cumulative real decline of more than 30 percent.

Prices for many metals are falling on the back of weaker demand

Several metals prices have plummeted in recent months because of slowing global growth and improving supply prospects. Nickel prices have fallen more than three-quarters from their 2007 peak, partly because of difficulties in the automobile and construction sectors. Prices have fallen below the marginal costs of high-cost producers, and some plants are being closed and new projects delayed or reconsidered. Zinc prices have fallen almost as much as nickel in percentage terms. Lead prices have fallen more than 60 percent on improving supply prospects. Prices for these metals are expected to decline further as new capacity comes online.

Copper is among the few metals whose price remained elevated during the first half of 2008, despite weak demand; numerous supply disruptions tied to strikes in Latin America and delays bringing on new capacity kept copper prices high. However, prices plunged in the second half of the year in the wake of the financial crisis and the weakening global economic environment. China's import demand has been weak in 2008, and the slowdown in global housing construction more broadly contributed to diminishing demand. Prices nonetheless remain well above production costs and are expected to continue to decline significantly through 2010 as new capacity comes online.

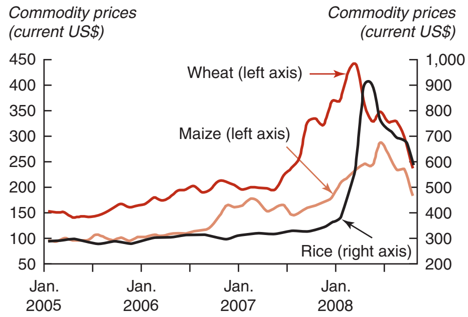
Aluminum—the one major metal whose price has not surged during the current cycle because of the growth of capacity in China—became more expensive recently because of still-strong global demand and increasing costs of electricity, a major input to the production of aluminum. The outlook for aluminum prices depends critically on the pace of investment in new capacity (especially in China and the Middle East), as well as on the level of energy costs and deregulation of power markets. Even if new capacity is concentrated in areas with stranded, low-cost energy sources, such as the Middle East, there is limited downside potential for prices, because aluminum has been fluctuating near the upper portion of the cost curve.

Taken together, the index of metals and minerals prices is projected to fall 25 percent in 2009 and an additional 5 percent in 2010 compared to 2008.

Prices of agricultural commodities are falling sharply from peaks

Prices for food traded internationally increased almost 60 percent during the first half of 2008 in dollar terms, with basic staples such as grains and oilseeds showing the largest increases. Wheat prices more than doubled, from $200 a ton to $440 between March 2007 and March 2008, while rice prices almost tripled in the four months ending April 2008 (figure 1.29). Soybean and palm oil prices increased 44 percent from 2007 to 2008. Prices have since declined sharply. Wheat prices, for example, fell to less than $240 a ton in November. Since their peak in April 2008, grain prices have declined by more than 30 percent. The spike in rice prices in April and May 2008, on concerns regarding the adequacy of global food supplies and export bans, appears to have subsided, with prices falling from nearly $1,000 a ton to $550 a ton in November. Export bans that had been in place were either eliminated by many countries or partly circumvented through bilateral agreements. For example, Egypt, which had accumulated 7 million tons of rice during the period of its export ban, is expected to curb the intervention soon. Similarly, India has allowed shipments of non-basmati rice to four African nations.

Figure 1.29 Grains prices show sharp declines from recent peaks



Source: World Bank data.

Oilseed prices also have fallen sharply. Palm oil prices averaged less than $480 a ton in November, down from $1,250 a ton in March 2008. Similar declines took place in most edible oils (soybean oil dropped from $1,475 a ton to $835, and coconut oil from $1,470 a ton to $705 over the period). The weakening of edible oil prices reflects not only slowing economic growth but also improved supplies, and perhaps mounting pressure in the European Union (EU) to scale back biofuel mandates—most of the EU's biofuel production is biodiesel, whose feedstock is rapeseed oil, a close substitute for palm and soybean oils.

Rubber prices began easing in July and August 2008, an unsurprising development because they track crude oil prices closely (synthetic rubber is made from petroleum). Signs of weakening prices have also been evident in beverages, with cocoa averaging a little over $2 a kilogram in November, down from $3.00 in June 2008. Other agricultural commodities, especially raw materials and some foods such as bananas and sugar, have experienced smaller declines, because their price increases were not as sharp and they are less closely linked to energy prices.

Fertilizer prices experienced the largest increase among all commodity groups in 2008, with the index up 116 percent between January and August 2008; prices were driven up by the combination of strong demand growth (in response to high crop prices), limited surplus production capacity, higher production costs related to high energy prices, and an export tax imposed by China to protect domestic supplies. Phosphate prices (DAP), for example, increased by almost 110 percent between January and August 2008 while urea prices doubled in just four months (December 2007 to April 2008). The decline in crude oil and grain prices, along with weak demand, however, is now being reflected in fertilizer prices. Urea, for example, declined to $250/ton (a two-year low) while DAP averaged below $650/ton as of November 20.

Current crop prospects are favorable. Grain production is projected to increase about 4 percent in the current crop year, and oilseed production is anticipated to rise by twice as much. Although this production increase will allow some rebuilding of stocks, continued growth of demand for biofuels should keep pressure on inventories. Maize used for ethanol in the United States is expected to increase to 33 percent of the crop in 2008, accounting for nearly all of the increase in global maize consumption and causing global maize stocks to fall. In contrast, large increases in wheat and oilseed production should allow some rebuilding of stocks. Stocks will remain low by historic standards, however, and prices will remain vulnerable to supply disruptions or demand surges.

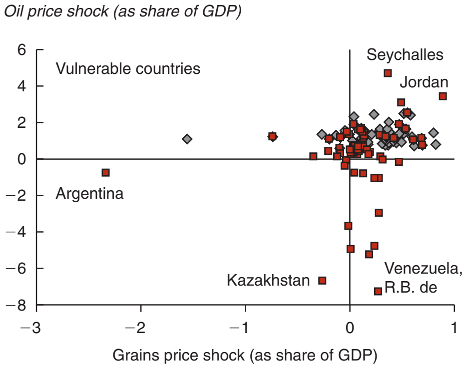
Overall, grain prices are projected to decline about 28 percent in 2009 and to recoup 3 percent in 2010. Fats and oil prices are anticipated to fall by 27 percent in 2009 and another 5 percent in 2010. And beverages are projected to decline 18 percent and 4 percent, respectively. Despite these developments, food prices are expected to remain much higher than during the 1990s and more than 60 percent higher than their levels in 2003.

In the baseline, the very tight credit conditions observed in November are projected to dissipate during the first quarter of 2009—which together with a strong crop this season should ensure that prices do not rise sharply in the medium term. However, if farmers in high- and middle-income countries are unable to get financing for seed and fertilizer purchases for plantings for next season, plantings may be lower than expected, which could cause agricultural prices to rebound during the 2009/10 crop year. Farmers in key agricultural producing and exporting countries, including Australia, Argentina, Brazil, the United States, and the European Union, rely on short-term financing for inputs (e.g., fertilizer) and longer-term financing for the purchase of machinery. The short-term financing is typically guaranteed by placing land as collateral and to a lesser extent by hedging in futures markets for a minimum price guarantee (the latter mostly in the United States). The credit crunch combined with declining commodity prices has made banks reluctant to lend. The situation may worsen if land prices begin to decline—there are already signs that land prices are falling in some EU countries—or if credit conditions do not begin to thaw. At the same time, farmers appear to have lost faith in hedging instruments.

Commodity price declines carry significant implications for the terms of trade

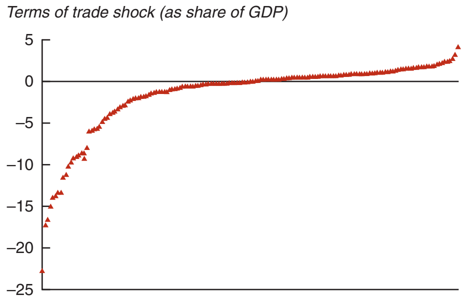
The decline of commodity prices anticipated for 2009 will drive sharp changes in developing countries' terms of trade. Some 30 countries are expected to gain more than 1.5 percent of GDP from the decline in oil prices (figure 1.30). Of these, Cyprus, Guyana, Jamaica, Jordan, the Kyrgyz Republic, Moldova, Nicaragua, the Seychelles, and Tajikistan stand to gain more than 2.5 percent of GDP. And the fall in food prices will help to ease both external and fiscal positions (as the cost of food subsidies declines) for many of the world's poorest countries, including Benin,

Figure 1.30 Most vulnerable countries will benefit from the decline in grains and oil prices



Source: World Bank.

Figure 1.31 First-round income impact of lower commodity prices will be positive in more than half of developing countries



Source: World Bank.

Eritrea, Ghana, Guinea, Haiti, Madagascar, Niger, Senegal, and Togo.

At the same time, oil-exporting countries will experience large terms of trade losses, with Angola, Azerbaijan, the Republic of Congo, Equatorial Guinea, Gabon, the Islamic Republic of Iran, Kuwait, Libya, Nigeria, and Saudi Arabia incurring first-round income losses in excess of 10 percent of GDP. Weaker metals prices are anticipated to reduce incomes by more than 2 percent of GDP in Chile, Mauritania, Mongolia, Papua New Guinea, Suriname, and Zimbabwe. Countries that rely heavily on grains exports are likely to be hit hard. Exporters like Argentina (maize, soybeans, wheat), Bolivia (soybeans), The Gambia (groundnuts), Guinea-Bissau (groundnuts), Guyana (rice), and Paraguay (soybeans) will experience losses ranging from 1.6 percent to 9 percent of GDP, though for some the impact will be softened by falling oil prices.

Taking into account the effects of commodity price declines on both import and export prices, more than half of the countries in a sample of 162 economies are expected to see an increase in the terms of trade, of which 24 will experience gains in excess of 1.5 percent of GDP. About a quarter of the countries, including most oil producers, are seen to incur first-round income losses in excess of 1.5 percent of GDP (figure 1.31).

Key risks and uncertainties

The freezing of credit markets, collapse of stock markets, large shifts in exchange rates and commodities prices, and unprecedented policy reactions have combined to create an extremely uncertain environment for market participants and forecasters alike. Several possible outcomes for the global economy remain plausible at this juncture—even assuming that a catastrophic meltdown of markets is avoided. Global GDP growth could reasonably be expected to be as strong as 1.4 percent in 2009 and as weak as 0.4 percent, compared with the baseline projection of 0.9 percent growth presented in this chapter.

The confidence interval around projections for 2010 is even wider. Instead of the typical cyclical rebound envisaged in the baseline, output could remain subdued as consolidation in the banking sector acts as a persistent drag on growth, and credit growth remains almost stagnant for several years (see Hebling 2005; IMF 2008). Alternatively, the crisis may have less pronounced direct effects on the real economy, in which case the aggressive monetary loosening and large-scale fiscal stimulus that the crisis has provoked could lead to a sharper rebound in 2010. Such a scenario runs the risk of reaccelerating inflation, which would likely need to be followed by a tightening of both monetary and fiscal policies.

In such an environment, policy makers in both developing and high-income countries must be prepared to weather a worst-case scenario of even lower growth, including the possibility of a decline in world GDP for the first time in the postwar period, as well as a financial meltdown that could lead to a sudden stop of credit flows to all but the most creditworthy borrowers. Whatever the eventual outcome, the environment over the next two years will be radically different from that which was expected only a few months ago, and policies will need to adapt.

Understandably (and correctly) under current circumstances, with the world economy confronted with systemic financial risks, short-term attention is focused on dealing with the immediate crisis, minimizing risks, and reacting to rapidly evolving developments. Major risks concern the possibility of balance of payments and currency crises in individual countries—a real risk at this stage for at least some developing countries. A collapse of the domestic banking system in select developing countries is also a tenable possibility. In the case of Russia, where the economy is flush with petrodollars, the authorities look to be in a position to rescue domestic financial institutions. Other countries are less well positioned and may have to draw upon international assistance, a development that should be undertaken quickly if necessary. The longer the global stress lasts, the more currencies may come under pressure. The increase in corporate spreads still exceeds the increase in sovereign spreads by a large margin. In all cases preventing a financial crisis in one country from infecting a broader group of countries would be difficult. Therefore, instead of exploring the details of a potential crisis, it is paramount to avoid a crisis altogether through coordinated international action.

From a longer-term perspective, concerns are of a very different nature. The question is: How will developing countries emerge from the current downturn, and will they retain the underlying strength, confidence, and strong macroeconomic fundamentals that underpinned the record growth of the past five years? The danger for all countries is that too aggressive an effort to combat what looks to be an inevitable slowdown may prove too costly and undermine the strong fundamentals that had earlier underpinned growth. Countries need to react quickly and forcefully to signs of weakness in their financial sectors, including by liquidity injections and recapitalizing banks where necessary.

Care must also be taken, however, to avoid the possible entrenchment of inflationary pressures by ensuring that more general efforts to provide support to banking systems are highly targeted and efficient, and that any necessary liquidity injections are reabsorbed once growth revives. The long-term costs of such policies could be substantial even if they help to lighten the coming recession. Policy makers must ensure that the steps taken are clear and coherent. So far, the worst has been avoided by huge government interventions. If the market comes to view such interventions as ineffective, because they are poorly understood or seen as not addressing the most critical problems, then the policies likely will be ineffective. In this case, global economic difficulties could become very serious indeed.

Long-term prospects and poverty forecast

Despite the current financial turmoil and sharp slowdown in growth anticipated for 2009, longer-term prospects for developing countries have changed only modestly compared with last year's forecast. In part prospects are little changed because a slowdown had already been anticipated, albeit to a much lesser degree. The primary reason, however, lies in the long-term supply potential of developing countries, which should allow output to recoup the lost production induced by the coming growth recession during the first five years of the next decade.

Per capita GDP in developing countries over the period 2010–15 is expected to expand at a relatively rapid annual pace of 4.6 percent, much faster than the 2.1 percent pace of the 1990s and the 0.6 percent average of the 1980s, replicating the average performance of this decade. Improvements in macroeconomic policies (lower inflation, relaxation of trade restrictions, more flexible exchange rate regimes, and lower fiscal deficits) have combined with structural reforms (privatization and regulatory initiatives) to reduce uncertainty and generally improve incentives for investment. Projected future growth rates are higher than in the 1990s (and much more so than in the 1980s) in every developing region except East Asia and the Pacific, where growth is expected to decline somewhat because of an aging population.

Rapid growth should enable developing countries, as a group, to achieve the Millennium Development Goal of halving poverty by 2015. The poverty forecast for 2015 is 15.5 percent, well below the target of 20.9 percent—half of the revised 1990 level as explained in more detail below. The East Asia and Pacific region has clearly surpassed its individual target, and South Asia is on target. The main concern remains Sub-Saharan Africa. Although the incidence of poverty in the region has been declining over the past decade, at about 37.1 percent in 2015, the share of people living in extreme poverty will remain well above the region's target of 29 percent (table 1.5).

This year's poverty forecast is consistent with the World Bank's revised poverty estimates for developing countries. The new poverty estimates largely result from a revision of purchasing power parities (PPP) by using a new International Comparison Project survey of prices paid by households. The 2005 survey improved on the 1993 data and methods used to prepare previous estimates. The new price data reveal that the cost of living is higher in low- and middle-income countries than had been suggested by past surveys. Other factors influencing the changes to the poverty estimates include revisions to national accounts and the incorporation of new and more recent household surveys (see box 1.4 and Chen and Ravallion 2008 for more detail).

The new poverty estimates provide a significantly different picture of global poverty—back to 1990 and for the most recent year, 2005 (figure 1.32). Global poverty in 1990, the benchmark year for the Millennium Development Goals, is now estimated to have been 41.7 percent of the developing-country population

Table 1.5 Poverty in developing countries by region, selected years

Region or country	1990	2005	2015
Number of people living on less than \$1.25/day (millions)			
East Asia and the Pacific	873.3	316.2	137.6
China	683.2	207.7	84.3
Europe and Central Asia	9.1	17.3	9.8
Latin America and the Caribbean	49.6	45.1	30.6
Middle East and North Africa	9.7	11.0	8.8
South Asia	579.2	595.6	403.9
India	435.5	455.8	313.2
Sub-Saharan Africa	297.5	388.4	356.4
Total	1,818.5	1,373.5	947.2
Number of people living on less than \$2.00/day (millions)			
East Asia and the Pacific	1,273.7	728.7	438.0
China	960.8	473.7	260.9
Europe and Central Asia	31.9	41.9	26.7
Latin America and the Caribbean	86.3	91.3	72.4
Middle East and North Africa	44.4	51.5	33.3
South Asia	926.0	1,091.5	959.5
India	701.6	827.7	714.5
Sub-Saharan Africa	393.6	556.7	585.0
Total	2,755.9	2,561.5	2,115.0
Percentage of the population living on less than \$1.25/day			
East Asia and the Pacific	54.7	16.8	6.8
China	60.2	15.9	6.1
Europe and Central Asia	2.0	3.7	2.2
Latin America and the Caribbean	11.3	8.2	5.0
Middle East and North Africa	4.3	3.6	2.5
South Asia	51.7	40.3	23.8
India	51.3	41.6	25.4
Sub-Saharan Africa	57.6	50.9	37.1
Total	41.7	25.2	15.5
Percentage of the population living on less than \$2.00/day			
East Asia and the Pacific	79.8	38.7	21.6
China	84.6	36.3	18.9
Europe and Central Asia	6.9	8.9	6.0
Latin America and the Caribbean	19.7	16.6	11.8
Middle East and North Africa	19.7	16.9	9.3
South Asia	82.7	73.9	56.6
India	82.6	75.6	57.9
Sub-Saharan Africa	76.2	73.0	60.8
Total	63.2	47.0	34.6

Source: World Bank.

Box 1.4 The impact of the new price survey on poverty estimates

Surveys of prices are obviously critical in determining the cost of the common basket of goods and services in each country that is used to define poverty. The price surveys determine the purchasing power parity (PPP) exchange rate used in translating domestic prices into international dollars. Compared with the measure provided by market exchange rates, these PPP exchange rates provide a more accurate measure of the affordability of nontraded goods in the poverty basket (because prices of nontraded goods vary enormously across countries at different levels of development). Previously, the PPP exchange rates were based on a 1993 survey of prices that covered relatively few countries and used a weak survey methodology. In 2005, the World Bank, in partnership with other international organizations and national statistical offices, concluded a new price survey that covers 146 countries—of which 101 are developing—and between 600 and 800 products (World Bank 2008). The survey includes China for the first time and updates the earlier survey of India, which dated from 1985. The new price survey has had two impacts on measured poverty.

First, it has revealed that prices paid by the poor in developing countries are higher than thought previously, thereby reducing estimates of mean per capita consumption (or income) based on a common unit, that is, international dollars. In China, for example, average per capita consumption in 2005 was estimated to be about $2,400 at the old PPP exchange rate but only about $1,400 at the new PPP exchange rate. These newer price levels imply quite naturally that households can afford fewer goods and that many more are living on less than a $1 a day.

Second, in light of the new price survey, the definition of the "international" poverty line has been reevaluated. The international poverty line is meant to capture a notion of extreme poverty. As such, it is calculated as the average poverty line of the poorest countries. Using the new PPP estimates, the new poverty line for extreme poverty is now measured at $1.25 (in 2005 international dollars, and represents the average of the poverty lines of the fifteen poorest countries for which there is data). This new poverty line is about 14 percent lower than the old international poverty line, which in 2005 dollars is $1.45. This reflects the higher PPPs for the poorest countries implied by the 2005 survey data. To capture a broader notion of poverty, the World Bank's poverty forecast has also presented statistics relevant to the so-called $2/day poverty line that was double the $1/day poverty line and reflected the average of the national poverty lines of the middle-income countries. The new $2/day poverty line, measured in 2005 prices, represents the median of all of the national poverty lines in the available surveys.

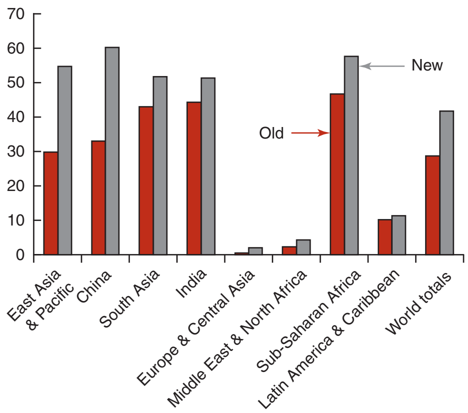
The increased estimates of prices in many countries and a lowering of the international poverty line have changed the picture of poverty globally—over time and in 2005. As reported in Chen and Ravallion (2008), these two effects partially offset each other. The revisions in the PPPs alone, with no change in the poverty line, would have raised the poverty estimate in 2005 from the previous 17 percent to 32 percent. The reduction in the poverty line to $1.25 a day lowers this estimate to 25 percent. The net effect is to raise the poverty estimate for 2005 by 8 percentage points. The upward revision in the poverty level does not imply that the rate of poverty reduction, say between 1990 and 2005, has not been as rapid as previously reported.

(compared with the previous estimate of 28.7 percent using the old prices and guidelines). This implies that the target for the poverty MDG is 20.9 percent, rather than the previous 14.4 percent. The revisions had a significant affect on all regions, except Latin America and the Caribbean, which saw only minor adjustments. The case of China is illustrative. The headcount index for 1990 jumped from 33 percent to 60.2 percent. This dramatic change was attributable mainly to the poor price comparison basis for the earlier estimate rather than to any underlying change in China itself.

The combination of a new estimate of mean consumption and a new poverty line also

Figure 1.32 Revised poverty estimates following from new price survey

Headcount poverty index in 1990



Source: World Bank data and staff calculations.

Note: The comparison reflects both revisions necessitated by the change in purchasing power parities and the new international poverty line, which was $1.45 per day in 2005 dollars under the old methodology and has been revised down to $1.25 per day in 2005 dollars with the new methodology.

implies a change in the starting value of the growth-to-poverty elasticity. Even if the shape of the income distribution is broadly the same as in earlier income surveys (as is the case for many countries), the fact that the poverty line intersects the distribution at a different spot means that the impact of a given increase in per capita incomes has changed. Nevertheless, the rate of improvement in the headcount poverty rate between 1990 and 2005 has not changed that much using the new estimates.[3] This year's forecast reports an annual decline in global poverty between 1990 and 2005 of some 3.3 percent, which is very close to the earlier estimated annual decline of 3.2 percent. However, the higher poverty level means that 25.2 percent of the developing world's population was living on less than $1.25 a day in 2005, compared with last year's estimate of 18.1 percent for 2004. As before, much of decline in global poverty between 1990 and 2005 results from increased incomes in China, where the level of extreme poverty fell from over 60 percent in 1990 to less than 16 percent in 2005.

It should be noted that the impact on the poverty forecast of the recent rise in food and energy prices is not fully reflected in these projections, which largely reflect neutral changes in per capita incomes.[4] As discussed in chapter 3, the increase in food prices between January 2007 and January 2008 is likely to have increased global poverty by between 130 million and 155 million people, or by 1.3–1.5 percentage points. With prices now declining but not expected to return to their earlier levels, at least some of this deterioration is likely to be permanent.

Notes

1. Prices are as of November 20, 2008.

2. Total assets of U.S. households began to decline in the fourth quarter of 2007, as real estate values dropped by $185 billion and financial assets fell by $200 billion. By the second quarter of 2009, the cumulative decline in household assets amounted to $2.4 trillion, the equivalent of 16 percent of GDP.

3. It is difficult to make an exact comparison because last year's forecast was benchmarked to 2004, not 2005 as is this year's forecast. As well, there have been (slight) revisions to historical national income and product accounts.

4. Because of the inherent delays in processing household surveys, the current forecast reflects surveys that were taken in 2005—before the rapid increase in commodity prices in 2007 and the first half of 2008.

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